IFRS 4 amendments - a call for action

Applying IFRS 9 Financial Instruments with IFRS 4 Insurance contracts

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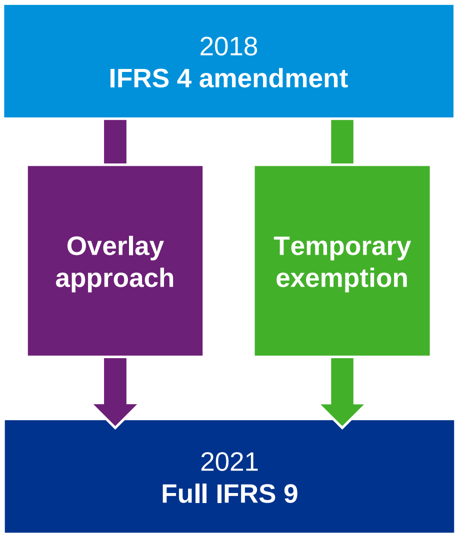
February 2018

Significant impact on 2018 financials

The IASB introduced amendments to IFRS 4 Insurance Contracts in order to reduce the impact of the different effective dates of IFRS 9 Financial Instruments and the forthcoming standard IFRS 17 Insurance Contracts. The available options to deal with this include various complexities that require detailed analysis for the 2018 (Interim) Financial Statements for insurers. In addition to full adoption of IFRS 9 per 1 January 2018, the IASB introduced two alternatives for qualifying Insurers: the overlay approach and the temporary exemption.



Opting for the Overlay approach

The application of the overlay approach, and the calculations required to implement it, are complex. Under the overlay approach the entity is permitted to reclassify between profit or loss and OCI the difference between the amounts recognised under IFRS 9 and those that would have been reported under IAS 39. Entities applying the overlay approach will have to maintain processes, systems and data to produce and track both IAS 39 and IFRS 9 values in parallel. This will cause insurers to effectively apply IFRS 9 in 2018, resulting in extensive work regarding Business Model assessments, SPPI testing, and ECL Impairments.

Opting for the Temporary exemption

Entities with predominant insurance activities are permitted to continue applying IAS 39 until the adoption of IFRS 17. However the entity has to disclose the fair value and change in the fair value for financial assets that meet the IFRS 9 SPPI test, as well as instruments that do not meet the SPPI criterion. Preparing the disclosures will require significant effort with respect to implementing processes and systems for the SPPI test and for determining the financial assets that do not have “low credit risk”.

Actions to be undertaken when applying the IFRS 4 amendment options

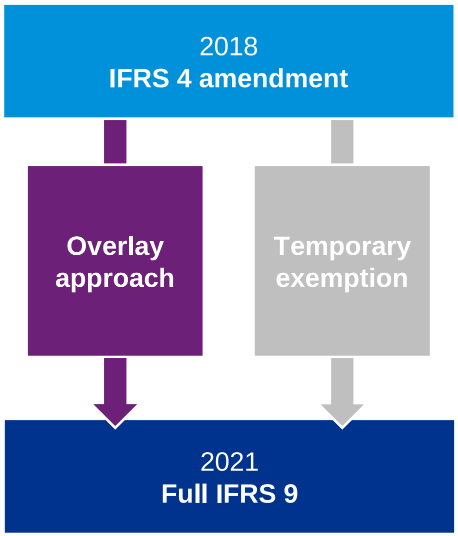
Entities applying the temporary exemption have to implement a process which enables disclosure of comparable fair value information in line with IFRS 9. In addition, extensive SPPI testing for financial assets in scope of IFRS 9 is needed as well. When applying the overlay approach entities have to apply IFRS 9 parallel to IAS 39. Insurers applying these exemptions should therefore not directly assume that they can defer IFRS 9 implementation projects.

Assistance KPMG Accounting Advisory Services

KPMG’s Capital Market Accounting Advisory Services (CM AAS) is a dedicated team of technical accounting specialists. We are a client-facing team with a proven track record in IFRS 9 implementations including running large scale SPPI testing projects. We can help assist in the project management as well as the technical implementation of the IFRS 4 amendments. Proven SPPI tooling is available to streamline the process and execute for you in an effective way.

Overlay approach

TOPICS TO CONSIDER



System and processes

Entities applying the overlay approach will have to produce and track IAS 39 and IFRS 9 values in parallel for in-scope financial assets.

Entities will have to change their systems and processes to do this. In parallel, entities will also have to design, implement, and maintain systems and controls under both standards. Furthermore entities have to develop methods to calculate the overlay adjustments and to track financial assets for reporting and disclosure purposes.

Producing amounts under IFRS 9 and IAS 39

An entity is required to present the effect of the overlay adjustment in profit and loss and in OCI.

The entity does not only have to comply with the IFRS 9 Classification & Measurement requirements, but also already implement the expected credit loss (ECL) impairment model during the 'overlay' period up to 2021. This impacts the financial assets that are measured at amortised costs or fair value through OCI.

