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**Article — Published Version**

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Journal of Corporate Accounting & Finance

**Provided in Cooperation with:**

John Wiley & Sons

*Suggested Citation:* Dobler, Michael (2019) : The European Union's endorsement of Amendments to International Financial Reporting Standard 4: An unprecedented “top up”, Journal of Corporate Accounting & Finance, ISSN 1097-0053, John Wiley & Sons, Inc., Hoboken, USA, Vol. 31, Iss. 3, pp. 190-196,  
<https://doi.org/10.1002/jcaf.22436>

This Version is available at:

<https://hdl.handle.net/10419/230130>

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EDITORIAL REVIEW

# The European Union's endorsement of Amendments to International Financial Reporting Standard 4: An unprecedented “top up”

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## Abstract

The International Financial Reporting Standards (IFRS) must pass a formal endorsement process to become binding for companies based in the European Union (EU). In an unparalleled instance, the EU recently endorsed “Amendments to IFRS 4” with a modification labeled as “top up” by allowing European financial conglomerates to defer the application of IFRS 9 “Financial Instruments” in their insurance sectors. This paper explains the background of this decision, identifies the “top up” as an unprecedented case of carve-in, and discusses the key implications for regulation and practice.

## KEYWORDS

carve-in, European Union (EU), financial conglomerate, financial instruments, insurance, international accounting, International Financial Reporting Standards (IFRS), top up

## 1 | INTRODUCTION

In the European Union (EU), Regulation (EU) 2017/1988 endorsed “Amendments to IFRS 4: Applying IFRS 9 Financial Instruments with IFRS 4 Insurance Contracts” (International Accounting Standards Board [IASB], 2016) with a modification of their original content. The protocols of EU deliberations refer to the modification as an EU “top up,” a new term in the International Financial Reporting Standards (IFRS) endorsement process. In brief, this “top up” extends the scope of an optional temporary exemption from IFRS 9 from predominate insurers to the insurance sectors of EU-based financial conglomerates. What seems to be a minor adjustment at first glance is an unprecedented case in the history of IFRS endorsement in the EU. It is surprising how little attention academics and practitioners have devoted to this unique case, which

has passed almost unnoticed beyond an inner circle of European experts in insurance accounting.

What is the economic and political background of the EU “top up”? Is this “top up” not, in fact, a carve-in? What are its implications for financial accounting regulation and practice? To address the above questions, this paper summarizes the deliberations and key arguments that led to the “top up” and analyzes the characteristics of the scope extension provided by the “top up.” My discussion of the regulatory implications centers on power arguments and the potential impact on future EU endorsement decisions. By discussing the implications for preparers and users of financial statements, I provide the initial evidence on how many and which financial conglomerates actually chose to exempt themselves from IFRS 9 in their insurance sectors. The findings add to our understanding of the politics of adopting IFRS in the EU and suggest obstacles to IFRS financial statement analysis in insurance-related sectors.

## 2 | BACKGROUND ON IFRS ENDORSEMENT IN THE EU

IFRS serve as the key financial accounting language used worldwide. More than 130 countries around the globe are applying IFRS, although sometimes using versions that differ from “full IFRS” as issued by the IASB (De George, Li, & Shivakumar, 2016). In the EU—a key early adopter of IFRS (Forst & Salerno, 2016)—any new, revised or amended standard or interpretation of the IASB must pass a formal endorsement process before it becomes binding for EU-based companies. This endorsement process involves a number of EU-level institutions (Van Mourik & Walton, 2018). The endorsement decision depends on whether criteria—referring to true and fair view, qualitative characteristics of financial information, and European public good—as set out in Regulation (EC) 1606/2002 are met (Bischof & Daske, 2016). This regulation allows the EU to

- adopt an IFRS standard as issued by the IASB as it stands,
- partially adopt an IFRS by leaving out some parts (e.g., as experienced in regard to IAS 39 “Financial Instruments: Recognition and Measurement”); or
- reject the adoption (e.g., as experienced in regard to IFRS 14 “Regulatory Deferral Accounts”).

The latter two cases are referred to as EU-level “carve-outs.” A carve-out relates to full or partial non-endorsement of an IFRS standard. The parts of IFRS carved out are nonbinding for EU-based companies. Therefore, a carve-out leads to a deviation between “full IFRS” as issued by the IASB and “EU IFRS” as a subset of the former. However, Regulation (EC) 1,606/2002 does not explicitly provide the option of an EU-level “carve-in.” A carve-in relates to the modification of the content of IFRS as issued by the IASB (beyond carve-outs) in the endorsement process. It would permit additional deviations where “EU IFRS” are no subset of “full IFRS.”

