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Kris Peach
The Chair
Australian Accounting Standards Board
PO BOX 204
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10 February 2016

Dear Kris

Exposure Draft ED 274 Applying AASB 9 Financial Instruments with AASB 4 Insurance Contracts (Proposed amendments to AASB 4)

Thank you for the opportunity to respond to the Australian Accounting Standard Board's Exposure Draft 274 *Applying AASB 9 Financial Instruments with AASB 4 Insurance Contracts (Proposed amendments to AASB 4)* which incorporates the International Accounting Standards Board's Exposure Draft 2015/4 of the same name).

I am enclosing a copy of Deloitte Touche Tohmatsu Limited's comment letter to the International Accounting Standards Board's Exposure Draft 2015/11.

This letter reflects the views of the Deloitte Touche Tohmatsu Limited network of the member firms (Deloitte Global) and, therefore, includes our own comments on the Discussion Paper.

Yours sincerely

Anna Crawford
Partner
Deloitte Touche Tohmatsu

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Hans Hoogervorst
Chairman
International Accounting Standards Board
30 Cannon Street
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8 February 2016

Dear Mr Hoogervorst

Exposure draft 2015/11 – Applying IFRS 9 *Financial Instruments* with IFRS 4 *Insurance Contracts* (Proposed amendments to IFRS 4)

Deloitte Touche Tohmatsu Limited is pleased to respond to the International Accounting Standards Board's (the IASB's) Exposure Draft *Applying IFRS 9 Financial Instruments with IFRS 4 Insurance Contracts (Proposed amendments to IFRS 4)* ('the exposure draft').

We welcome the IASB's initiative in addressing the issue of the different effective dates of IFRS 9 and of the yet to be completed standard for insurance contracts. We agree that the exposure draft has identified valid reasons to introduce a temporary solution to issues arising from transitioning to two major and interrelated new standards at different times.

We agree that an option to defer IFRS 9 should be available for insurance activities and that a predominance criterion based on the carrying amount of liabilities is the appropriate means to determine when that option should be available. However, we have concerns over the methodology for measuring that criterion and also disagree that it should be assessed only at the reporting entity level.

In respect of the level at which 'predominance' should be assessed, we do not believe that it is appropriate for a clearly defined insurance business to be excluded from the deferral approach only because it is part of a larger group including, for example, banking activities. As a result, we recommend that application of the predominance test (and, therefore, of deferral of IFRS 9) be permitted either at the reporting entity level or at a lower level (being the highest reporting entity level within a group for which the predominance test is met). This would appropriately capture a broader population of predominantly insurance entities, whilst also drawing a more precise boundary around the financial assets related to their insurance activities which should be the subject of a deferral of IFRS 9.

As such, we recommend that a reporting entity should initially assess the predominance criterion at the reporting entity level. If the criterion is not met at that level, the same assessment could then be made at each level below the parent entity using a 'waterfall' approach. As a result, a reporting entity would be able to apply the deferral approach in its consolidated financial statements only to the financial assets of those subsidiaries meeting the predominance criterion. While this would result in the application of non-uniform accounting policies in the entity's consolidated financial assets (as, indeed, would application of the overlay approach to the presentation of gains and losses on only some financial assets), we consider that, on pragmatic grounds, to be acceptable on a temporary basis when accompanied by suitable disclosures.

In terms of the calculation of the 'predominance' of liabilities arising from contracts within the scope of IFRS 4, we observe that there is a balance to be struck between a simple calculation (which might justify a lower threshold to take account of the fact that even a 'pure' insurance company is likely to have liabilities that do not arise from insurance contracts, such as tax balances) and a more precise calculation that seeks to exclude the effect of certain balances because it is not those balances that enable the identification of an insurer. We have some suggestions, as outlined further in the Appendix to this letter, on how the predominance test could be modified to ensure that the temporary deferral can be applied by an appropriate population of entities.

We believe that if the deferral approach was modified as recommended above this modified deferral approach is likely to prove an effective solution that may reduce the need for an overlay approach.

We agree with the proposed expiry date for the deferral approach, but strongly recommend that the IASB conclude its deliberations on the new insurance contracts standard taking into account the inputs received from comment letters and outreach activities, so that the effective date of the new standard is within this timescale.

