Paper 1

Background

Insurer P underwrites a portfolio of insurance contracts with participation features that will qualify for the variable fee approach under IFRS 17 (VFA Contracts). The underlying items of the VFA Contracts are held by P through an internally segregated Par Fund which holds an associate that was acquired before 1 Jan 2022 and has been accounted for using the equity method under IAS 28.

IFRS 17 para B111 – B114 requires the reporting entity to adjust:

(a) the fulfilment cash flows of the insurance contract liabilities for the change in the policyholders' share of the fair value of the underlying items, and

(b) the contractual service margin of the insurance contract liabilities for the change in the reporting entity's share of the fair value of the underlying items.

In accordance with IFRS 17 para B111 and B128, the change in the fair value of the underlying item is included in insurance finance income or expenses ("IFIE"), which is recognised in profit or loss unless the reporting entity elects to recognise some amounts in other comprehensive income ("OCI") applying the book yield approach as specified in para 89(b) of IFRS 17 (the "OCI option"). P is not going to elect the OCI option to its VFA contracts so all the changes in the fair value of the underlying items will be recorded in profit or loss when applying the insurance accounting under IFRS 17. To mitigate the accounting mismatches arising from recognising and measuring the VFA contracts liabilities and the assets backing those VFA contracts, P intends to measure all the assets included in the underlying items at fair value through profit or loss ("FVTPL") subject to the requirements of respective IFRS standards that shall be applied to those assets.

In view of this, P is considering changing the accounting for the associate held by the underlying items from equity method to FVTPL upon transition to IFRS 17.

Question/issue

Can P change the accounting from equity method to FVTPL for the associate held by the underlying items of VFA Contracts upon transition to IFRS 17?

Discussion and alternative views

View 1: No, P cannot make the change as the election of FVTPL shall be made at the initial recognition of the associate

IAS 28 para 18 is clear that the election of FVTPL shall be made at initial recognition of the associate. The consequential amendments to IAS 28 para 18 due to the issue of IFRS 17 do not make any changes to this requirement. Rather it just takes the fund held as the underlying items of VFA contracts as an example of investment-linked insurance fund.

As the associate was recognised before P applies IFRS 17 and FVTPL was not elected, P cannot change the accounting for the associate from equity method to FVTPL subsequently including upon transition to IFRS 17.

View 2: Yes, P can change the accounting retrospectively from equity method to FVTPL

Notwithstanding the requirement under IAS 28 para 18 on election of FVTPL at initial recognition of an associate, P can change the accounting for the associate retrospectively from equity method to FVTPL upon transition to IFRS 17 due to the following reasons:

- As noted in IFRS 17.BC56, accounting mismatches would arise if the assets held by the underlying items are not measured at fair value. In view of this, the IASB amended a few other standards, eg IAS 16, IAS 32, IAS 40, IFRS 9, to allow FVTPL accounting specifically for the underlying items of VFA contracts. And IFRS 17 includes specific transition rules by allowing redesignation of financial assets for those entities that had applied IFRS 9. All these efforts made by the IASB were to remove the obstacles of allowing measuring the assets held by the underlying items at FVTPL.

- With that, it's believed the purpose of making consequential amendments to IAS 28 para 18 when IFRS 17 was issued is to allow FVTPL accounting for an associate or a joint venture that is held by the underlying items of VFA contracts regardless of whether the associate or joint venture was acquired before or after the date of applying IFRS 17.

- IAS 28 para 45F notes an entity shall apply the amended para 18 of IAS 28 when it applies IFRS 17. This could be interpretated as that the P will apply the amended para 18 of IAS 28 for the first time when it applies IFRS 17, consequently it can make the election of FVTPL retrospectively, ie going back to the initial recognition of the associate.

Technical references/guidance

<u>IAS 28. 18 [as amended by IFRS 17]</u>
When an investment in an associate or a joint venture is held by, or is held indirectly through, an entity that is a venture capital organisation, or a mutual fund, unit trust and similar entities including investment-linked insurance funds, the entity may elect to measure that investment at fair value through profit or loss in accordance with IFRS 9.

An example of an investment-linked insurance fund is a fund held by an entity as the underlying items for a group of insurance contracts with direct participation features. For the purposes of this election, insurance contracts include investment contracts with discretionary participation features. An entity shall make this election separately for each associate or joint venture, at initial recognition of the associate or joint venture. **(See IFRS 17 Insurance Contracts for terms used in this paragraph that are defined in that Standard.)**

NB: the texts in bold are consequential amendments by IFRS 17.

<u>IAS 28.45F</u>
IFRS 17, issued in May 2017, amended paragraph 18. An entity shall apply that amendment when it applies IFRS 17.

<u>IFRS 17 appendix A</u>

underlying items	Items that determine some of the amounts payable to a policyholder. Underlying items can comprise any items; for example, a reference portfolio of assets, the net assets of the entity, or a specified subset of the net assets of the entity.

<u>IFRS 17 para B101</u>
Insurance contracts with direct participation features are insurance contracts that are substantially investment-related service contracts under which an entity promises an investment return based on underlying items. Hence, they are defined as insurance contracts for which:

(a) the contractual terms specify that the policyholder participates in a share of a clearly identified pool of underlying items (see paragraphs B105–B106);
(b) the entity expects to pay to the policyholder an amount equal to a substantial share of the fair value returns on the underlying items (see paragraph B107); and
(c) the entity expects a substantial proportion of any change in the amounts to be paid to the policyholder to vary with the change in fair value of the underlying items (see paragraph B107).

<u>IFRS 17.BC56</u>
Insurance contracts with direct participation features are measured by reference to the fair value of the underlying items (see paragraphs BC238–BC249). This measurement reflects the investment-related nature of the contracts. Applying IFRS Standards, many underlying items will also be measured at fair value. The Board also decided to amend some IFRS Standards to enable additional underlying items to be measured at fair value (see paragraph BC65(c)). However, there could still be underlying items that cannot be measured at fair value applying IFRS Standards; for example, other insurance contracts or net assets of a subsidiary. The Board noted that all such mismatches would be eliminated only if all assets and liabilities were recognised and measured at fair value.

<u>IFRS 17 para BC65</u>

IFRS 17 generally does not set requirements for the other assets and liabilities of entities that issue insurance contracts, because those assets and liabilities fall within the scope of other IFRS Standards. However, IFRS 17 provides the following exceptions:

(c) it amends other IFRS Standards (see Appendix D of IFRS 17) to permit an entity to recognise its own shares as assets and to measure such assets, own debt and owner-occupied property at fair value when held in an investment fund that provides investors with benefits determined by units in the fund or when an entity holds the investment as an underlying item for insurance contracts with direct participation features. The Board decided that for many contracts that specify a link to returns on underlying items, those underlying items include a mix of assets that are almost all measured at fair value through profit or loss. Measurement of own shares, own debt and owner-occupied property at fair value through profit or loss would be consistent with the measurement of the majority of the underlying assets and would prevent accounting mismatches.