Notably, in a public consultation on the fitness check on the EU framework for public reporting, the majority of European respondents opposed introducing a carve-in option at the EU level, cautioning against further fragmentation of IFRS and potential undesirable consequences (European Commission, 2018). Against this background, it is astonishing to see the endorsement of Amendments of IFRS 4 with an EU-level scope extension of an optional exemption from IFRS 9, labeled a “top up” rather than referred to as a carve-in. The latter would be a well-established term in the context of IFRS endorsement deliberations.

## 3 | AMENDMENTS TO IFRS 4 BY THE IASB

Accounting for both financial instruments and insurance contracts substantially shapes the financial statements of insurance businesses and has been among the most controversial standard-setting topics on the IASB agenda (Hewa, Mala, & Chen, 2018; Walton, 2018). The recently completed IASB standard-setting projects addressing these topics imply major accounting changes for entities that are engaged in the insurance sector and prepare (consolidated) financial statements under IFRS:

- IFRS 9 “Financial Instruments” replaces IAS 39 “Financial Instruments: Recognition and Measurement.” In general, IFRS 9 has an effective date of January 1, 2018.
- IFRS 17 “Insurance Contracts” (based on the IASB project “Insurance Contracts—Phase II”) replaces the interim standard IFRS 4 “Insurance Contracts.” The original effective date of IFRS 17 is January 1, 2021, but it is likely to be further postponed (IASB, 2019).

The two new standards—IFRS 9 and IFRS 17, respectively—have different effective dates. This schedule is the result of issues anticipated during the slow progress of developing the new standard on insurance contracts, and was cautioned against by insurers and other stakeholders of the IASB. Critics expressed concerns about undesirable consequences—such as accounting mismatch, additional costs of implementation, and obstacles to financial statement users—if IFRS 9 is applied before IFRS 17. To address these concerns, the IASB (2016) issued “Applying IFRS 9 Financial Instruments with IFRS 4 Insurance Contracts (Amendments to IFRS 4)” in September 2016, that is, before IFRS 9 became effective and before IFRS 17 was issued.

The Amendments to IFRS 4 introduce an optional temporary exemption from IFRS 9, the so-called “deferral approach.” This pragmatic approach allows predominant insurers to apply the “old” standard for financial instruments (IAS 39) rather than the “new” one (IFRS 9) for annual periods beginning before January 1, 2021 (see IASB, 2019 for proposed further deferral until 2022). It thus optionally defers the application of IFRS 9 for those entities preferring to adopt the two new standards IFRS 9 and IFRS 17 simultaneously. An insurer that elects to apply the exemption from IFRS 9 must provide additional disclosures in financial statements that would facilitate a basic level of comparability with entities applying IFRS 9.

Most importantly, in our context, the temporary exemption from IFRS 9 is limited to predominant insurers, defined as insurers whose “activities are predominantly

connected with insurance” (IFRS 4 para. 20B). Predominance is further specified by indicators such as financial accounting ratios assessed at the level of the reporting entity. Therefore, only predominant insurance activities at the group level qualify for the exemption from IFRS 9 in consolidated financial statements. The IASB explicitly rejected suggestions to permit an exemption from IFRS 9 for other insurers, for financial conglomerates, or below the level of the reporting entity, aiming to focus on predominant insurers that would potentially be the most significantly affected by different effective dates of the two new standards. This scope thus reflects a compromise reached at the international level that attempts to balance industry needs, financial statement user’s demands and regulatory consistency.

## 4 | ENDORSEMENT OF AMENDMENTS TO IFRS 4 IN THE EU

### 4.1 | Deliberations in the endorsement process

At the EU level, the Amendments to IFRS 4 were subject to the endorsement process. While this process involves a number of EU-level institutions (Van Mourik & Walton, 2018), deliberations at two of them are of particular interest:

- European Financial Reporting Advisory Group (EFRAG): As a private expert institution involved in public consultations, EFRAG provides expert advice to the European Commission on whether IFRS meet the endorsement criteria.
- Accounting Regulatory Committee (ARC): Composed of representatives of EU member states, ARC provides opinion based on EFRAG’s advice to the European Commission on proposals adopting IFRS.