Our detailed responses to the questions in the invitation to comment are included in the Appendix to this letter.

If you have any questions concerning our comments, please contact Veronica Poole in London at +44 (0) 20 7007 0884 or Francesco Nagari at +852 2852 1977.

Yours sincerely

Veronica Poole
Global IFRS Leader

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Appendix

Question 1 – Addressing the concerns raised

Paragraphs BC9–BC21 describe the following concerns raised by some interested parties about the different effective dates of IFRS 9 and the new insurance contracts Standard:

- *(a) Users of financial statements may find it difficult to understand the additional accounting mismatches and temporary volatility that could arise in profit or loss if IFRS 9 is applied before the new insurance contracts Standard (paragraphs BC10–BC16).*
- *(b) Some entities that issue contracts within the scope of IFRS 4 have expressed concerns about having to apply the classification and measurement requirements in IFRS 9 before the effects of the new insurance contracts Standard can be fully evaluated (paragraph BC17–BC18).*
- *(c) Two sets of major accounting changes in a short period of time could result in significant cost and effort for both preparers and users of financial statements (paragraphs BC19–BC21).*

The proposals in this Exposure Draft are designed to address these concerns. Do you agree that the IASB should seek to address these concerns? Why or why not?

We agree that the IASB should seek to address these concerns and that the exposure draft has identified valid reasons to introduce a temporary solution to issues arising from the different effective dates of IFRS 9 and of the yet to be completed standard for insurance contracts.

Question 2 – Proposing both an overlay approach and a temporary exemption from applying IFRS 9

The IASB proposes to address the concerns described in paragraphs BC9–BC21 by amending IFRS 4:

- *(d) to permit entities that issue contracts within the scope of IFRS 4 to reclassify from profit or loss to other comprehensive income some of the income or expenses arising from designated financial assets that:*
- *(i) are measured at fair value through profit or loss in their entirety applying IFRS 9 but*
- *(ii) would not have been so measured applying IAS 39 (the 'overlay approach') (see paragraphs BC24–BC25);*
- *(e) to provide an optional temporary exemption from applying IFRS 9 for entities whose predominant activity is issuing contracts within the scope of IFRS 4 (the 'temporary exemption from applying IFRS 9') (see paragraphs BC26–BC31).*

Do you agree that there should be both an overlay approach and a temporary exemption from applying IFRS 9? Why or why not?

If you consider that only one of the proposed amendments is needed, please explain which and why.

We believe that the deferral approach, if modified in our recommendation as described in our response to Question 4 below, is likely to prove a more effective solution to issues arising from the application of IFRS 9 and the new insurance contracts standard than the overlay approach and therefore could potentially dispense with the need for an overlay approach.

Based on informal discussions with insurance companies in different jurisdictions, we do not believe the overlay approach as proposed in the exposure draft would be widely used as the costs of the overlay approach outweigh the benefits of preserving the profit or loss effect of IAS 39 until the effective date of the new IFRS for insurance contracts.

Question 3 – The overlay approach

Paragraphs 35A–35F and BC32–BC53 describe the proposed overlay approach.

(a) *Paragraphs 35B and BC35–BC43 describe the assets to which the overlay approach can be applied. Do you agree that the assets described (and only those assets) should be eligible for the overlay approach? Why or why not? If not, what do you propose instead and why?*
(b) *Paragraphs 35C and BC48–BC50 discuss presentation of amounts reclassified from profit or loss to other comprehensive income applying the overlay approach. Do you agree with the proposed approach to presentation? Why or why not? If not, what do you propose instead and why?*
(c) *Do you have any further comments on the overlay approach?*

As explained in our response to Question 2 above, we recommend that the Board consider whether an alternative to the deferral approach is necessary, particularly if the deferral approach is modified to make it available to a broader population of insurers.

If it is concluded that inclusion of the overlay approach is warranted, we have the following comments on its application.

