EFRAG's Draft Letter to the European Commission Regarding Endorsement of Initial Application of IFRS 17 and IFRS 9 — Comparative Information (Amendment to IFRS 17)

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European Commission
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[dd] [mm] 2022

Dear Mr John Berrigan

Endorsement of Initial Application of IFRS 17 and IFRS 9 – Comparative Information (Amendment to IFRS 17)

Based on the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards, EFRAG is pleased to provide its opinion on the *Initial Application of IFRS 17 and IFRS 9 — Comparative Information (Amendment to IFRS 17)* ('the Amendment'), which was issued by the IASB on 9 December 2021. An Exposure Draft of the Amendment was issued on 28 July 2021. EFRAG provided its comment letter on that Exposure Draft on 8 October 2021.

The narrow-scope Amendment addresses an important issue related to accounting mismatches between insurance contract liabilities and financial assets arising in the comparative information presented on initial application of IFRS 17 *Insurance Contracts* and IFRS 9 *Financial Instruments*.

The Amendment shall be applied on initial application of IFRS 17 and will be available to be used for all comparative periods that have been restated for IFRS 17. A description is included in Appendix 1 to this letter.

In order to provide our endorsement advice as you have requested, we have first assessed whether the Amendment would meet the technical criteria for endorsement, in other words whether the Amendment would provide relevant, reliable, comparable and understandable information required to support economic decisions and the assessment of stewardship, leads to prudent accounting and is not contrary to the true and fair view principle. We have then assessed whether the Amendment would be conducive to the European public good. We provide our conclusions below.

Does the Amendment meet the IAS Regulation technical endorsement criteria?

EFRAG has concluded that the Amendment meets the qualitative characteristics of relevance, reliability, comparability and understandability required to support economic decisions and the assessment of stewardship and raises no issues regarding prudent accounting. EFRAG has also assessed that the Amendment does not create any distortion in its interaction with other IFRS Standards and that all necessary disclosures are required. Therefore, EFRAG has concluded that the Amendment is not contrary to the true and fair view principle. EFRAG's reasoning is explained in Appendix 2 to this letter.

Is the Amendment conducive to the European public good?

EFRAG has assessed that the Amendment would improve financial reporting and would reach an acceptable cost-benefit trade-off. EFRAG has not identified that the Amendment could have any adverse effect on the European economy, including financial stability and economic growth. Accordingly, EFRAG assesses that endorsing the Amendment is conducive to the European public good. EFRAG's reasoning is explained in Appendix 3 to this letter.

In EFRAG's assessment of whether the Amendment would be conducive to the European public good, EFRAG has assessed whether the Amendment would improve financial reporting, would reach an acceptable cost-benefit trade-off, and whether the Amendment could affect economic growth.

Our advice to the European Commission

As explained above, we have concluded that the Amendment meets the qualitative characteristics of relevance, reliability, comparability and understandability required to support economic decisions and the assessment of stewardship, raises no issues regarding prudent accounting, and that it is not contrary to the true and fair view principle. We have also concluded that the Amendment is conducive to the European public good. Therefore, we recommend the Amendment for endorsement.

On behalf of EFRAG, I would be happy to discuss our advice with you, other officials of the European Commission or the Accounting Regulatory Committee as you may wish.

Yours sincerely,

Jean-Paul Gauzès
President of the EFRAG Board

Appendix 1: Understanding the changes brought about by the Amendment

Background of the Amendment and the issue

1 Many insurance entities will first apply IFRS 9 and IFRS 17 at the same time on or after 1 January 2023. The transition requirements in the two Standards apply at different dates:

(a) The IFRS 9 transition requirements apply on the date of initial application (i.e., 1 January 2023 for many insurance entities); and

(b) The IFRS 17 transition requirements apply on the transition date, being the beginning of the previous annual reporting period (i.e., 1 January 2022 for many insurance entities).

2 The current transition requirements of the two standards will result in the following one-time classification differences in the comparative information presented[1] on initial application of IFRS 17 and IFRS 9 by some insurance entities:

(a) Where the entity does not restate its IFRS 9 comparatives as allowed, significant accounting mismatches between insurance contract liabilities measured at current value and those related financial assets measured at amortised cost.