In September 2016, the European Commission formally requested EFRAG’s endorsement advice on the Amendments to IFRS 4. The request specifically asked EFRAG to address potential issues around economic competition and level playing fields within the EU financial service sector that may be raised by the amendments, notably by the exemption from IFRS 9. EFRAG’s final endorsement advice recommended the Amendments to IFRS 4 for endorsement (EFRAG, 2017). However, its feedback is quite ambiguous in regard to the scope of the temporary exemption from IFRS 9. EFRAG concludes that the focus on predominant insurers meets the endorsement criteria but does not address cost concerns of other entities engaged in the insurance sector. Although the IASB scope of the exemption from IFRS

9 may give rise to competition issues within the EU financial and insurance sectors, EFRAG does not consider itself “in a position to conclude whether this is material from an economic perspective” (EFRAG, 2017, p. 3). EFRAG’s expert advice, thus, appears to recognize notable opposition to the focus on predominant insurers, for example, from France. Ultimately, it opened the political path to extend the scope of the exemption from IFRS 9 within the EU.

Based on EFRAG’s advice, the discussion at the ARC centered on the question of whether to endorse the Amendments to IFRS 4 as they stand or with provisions that extend the scope of the exemption from IFRS 9. Notably, an informally distributed paper of the European Commission staff proposed a possible scope extension for insurance entities within bank-led financial conglomerates (which would not meet the predominance criterion) under additional safeguards. The positions expressed by representatives at the ARC meeting on January 31, 2017 were contradictory (ARC, 2017). One group of representatives, including the European Supervisory Authorities, opposed a scope extension, warning of regulatory inconsistencies, decreasing transparency in financial conglomerates’ financial statements, potential competition effects in the banking sector and issues with bank supervision. Another group of representatives supported a scope extension as a way to mitigate concerns expressed by EU financial conglomerates and potential competition effects without causing either severe or permanent deviations from IFRS. Other representatives favored maintaining the scope as it stood but signaled a willingness to compromise. Notably, the representative of the European Central Bank stated that they would not generally oppose scope extension “provided that it (i) is deemed absolutely necessary by the European Commission; (ii) does not result in material banking activities being eligible to defer IFRS 9; (iii) avoids accounting arbitrage; (iv) contains a sunset clause” (ARC, 2017, p. 4). On June 29, 2017, the ARC gave a positive opinion on the endorsement of the Amendments to IFRS 4 with a scope extension under specific safeguards.

Despite further warnings by the European Supervisory Authorities (2017b), the political decision to extend the scope of the temporary exemption from IFRS to financial conglomerates in the EU was, in fact, settled. The protocols of the deliberations at the EU level refer to the scope extension as a “top up.”

### 4.2 | Final endorsement with “top up”

Regulation (EU) 2017/1988 endorsed the Amendments to IFRS 4 including the “top up.” Article 2 of this regulation states: “A financial conglomerate... may elect that none of its entities operating in the insurance sector... apply

IFRS 9 in the consolidated financial statements for financial years the commencement of which precedes 1 January 2021.” To elect to defer IFRS 9 in the insurance sector of a financial conglomerate, several safeguarding conditions must be met. These conditions include the ban on transfers of financial instruments between the insurance sector and any other sector of a financial conglomerate (to limit accounting arbitrage); and provision of additional required disclosures, such as separate disclosures on financial instruments for the insurance sector and the rest of the financial conglomerate (to maintain a basic level of financial information quality and comparability).

The European Commission seems to be aware that this “top up” is not only pragmatic but also has strange effects. However, it considers the safeguards sufficient to mitigate undesirable consequences that may occur during the limited period before IFRS 17 becomes effective.

## 5 | ISN'T THE “TOP UP” A CARVE-IN AT THE EU LEVEL?

To date, the EU scope extension (and deviation from IFRS 4 as amended by the IASB) is mostly referred to as a “top up” rather than a “carve-in.” Only a few opponents of the scope extension use the latter term (e.g., European Supervisory Authorities, 2017a). Using the term “top up,” however, is likely to play down the modification of the content of IFRS 4 as amended by the IASB at the EU level. Tellingly, a proponent of the scope extension stated: “The solution is pragmatic as it changes the scope while not modifying the IASB's approach and being consistent with international standards in the longer term” (ARC, 2017, p. 3). This view somewhat glosses things over:

- It is true that the EU solution is pragmatic. However, it modifies the content of IFRS 4 as amended by the IASB in a way that is not explicitly provided for in the regulations on the endorsement process.
- It is true that the EU solution merely changes the scope of application of the exemption from IFRS 9. However, it modifies the approach taken by the IASB, which explicitly denies financial conglomerates an exemption from IFRS 9.
- It is true that the EU solution merely leads to temporary inconsistencies with IFRS as issued by the IASB given the sunset clause. However, it is inconsistent with IFRS 4 for an interim period that is likely to be prolonged beyond 2021 (IASB, 2019)—or even 2022—depending on the final effective date of IFRS 17.