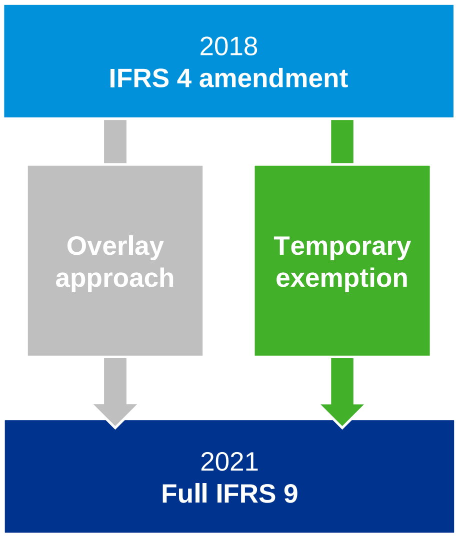
Shadow accounting

Shadow accounting is to be used to adjust and aggregate insurance liabilities to reduce accounting mismatches for unrealised gains and losses held by the entity.

Entities applying shadow accounting will need to have processes in place to track these liabilities and their accounting.

Temporary exemption

TOPICS TO CONSIDER



System and processes

When applying the temporary exemption an entity is required to provide disclosures that enable users of the financial information to understand how the entity qualified for the temporary exemption and compare entities that apply the temporary exemption with those that do not.

Preparing the disclosures will require significant effort with respect to implementing processes and systems for the SPPI test and for determining the financial assets that do not have “low credit risk”.

Producing amounts under IFRS 9

An entity applying the temporary exemption option should disclose the fair value and the change in fair value for the following for each of these groups:

- Financial assets that meet the SPPI test in IFRS 9, excluding any financial assets that meet the definition of held for trading in IFRS 9 or that are managed and evaluated on a fair value basis.
- All other financial assets: i.e. financial assets that do no meet the SPPI test, that do meet the definition of held for trading, or that are managed and evaluated on a fair value basis.

Disclosures

In addition, when applying the temporary exemption, an entity needs to disclose information about the credit characteristics of financial assets by presenting:

- For all financial assets that meet the SPPI criterion the gross carrying amounts under IAS 39 aggregated by credit risk rating grades as defined in IFRS 7.
- For financial assets that meet the SPPI criterion, and that do not have low credit risk as defined in IFRS 9, the fair value and the gross carrying amounts under IAS 39.

KPMG CM AAS can assist you with developing an SPPI approach and execute testing in an effective and efficient way.

We will utilise our automated tooling and questionnaires and help you establish clear audit trails.

SPPI testing

One of the criteria for determining whether a financial asset should be classified as measured at amortised costs or fair value through profit and loss under IFRS 9, is whether the cash flows from the financial asset meet the SPPI criterion – i.e. whether the contractual terms of the financial asset give rise, on specified dates to cash flows that are solely payments of principal and interest.

The assessment is performed on the overall instrument. Assessing the SPPI criterion may require judgement to ensure that financial assets are classified into the appropriate measurement category. As a result entities need to undertake a comprehensive review of loan documentation and the terms of securities.

The new standard's approach to assessing SPPI focuses on an overall assessment of what the entity is being compensated for and whether there is a basic lending arrangement, rather than on how much the entity receives for a particular element.

Elements to consider

Do the asset's contractual terms give rise to cash flows that are SPPI – solely payments of principal and interest ?

SPPI

consider…

- **time value of money**
- **credit risk**
- **other basic lending risks**
- **other associated costs**
- **profit margin**
- **extensions / prepayment**
- **leverage / non-recourse**

How to approach this project

Things to consider…

…Which financial assets are in scope?

…What's the appropriate level on which contract testing is to be performed?

…What's the most effective and efficient testing approach?

…Is it possible to cluster homogeneous products to lower number of tests?

…Are controls in place ensuring the homogeneity?

KPMG
CM AAS

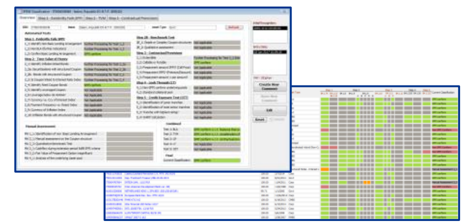
We can assist in managing your accounting change challenges such as business model assessments, SPPI testing, and ECL model development..

We have wide experience in IFRS 9 and SPPI Testing in the Financial Services industry.

For more information on how we can help you with IFRS 4 amendments contact us.

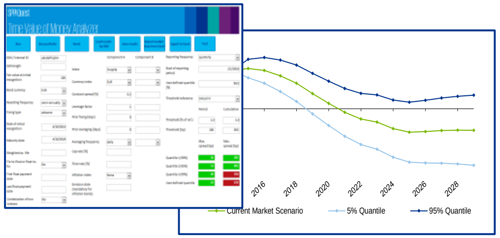
SPPI Tooling

SPPI Quest
KPMG's classification tool for listed securities

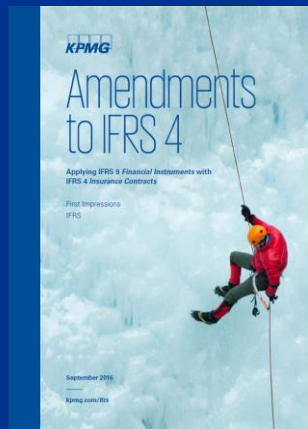


IFRS 9 Lending tool
KPMG's classification tool for financial assets

Time Value of Money Analyser
KPMG's analysis tool for modified interest and time values



Publications



IFRS 4
Amendments

IFRS 9
First Impressions

IFRS 17
First Impressions

IFRS 17
Illustrative disclosures

Contacts

Dick Korf
Partner
Capital Markets Accounting Advisory Services

Wilbert Vos
Senior Manager
Capital Markets Accounting Advisory Services

Frank van den Wildenberg
Partner
Insurance Accounting Change