(b) If the entity chooses to restate comparative information for IFRS 9, classification differences between financial assets derecognised in 2022 and 2021 (to which IAS 39 will apply) and other financial assets (to which IFRS 9 will apply).

How the issue has been addressed and what has changed

3 An amendment is being introduced that will permit an entity to present its comparative information about a financial asset on initial application of IFRS 17 and IFRS 9 based on its expected classification under IFRS 9, as if the classification and measurement requirements of IFRS 9 had been applied to that financial asset (classification overlay).

4 The classification overlay allows preparers to apply IFRS 9 instead of IAS 39 in the following situations:

(a) preparers that first apply IFRS 17 and IFRS 9 at the same time and that will restate comparative information for IFRS 9. For those preparers the classification overlay could be applied to financial assets derecognised in the comparative period (i.e., financial assets to which IFRS 9 is not applied).

(b) preparers that first apply IFRS 17 and IFRS 9 at the same time and that will not restate comparative information for IFRS 9. For those preparers the classification overlay could be applied to any financial asset in the comparative period.

(c) preparers that have already applied IFRS 9 before applying IFRS 17. For those preparers, the classification overlay is applicable only in particular circumstances, i.e., in case of redesignation of financial assets derecognised in the comparative period.

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[1] For those companies that present more than one period of comparative information under IFRS 17, the comparative periods may include 2021 for the 2023 financial statements.

5 An entity:

(a) is permitted to apply the classification overlay to any financial asset for which comparative information has not been restated for IFRS 9;

(b) shall use reasonable and supportable information available at transition date to determine how the entity expects that financial asset to be classified on initial application of IFRS 9;

(c) is permitted, but not required, to apply the impairment requirements of IFRS 9;

(d) would not apply comparative information for reporting periods prior to the transition date of IFRS 17; and

(e) would apply the classification overlay optionally on an instrument-by-instrument basis.

When does the Amendment become effective?

6 An entity applies the Amendment when it first applies IFRS 17 which has an effective date of 1 January 2023 and will be available to be used for all comparative periods that have been restated for IFRS 17 (as long as the entity has collected the information needed to apply the Amendment). IFRS 17 has been endorsed by the European Union on 23 November 2021 with the effective date of 1 January 2023.

Appendix 2: EFRAG's technical assessment on the Amendment against the endorsement criteria

Notes to Constituents:

This appendix sets out the basis for the conclusions reached, and for the recommendation made, by EFRAG on the Amendment. In it, EFRAG assesses how the Amendment satisfies the technical criteria set out in the Regulation (EC) No 1606 2002 for the adoption of international accounting standards. It provides a detailed evaluation for the criteria of relevance, reliability, comparability and understandability, so that financial information is appropriate for economic decisions and the assessment of stewardship. It evaluates separately whether the Amendment leads to prudent accounting and finally considers whether the Amendment would not be contrary to the true and fair view principle.

In its comment letters to the IASB, EFRAG points out that such letters are submitted in EFRAG's capacity of contributing to the IASB's due process. They do not necessarily indicate the conclusions that would be reached by EFRAG in its capacity of advising the European Commission on endorsement of the definitive IFRS Standards in the European Union and European Economic Area.

In the latter capacity, EFRAG's role is to make a recommendation about endorsement based on its assessment of the final IFRS Standard or Interpretation against the technical criteria for European endorsement, as currently defined. These are explicit criteria which have been designed specifically for application in the endorsement process, and therefore the conclusions reached on endorsement may be different from those arrived at by EFRAG in developing its comments on proposed IFRS Standards or Interpretations. Another reason for a difference is that EFRAG's thinking may evolve.

Does the accounting that results from the application of the Amendment meet the technical criteria for endorsement in the European Union?

7 EFRAG has considered whether the Amendment meets the technical requirements of the European Parliament and of the Council on the application of international accounting standards, as set out in Regulation (EC) No 1606/2002 (The IAS Regulation), in other words that the Amendment:

(a) is not contrary to the principle set out in Article 4 (3) of Council Directive 2013/34/EU (The Accounting Directive); and

(b) meets the criteria of understandability, relevance, reliability, and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

8 Article 4(3) of the Accounting Directive provides that:

The annual financial statements shall give a true and fair view of the undertaking's assets, liabilities, financial position and profit or loss. Where the application of this Directive would not be sufficient to give a true and fair view of the undertaking's assets, liabilities, financial position and profit or loss, such additional information as is necessary to comply with that requirement shall be given in the notes to the financial statements.