- The condition that a financial asset be 'designated as relating to contracts that are within the scope of IFRS 4' could be clarified by a statement that such a designation can be made only when there are documented policies that indicate management of the entity considers those assets as either backing liabilities from contracts within the scope of IFRS 4 or the assets are held to fund capital requirements (both externally imposed or internal) associated with the risks arising from such contracts. This would impose an appropriate degree of rigour to application of an overlay approach. However, identification of the scope of assets to which it could be applied would still be challenging for entities that issue contracts within the scope of IFRS 4 and contracts within the scope of IAS 39 (for example, investment contracts with and investment contracts without discretionary participating features) and, in complying with overall solvency regulatory capital requirements, hold a portfolio of assets to fund the liabilities arising from the pool of contracts as a whole. Addressing such complexities is likely to increase further the cost of applying the overlay approach.
- As either fair value gains or losses might be recognised under IFRS 9 on individual assets, the overlay adjustment could affect both the investment income and investment expense line items in profit or loss. Given this possibility, we recommend that presentation of the effect of the overlay adjustment on each line item on the face of the statement of profit or loss be required rather than, as proposed in paragraph 35C of the exposure draft, presentation of that effect only in the notes to the financial statements being permitted as an alternative. To make the application of the overlay approach as consistent as possible, we also recommend that the use of a single line item in other comprehensive income be required.

We also note that the exposure draft does not provide clear requirements for subsequent reclassification of the amounts presented in other comprehensive income in accordance with paragraph 35A to profit or loss and recommend that additional clarity be provided on this point.

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Question 4 – The temporary exemption from applying IFRS 9

As described in paragraphs 20A and BC58–BC60 the Exposure Draft proposes that only entities whose predominant activity is issuing contracts within the scope of IFRS 4 can qualify for the temporary exemption from applying IFRS 9.

(a) *Do you agree that eligibility for the temporary exemption from applying IFRS 9 should be based on whether the entity's predominant activity is issuing contracts within the scope of IFRS 4? Why or why not? If not, what do you propose instead and why?*

As described in paragraphs 20C and BC62–BC66, the Exposure Draft proposes that an entity would determine whether its predominant activity is issuing contracts within the scope of IFRS 4 by comparing the carrying amount of its liabilities arising from contracts within the scope of IFRS 4 with the total carrying amount of its liabilities (including liabilities arising from contracts within the scope of IFRS 4).

(b) *Do you agree that an entity should assess its predominant activity in this way? Why or why not? If you believe predominance should be assessed differently, please describe the approach you would propose and why.*

Paragraphs BC55–BC57 explain the IASB's proposal that an entity would assess the predominant activity of the reporting entity as a whole (i.e. assessment at the reporting entity level).

Do you agree with the proposal that an entity would assess its predominant activity at the reporting entity level? Why or why not? If not, what do you propose instead and why?

We agree that a predominance criterion based on the carrying amount of liabilities is the appropriate means to determine whether a temporary exemption from applying IFRS 9 is available, but have concerns over the methodology for measuring that criterion and disagree that it should be assessed only at the reporting entity level. In respect of the level at which 'predominance' should be assessed, we do not believe that it is appropriate for a clearly defined insurance business to be excluded from the deferral approach only because it is part of a larger group including, for example, banking activities. Conversely, we would be concerned by a bank being permitted to defer application of IFRS 9 as a result of being part of a larger insurance group. As a result, we recommend that application of the predominance test (and, therefore, of deferral of IFRS 9) be permitted either at the reporting entity level or at a lower level (being the highest reporting entity level within a group for which the predominance test is met). This would appropriately capture a broader population of predominantly insurance entities, whilst also drawing a more precise boundary around the financial assets related to their insurance activities which should be the subject of a deferral of IFRS 9.

As such, we recommend that a reporting entity should initially assess the predominance criterion at the reporting entity level. If the criterion is not met at that level, the same assessment could then be made at each level below the parent entity using a 'waterfall' approach. As a result, a reporting entity would be able to apply the deferral approach in its consolidated financial statements only to the financial assets of those subsidiaries meeting the predominance criterion. While this would result in the application of non-uniform accounting policies in the entity's consolidated financial assets (as, indeed, would application of the overlay approach to the presentation of gains and losses on only some financial assets), we consider that, on pragmatic grounds, to be acceptable on a temporary basis when accompanied by suitable disclosures as described in paragraph 37A-B of the exposure draft.