Avoiding the term “carve-in” cannot obscure the fact that the EU modified the content of an IFRS standard,

that is, IFRS 4, in the endorsement process. This modification undoubtedly constitutes what is generally referred to as a carve-in, and the remainder of this paper uses the latter well-established term. Although it could be argued that the “top up” is a special case of a carve-in, the EU established an unprecedented case of a carve-in that has implications from both regulatory and practical perspectives.

## 6 | IMPLICATIONS

### 6.1 | Regulatory perspectives

From a regulatory perspective, the carve-in is an undeniable fact, yet overall, its occurrence is astonishing. First, the carve-in contrasts with the views expressed in general consultations at the EU level that cautioned against carve-ins (European Commission, 2018). Second, the EU endorsement process does not explicitly provide the carve-in as an instrument. Third, the carve-in implies a novel breach of uniform accounting policies in consolidated financial statements because a financial conglomerate making use of the provisions of the carve-in will be accounting for financial instruments under IAS 39 for its insurance sector but under IFRS 9 for the rest of the group.

Local deviations from “full IFRS” (as issued by the IASB) are known to hamper the IASB's mission to establish and maintain a consistent set of accounting standards for use around the globe. Carve-ins enhance the toolbox in the EU endorsement process by allowing for further deviations from “full IFRS” and are contrary to the interests of the IASB (2018). Therefore, the present case of a carve-in is a crucial event impacting international regulatory consistency and the legitimacy of the IASB. This carve-in appears to express a willingness to foster the fragmentation of the international accounting system and a trend toward a set of “EU IFRS,” which is welcomed only by a minority of European constituents.

Proponents of carve-ins in the EU typically offer two arguments. First, carve-ins would emphasize and effect EU regulatory sovereignty and flexibility in accounting standard-setting, which is a privilege enjoyed by a number of non-EU jurisdictions. Second, the threat of carve-ins could increase the EU's influence over the IASB standard-setting process (European Commission, 2018). The present case is clearly consistent with the first argument. However, the second argument cannot be assessed because it is unlikely that the unprecedented carve-in could have been anticipated in the IASB standard-setting process.

While non-EU stakeholders of the IASB typically scrutinize EU influence over the IASB with a skeptical eye (Dobler & Knospe, 2016), it could be argued that a



carve-in mechanism might mitigate EU pressure on the IASB. With a carve-in, the EU could modify the content of an IFRS standard as issued by the IASB beyond a “yes–no” endorsement decision if that standard does not meet the particular needs of the EU (or some of its member states). However, it is unlikely that European players will forfeit power in the IASB standard-setting process and concentrate on the endorsement process rather than continuing to lobby on both levels. Regardless, a carve-in option would lead to a relative shift of politics to a within-EU level.

The present case illustrates this facet of the politicization of accounting standard-setting in the EU. It highlights that representatives from a limited number of EU member states (those with major financial conglomerates, such as France) did not succeed in extending the scope of the exemption from IFRS 9 in the IASB standard-setting process. However, they succeeded to do so in the European endorsement process, despite notable opposition from other EU member states and the European Supervisory Agencies. This experience establishes that particular political interests can be and actually are enforced in the EU endorsement process even beyond EFRAG’s public consultation processes recently investigated by Gäumann and Dobler (2019).

Although the present carve-in can be seen as a temporary pragmatic solution for a specialized sector where no perfect solution can be obtained, it has created a precedent, which will likely be referred to in future cases where strong players in the EU seek to modify the content of an IFRS standard as issued by the IASB. It is an open question whether another pragmatic carve-in will be limited to an interim period and a specialized sector or if one may go beyond. It is likely that the EU has opened Pandora’s box.

## 6.2 | Practical perspectives

From a practical perspective, there are implications for the preparers and users of financial statements. An EU-based financial conglomerate within the extended scope offered by the EU carve-in would need to decide whether to exert the exemption from IFRS 9 based on cost–benefit considerations. The insurance sector of a conglomerate can benefit from the deferral of IFRS 9 by gaining essential time to accomplish its complex adoption process and by avoiding accounting mismatch induced by the stepwise initial adoption of IFRS 9 and IFRS 17. However, financial conglomerates exempting from IFRS 9 in their insurance sectors could incur additional costs related to skeptical or adverse reactions by financial statement users (or supervisory authorities). Therefore, financial

conglomerates are likely to exert the option provided by the carve-in in different ways.