9 The IAS Regulation further clarifies that *'to adopt an international accounting standard for application in the Community, it is necessary firstly that it meets the basic requirement of the aforementioned Council Directives, that is to say that its application results in a true and fair view of the financial position and performance of an enterprise - this principle being considered in the light of the said Council*

Directives without implying a strict conformity with each and every provision of this Directive' (Recital 9 of the IAS Regulation).

10 EFRAG's assessment as to whether the Amendment would not be contrary to the true and fair view principle has been performed against the European legal background summarised above.

11 In its assessment, EFRAG has considered the Amendment from the perspectives of both usefulness for decision-making and assessing the stewardship of management. EFRAG has concluded that the information resulting from the application of the Amendment is appropriate both for making decisions and assessing the stewardship of management.

Relevance

12 Information is relevant when it influences the economic decisions of users by helping them evaluate past, present or future events or by confirming or correcting their past evaluations. Information is also relevant when it assists in evaluating the stewardship of management.

13 EFRAG considered whether the Amendment would result in the provision of relevant information – in other words, information that has predictive value, confirmatory value or both – or whether it would result in the omission of relevant information.

14 In applying the classification overlay, an entity would align the classification of a financial asset, in the comparative period, with the expected classification of that financial asset on initial application of IFRS 9. Therefore, by aligning the classification, the Amendment alleviates accounting mismatches between financial assets and insurance contract liabilities in the comparative period thus providing more useful and relevant information for users.

15 As the restatement of comparatives is optional, the Amendment also helps to relieve the operational burden of restating the comparatives for IFRS 9 and therefore indirectly encourages entities to restate their comparatives to the same basis. This will improve the relevance of the information provided to users.

16 As a result, EFRAG's overall assessment is that the Amendment would result in the provision of relevant information and therefore satisfies the relevance criterion.

Reliability

17 EFRAG also considered the reliability of the information that will be provided by applying the Amendment. Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully what it either purports to represent, or could reasonably be expected to represent, and is complete within the bounds of materiality and cost.

18 There are a number of aspects to the notion of reliability: freedom from material error and bias, faithful representation, and completeness.

19 An entity has to use reasonable and supportable information available at the transition date to determine the expected classification of a financial asset. For example, using a preliminary assessment of the business model and cash flow characteristics performed prior to the effective date to prepare for the transition to IFRS 9.

20 In order to apply IFRS 9 as from January 2023, EFRAG is aware that many entities will run IFRS 9 alongside IAS 39 in the prior reporting period for internal purposes. This will help in providing a basis for the reasonable and supportable information needed to apply the classification overlay.

21 In addition, EFRAG notes that the classification overlay is to be applied on an instrument-by-instrument basis. However, EFRAG does not consider that this would impact reliability because entities who will apply this classification overlay intend to reduce accounting mismatches and also intend to achieve greater consistency with how IFRS 9 will be applied.

22 Therefore, based on these reasons, EFRAG's overall assessment is that the Amendment results in reliable information.

Comparability

23 The notion of comparability requires that like items and events are accounted for in a consistent way through time and by different entities, and that unlike items and events should be accounted for differently.

24 EFRAG has considered whether the Amendment results in transactions that are:

(a) economically similar being accounted for differently; or

(b) transactions that are economically different being accounted for as if they are similar.

25 EFRAG considers that comparability between periods would be improved when applying the Amendment because the comparative information for financial assets to which the proposed classification overlay is applied will be consistent with first time application of IFRS 9. Furthermore, applying both IFRS 17 and IFRS 9 to the comparative periods will improve comparability for the financial statements of the entity over time, putting the 2023 results in context while providing a bridge to the 2022 financial statements.

26 EFRAG notes that the classification overlay is to be applied on an instrument-by-instrument basis. However, EFRAG does not consider that this basis of selection would impact comparability for the same reasons as in paragraph 21 above.

27 Therefore, for these reasons, EFRAG's overall assessment is that the requirements in Amendment will result in comparable information.

Understandability

28 The notion of understandability requires that the financial information provided should be readily understandable by users with a reasonable knowledge of business and economic activity and accounting, and the willingness to study the information with reasonable diligence.