In respect of any intra-group transfers of financial assets between a subsidiary that defers application of IFRS 9 and one that does not, we believe that the relevant transition requirements of IFRS 9 should be applied at that date, supported by the disclosures included in paragraphs 35E(c) and 37D(d) of the exposure draft in respect of assets transferring from the IAS 39 to the IFRS 9 measurement requirements in applying the overlay approach. In addition to these disclosures we propose that when transfers of financial assets are made within the reporting entity from insurance subsidiaries with pools of assets using IAS 39 to another subsidiary that is using IFRS 9 they should be:

- recognised at the fair value applicable at the transfer date if the financial asset will be included in a pool of assets that are classified and measured either at fair value through profit or loss or fair value through other comprehensive income and that the cumulative change in fair value shall be recognised at the date of the transfer in profit or loss or other comprehensive income as appropriate; and
- if the financial asset will be measured at amortised cost under IFRS 9, the carrying value of the financial asset at the transfer point should be the initial measurement of the asset under IFRS 9.

Further, to reduce the risk of earnings management the transfer should be deemed to take place at the start of the next reporting period, consistent with the approach already applied with reclassifications of financial assets in IFRS 9. Disclosure of the total amounts sold in the period and the relevant total gains or losses will be required while the deferral approach is applied.

We also recommend that the requirements for intra-group transfers establish a ‘one-way system’ such that assets transferred to a portion of the reporting entity using IAS 39 from another portion that uses IFRS 9 continue to be measured under IFRS 9 thereafter.

In terms of the calculation of the ‘predominance’ of liabilities arising from contracts within the scope of IFRS 4, we observe that there is a balance to be struck between a simple calculation (which might justify a lower threshold to take account of the fact that even a ‘pure’ insurance company is likely to have liabilities that do not arise from insurance contracts, such as tax balances) and a more precise calculation that seeks to exclude the effect of certain balances because it is not those balances that enable the identification of an insurer. One example is to remove financial liabilities that can be demonstrated to fund the insurance business so the predominance test is not influenced by whether the business is debt or equity funded. Another example is to exclude liabilities such as contracts issued by segregated funds that are measured at fair value through profit or loss (FVTPL) under IAS 39 and are likely to continue to be so measured under IFRS 9 and that relate directly to assets also measured at FVTPL (such that the value of the liability is a function of the value of the assets backing it). Contracts of this kind are issued in the insurance sector along with similar products that include an insurance guarantee (and hence fall within the scope of IFRS 4) and inclusion of such liabilities could, depending on the mix of products, lead to the failure of the predominance test even though measurement of the non-insurance financial assets and liabilities will be unchanged by IFRS 9.

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Question 5 – Should the overlay approach and the temporary exemption from applying IFRS 9 be optional?

As explained in paragraphs BC78‑BC81, the Exposure Draft proposes that both the overlay approach and the temporary exemption from applying IFRS 9 would be optional for entities that qualify. Consistently with this approach, paragraphs BC45 and BC76 explain that an entity would be permitted to stop applying those approaches before the new insurance contracts Standard is applied.

(a) Do you agree with the proposal that the overlay approach and the temporary exemption from applying IFRS 9 should be optional? Why or why not?
(b) Do you agree with the proposal to allow entities to stop applying the overlay approach or the temporary exemption from applying IFRS 9 from the beginning of any annual reporting period before the new insurance contracts Standards is applied? Why or why not?

We agree that the solution proposed in the exposure draft should be optional and also that entities be permitted to stop applying that solution prior to application of the new insurance contracts standard as we do not believe it would be appropriate to restrict individual entities from applying the most up-to-date guidance on accounting for financial instruments in full.

Question 6 – Expiry date for the temporary exemption from applying IFRS 9

Paragraphs 20A and BC77 propose that the temporary exemption from applying IFRS 9 should expire at the start of annual reporting periods beginning on or after 1 January 2021.

Do you agree that the temporary exemption should have an expiry date? Why or why not?

Do you agree with the proposed expiry date of annual reporting periods beginning on or after 1 January 2021? If not, what expiry date would you propose and why?

We agree with the proposed expiry date for the reasons stated in the Basis for Conclusions on the exposure draft, but strongly recommend that the IASB conclude its deliberations on the new insurance contracts standard taking into account the inputs received from comment letters and the outreach activities, so that the effective date of the new standard is within the timeline set out for the deferral approach.