For financial statement users, the EU carve-in is likely to cause unparalleled issues in financial statement analysis. These issues relate to the limited note disclosures required (and actually provided) by EU-based financial conglomerates opting for exemption from IFRS 9 in their insurance sectors and novel issues in the intercompany comparability of financial statements within financial sectors due to the lack of uniform accounting practices. Comparability is particularly challenged between EU-based financial conglomerates electing for exemption from IFRS 9 and (a) EU-based financial conglomerates not doing so; (b) financial conglomerates outside the EU that must apply IFRS 9; (c) predominant insurers either electing for exemption from or applying IFRS 9; and (d) banks and other entities that must apply IFRS 9.

To assess the scope of the challenges to comparability, it is important to know how financial conglomerates are actually exerting the option provided by the carve-in. To obtain evidence, I used a list of European financial conglomerates compiled by the Joint Committee of European Supervisory Authorities (2018). This list contains 78 conglomerates based in the EU or European Economic Area (EEA). I reviewed the 2018 consolidated financial statements of these conglomerates and checked those prepared under IFRS for disclosures on the exemption from IFRS 9. The key findings are as follows:

- As shown in Exhibit 1, there are only 10 financial conglomerates electing for exemption from IFRS 9 in their insurance sectors.
- Nine of them are EU-based, headquartered in France (4), Italy (3), Spain (1), and Portugal (1). These are “southern” EU member states whose constituents and representatives rather favored the scope extension. The tenth conglomerate is headquartered in Norway, where “EU IFRS” are used under the EEA agreement.
- Several further financial conglomerates, such as Allianz (Germany) and Delta Lloyd (Netherlands), qualify as predominant insurers. These conglomerates could choose exemption from IFRS 9 in their insurance sectors (under the EU carve-in) or for the entire group (under the original provisions of IFRS 4). However, all of them chose the latter, as do the vast majority of European predominant insurers.

The findings suggest that European financial conglomerates are overall making limited use of the exemption from IFRS 9 specifically provided by the carve-in. However, findings advise caution in analyzing and interpreting the consolidated financial statements of the

### EXHIBIT 1 EU/EAA-based financial conglomerates electing for temporary exemption from IFRS 9 in their insurance sectors

Financial conglomerate	Country
BNP Paribas	France
BPCE	France
CaixaBank	Spain
Crédit Mutuel	France
Crédito Agrícola	Portugal
Credito Emiliano	Italy
Gjensidige	Norway
Intesa San Paolo	Italy
Société Générale	France
Unipol	Italy

Source: Consolidated financial statements 2018 of financial conglomerates identified by the Joint Committee of European Supervisory Authorities (2018).

conglomerates listed in Exhibit 1 and comparing them to other (financial) entities. Novel issues of comparability imposed by the EU carve-in should be seen in context, as they complement existing caveats in insurance accounting under IFRS that offer enormous room for judgment and earnings management currently and in the transition to IFRS 17 (and IFRS 9).

## 7 | CONCLUSIONS

In the EU, Regulation (EU) 2017/1988 represents an unprecedented case of modifying the content of an IFRS standard as issued by the IASB in the EU endorsement process. What is labeled as “top up” is, in fact, a carve-in at the EU level. This carve-in leads to a novel type of deviation between “full IFRS” as issued by the IASB and “EU IFRS” applied in the EU. Thus, “EU IFRS” are no longer a pure subset of “full IFRS.”

While pragmatic, the EU's decision to offer financial conglomerates a temporary exemption from IFRS 9 is clearly political. Although it only affects a specialized sector and for a limited period of time, the carve-in is likely to have opened Pandora's box. It has created a precedent that will perhaps be referenced in future deliberations over controversial endorsements and thereby potentially lead to further fragmentation of IFRS in the future.

Financial statement users and analysts should be aware of the limited comparability between and lack of uniform accounting practices in the consolidated financial statements of financial conglomerates exempting from IFRS 9 in their insurance sectors. Given further

room for discretion under the current IFRS, we must cope with an almost “anarchic” period in insurance accounting under IFRS until both IFRS 9 and IFRS 17 are consistently applied. This is unlikely to be realized before 2022 (IASB, 2019).

Considering all aspects—such as the far-reaching regulatory implications of the EU carve-in and the small number of financial conglomerates that are actually making use of it—the ultimate issue emerges: Was it truly worth it?

### CONFLICT OF INTEREST

The author declares no potential conflict of interests.

### DATA AVAILABILITY STATEMENT

The data that support the findings of this study are available from the sources indicated in the text and from the author upon request.

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**How to cite this article:** Dobler M. The European Union's endorsement of Amendments to International Financial Reporting Standard 4: An unprecedented “top up.” *J Corp Acct Fin*. 2020;31: 190–196. <https://doi.org/10.1002/jcaf.22436>