29 Although there are a number of aspects related to the notion of 'understandability', EFRAG believes that most of the aspects are covered by the discussion above about relevance, reliability and comparability.

30 As a result, EFRAG believes that the main additional issue it needs to consider, in assessing whether the information resulting from the application of the Amendment is understandable, is whether that information will be unduly complex.

31 EFRAG is of the view that the resulting information would not be unduly complex to understand for users. Rather, the Amendment would improve the users' understanding by enabling them to understand the 'actual' comparative information on the statement of financial position.

32 Furthermore, IFRS 9 transitional requirements includes IFRS 7 disclosures (paragraphs 42I, 42L and 42M[2]) at 1 January 2023. Some have indicated that when

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[2] These disclosures include information about the IAS 39 and IFRS 9 measurement category and the related carrying values; changes in value in measurement category both those not resulting from a change in

applying the classification overlay, it would be more useful to provide these disclosures rather at 1 January 2022 than at the required date of 1 January 2023. They argue that this would be more informative to the users of financial statements. These stakeholders note that they will have to present such transitional disclosure as non-GAAP information as of 1 January 2022. In this case, providing disclosures for 1 January 2023 would add to the operational burden of implementing the two standards. EFRAG notes that the classification overlay does not replace the initial application of IFRS 9 and also considers that any changes to the expected classification of instruments under IFRS 9 when adopting the standard would in any case require disclosure. Therefore, EFRAG considers that entities may provide supplementary information to enhance understandability of the comparative information.

33 Taking into consideration the above reasons, EFRAG's overall assessment is that the requirements in the Amendment will result in information that is understandable.

Prudence

34 For the purpose of this endorsement advice, prudence is defined as caution in conditions of uncertainty. In some circumstances, prudence requires asymmetry in recognition such that assets or income are not overstated, and liabilities or expenses are not understated.

35 An entity that applies the Amendment is not required to apply the impairment requirements of IFRS 9. EFRAG acknowledges that optional application of the impairment requirements is a prudent approach as it recognises expected credit losses as soon as they are foreseeable. However, EFRAG also acknowledges that some entities may not yet be prepared to apply the IFRS 9 impairment requirements. EFRAG considers that even if these entities do not apply the impairment requirements, the Amendment would still provide useful information about comparative information.

36 Furthermore, the Amendment does not affect recognition and measurement for the current year as it only relates to presentation of comparative information.

37 Therefore, EFRAG has concluded that there are no issues in relation to prudence.

True and Fair View Principle

38 A Standard will not impede information from meeting the true and fair view principle when, on a stand-alone basis and in conjunction with other IFRS Standards, it:

(a) does not lead to unavoidable distortions or significant omissions in the representation of that entity's financial position and profit or loss; and

(b) includes all disclosures that are necessary to provide a complete and reliable depiction of an entity's assets, liabilities, financial position and profit or loss.

39 EFRAG has assessed that the Amendment does not create any negative interactions with other IFRS Standards. Accordingly, EFRAG has assessed that the Amendment does not lead to unavoidable distortions or significant omissions and therefore do not impede financial statements from providing a true and fair view.

40 EFRAG has concluded that the appropriate disclosures that are necessary to provide a complete and reliable depiction of an entity's assets, liabilities, financial position and profit or loss are required.

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measurement attribute to IFRS 9 and those that result from such a change as well as information about certain reclassifications.

41 As a result, EFRAG concludes that the application of the Amendment would not lead to information that would be contrary to the true and fair view principle.

Conclusion

42 Accordingly, for the reasons set out above, EFRAG's assessment is that the Amendment meets the technical requirements for EU endorsement as set out in the IAS Regulation.

Appendix 3: Assessing whether the Amendment is conducive to the European public good

Introduction

1 EFRAG considered whether it would be conducive to the European public good to endorse *Initial Application of IFRS 17 and IFRS 9 – Comparative information* ("the Amendment"). In addition to its assessment included in Appendix 2, EFRAG has considered a number of issues in order to identify any potential negative effects for the European economy on the application of the Amendment. In doing this, EFRAG considered:

(a) Whether the Amendment improves financial reporting. This requires a comparison of the Amendment with the existing requirements and how it/they fit into IFRS Standards as a whole;

(b) The costs and benefits associated with the Amendment; and

(c) Whether the Amendment could have an adverse effect to the European economy, including financial stability and economic growth.

2 These assessments allow EFRAG to draw a conclusion as to whether the Amendment is likely to be conducive to the European public good. If the assessment concludes there is a net benefit, the Amendment will be conducive to the objectives of the IAS Regulation.

Whether the Amendment is likely to improve the quality of financial reporting

3 Many insurance entities will first apply IFRS 9 and IFRS 17 at the same time on or after 1 January 2023. However, the transition requirements in the two Standards apply at different dates as illustrated in paragraph 1 of Appendix 1 above.

4 Without the Amendment, this difference in the transition requirements would result in the following one-time classification differences in the comparative information presented on initial application of IFRS 17 and IFRS 9 by some insurance entities:

(a) Significant accounting mismatches between insurance contract liabilities measured at current value and some related financial assets measured at amortised cost.

(b) If the entity chooses to restate comparative information for IFRS 9, classification differences between financial assets derecognised in 2022 and 2021 (to which IAS 39 will apply) and other financial assets (to which IFRS 9 will apply).

5 In addition to these classification differences, some insurance entities also highlighted operational challenges if the entity chooses to restate comparative information for IFRS 9. Those challenges will arise because the entity will not know to which financial assets IFRS 9 does and does not apply to in the comparative information until the end of 2022 (i.e., once the entity knows which assets have been derecognised in 2022 and where relevant, 2021).

6 To address those issues, the IASB has proposed a 'classification overlay' and this is applicable in the situations listed in paragraph 4 of Appendix 1.

7 EFRAG has assessed that this approach permits to address the issues raised and has therefore concluded that the Amendment is likely to improve the quality of financial reporting.

Costs and benefits of the Amendment

8 EFRAG has considered whether, and if so to what extent, implementing the Amendment in the EU might result in incremental costs for preparers and/or users, and whether those costs are likely to be exceeded by the benefits to be derived from their adoption.

Costs for preparers

9 EFRAG has learned that the existing IFRS 9 transition requirements are operationally burdensome and may constitute a significant part of the IFRS 9 implementation costs, thereby endangering a voluntary presentation of comparative information under IFRS 9.

10 Without the Amendment, the transitional requirements in IFRS 9 would necessitate entities to combine information from two different accounting ledgers which is seen as costly and technically challenging.

11 By applying the Amendment, the cost for applying different approaches (either IFRS 9 or IAS 39) to the restatement of comparative information can be avoided and preparers are likely to reduce their costs at transitioning to the new standard.

12 Nevertheless, some have indicated that when applying the classification overlay, providing two sets of IFRS 9 transitional disclosures - one required only as of 1 January 2023 as per paragraphs 42I, 42L and 42M in IFRS 7– and another as of 1 January 2022 would create operational burden and additional costs for preparers.

Costs for users

13 EFRAG notes that the Amendment improves comparability of the information provided both year on year but also between the assets and the insurance liabilities they relate to. This would enable users to understand better the statement of financial position.

14 While improving the quality of information that will be available to users, EFRAG assesses there is no direct impact on the costs for users, i.e., the Amendment is likely to be cost neutral for users.

Benefits for preparers and users

15 Preparers will benefit from the Amendment as they will be able to reduce the accounting mismatches at transition and can therefore present more useful information to the users of their financial statements. In addition, it will help them in reducing their costs at transitioning to the new standard.

16 Users will benefit from more useful information allowing them to understand the change from applying IAS 39 and IFRS 4 to IFRS 9 and IFRS 17 better.

Conclusion on the costs and benefits

17 EFRAG's overall assessment is that the Amendment is likely to outweigh costs associated with reference to the costs.

Conclusion

18 EFRAG believes that the Amendment will generally bring improved financial reporting when compared to applying the current transition requirements of IFRS 9. As such, its endorsement is conducive to the European public good in that improved financial reporting improves transparency and assists in the assessment of management stewardship.

19 EFRAG has not identified that the Amendment could have any adverse effect to the European economy, including financial stability and economic growth.

20 Furthermore, EFRAG has not identified any other factors that would mean endorsement is not conducive to the public good.

21 Having considered all relevant aspects, including the trade-off between the costs and benefits of implementing the Amendment, EFRAG assesses that endorsing *Initial Application of IFRS 17 and IFRS 9 – Comparative information* is conducive to the European public good.