

Implementation of IFRS 17 'Insurance Contracts'

Companion document on key judgements and accounting
policy choices

Global Public Policy Committee - January 2020



Preface

We are pleased to share this companion document to ‘The implementation of IFRS 17 Insurance Contracts’ which has been issued by the Global Public Policy Committee (GPPC)¹.

IFRS 17 fundamentally rewrites the accounting rules for insurance contracts set out in IFRS 4 ‘Insurance Contracts’. IFRS 4 was an interim accounting standard, primarily focused on enhancing disclosure, that was designed by the IASB to allow entities issuing insurance contracts to carry on accounting for them using policies that had been developed under their legacy accounting standards. The multitude of different approaches that presently exist under IFRS will cease when IFRS 17 comes into effect. Although the definition of an insurance contract remains largely unchanged in the replacement Standard, significant changes to the measurement, classification and disclosure of insurance contracts are required.

With IFRS 17’s anticipated mandatory effective date of 1 January 2022 moving ever closer, all types of businesses, and not just registered insurance businesses, need to start evaluating the impact of the new Standard now.

This companion paper discusses key judgments and accounting policy choices that insurers will have to consider on topics such as:

- the level of aggregation
- combining and separating out insurance contracts
- contract boundaries
- general measurement model, including estimation of future cash flows, discount rates, risk adjustment, and contractual service margin (CSM)
- premium allocation approach (PAA)
- variable fee approach (VFA)
- reinsurance, including measurement differences, contract boundary and coverage periods, and presentation
- transition, including discussion of the full retrospective approach, modified retrospective approach and fair value approach
- presentation, and
- disclosure.

It also summarises major changes to presentation and disclosure and sets out some questions for management related to key judgements and accounting policy choices that should be considered during the implementation of IFRS 17.

¹ The Global Public Policy Committee (GPPC) of the world’s six largest accounting networks comprises representatives from BDO, Deloitte, EY, Grant Thornton, KPMG and PwC.



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Global Public Policy Committee¹ of representatives of the six largest accounting networks

¹ GPPC is comprised of BDO International, Deloitte, EY, Grant Thornton, KPMG International, and PwC. One of the GPPC's primary objectives is to participate constructively in shaping global public policy in the public interest.



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1. Overview / Background on paper

This document was prepared as a companion document to ***Implementation of IFRS 17 Insurance Contracts: Considerations for those charged with governance January 2020*** and should be read in conjunction with that paper. This paper focuses on key judgements and accounting policy choices faced by insurers related to the adoption of IFRS 17.

Preamble

In May 2017, the International Accounting Standards Board (IASB) issued IFRS 17 *Insurance Contracts* (IFRS 17) which is proposed in the Exposure Draft² to become effective for reporting periods beginning on or after 1 January 2022, heralding a new era of accounting for insurers. The current standard, IFRS 4 *Insurance Contracts* (IFRS 4), focuses on enhanced disclosures and allows insurers and reinsurers (thereafter together insurers) to continue using their local GAAP with certain limitations. IFRS 17 provides principle-based requirements that aim to improve the comparability of the measurement and presentation of insurance contracts across entities reporting in jurisdictions applying International Financial Reporting Standards (IFRS). As in IFRS 17 itself, references in this paper to insurance contracts also include reinsurance contracts and investment contracts with discretionary participation features unless specified otherwise.

The impact of IFRS 17 will be felt by many stakeholders, including, but not limited to: preparers of financial statements, those charged with governance, investors, regulators, analysts and auditors. Given the importance of insurance entities to the financial service industry as well as to the wider economy, it is essential that the new standard is implemented effectively.

The impact of IFRS 17 on financial statements and key performance indicators (KPIs) will likely vary significantly based on circumstances and characteristics of the issuer:

- products presently classified as “Life” or “long duration” are likely to see their accounting model and earning patterns modified more significantly than products presently classified as “property-casualty” or “short duration” (with this being subject to detailed analysis of precise terms as the range of insurance products is complex and varies widely from country to country and is often influenced by local law and regulation);
- insurers operating across multiple jurisdictions with geographical spread will typically need to model a diverse range of insurance products and consider a more diverse range of accounting and measurement models;

² The IASB issued an Exposure Draft in June 2019 which included various proposed changes to IFRS 17.



- organisational structure, size, the variety of products, and the means of distribution will also drive the level of practical difficulty in the implementation of the standard.

No matter the approach selected, or the size and scale of an entity's project to implement IFRS 17, investors, boards and regulators need to understand the status of an entity's IFRS 17 implementation project, the anticipated impact that IFRS 17 will have on financial reporting (including KPIs), and the key judgements, significant estimates, and assumptions made by management. Judgements and key decisions include estimates, interpretations of the standard, explicit accounting policy choices, accounting and actuarial methodologies, governance, processes and controls as well as decisions over system solutions. As representatives from the largest six accounting networks, we are familiar with the challenges and key decisions that matter most with respect to IFRS 17 and are closely following and involved in how the insurance industry is addressing them.

The Global Public Policy Committee (GPPC) is publishing this paper to assist those charged with governance, which may be a Board of Directors (the board) and/or an Audit Committee, to fulfil their responsibilities with respect to an effective implementation of IFRS 17. This paper can help those charged with governance evaluate management's progress towards implementation of IFRS 17.

Section 2 of this paper provides background on the key judgements and accounting policy choices entities will need to make, Section 3 covers major changes to presentation and disclosure requirements introduced by IFRS 17, while Section 4 gives those charged with governance questions they can ask of management. The key judgement and accounting policy choices in this paper were selected as they are some of the most prevalent across industry participants. They are not intended to be comprehensive. Each insurer, and the insurance contracts that it writes, will have unique facts and circumstances that will need to be assessed individually.

About this paper

The GPPC is the global forum of representatives from the six largest international accounting networks – BDO, Deloitte, EY, Grant Thornton, KPMG and PwC. Its public interest objective is to enhance quality in auditing and financial reporting.

The information contained in this paper is meant to reflect general considerations. It does not provide interpretations and does not replace insurers' own research and interpretation or application of IFRS 17. Further analysis will be needed for an insurer to apply IFRS 17 to its own facts, circumstances and individual transactions.

Unless otherwise noted, any technical discussion in this paper is based on IFRS 17 as issued by the IASB in May 2017. An Exposure Draft incorporating proposed changes was issued in June 2019. This document identifies the main areas that may be impacted by the exposure draft by



providing footnotes. The comment period for the Exposure Draft closed in September 2019. The IASB is in the process of reviewing the comments received and deliberating the proposed changes. A revised standard is anticipated by the middle of 2020. The interpretation and application of IFRS 17 may also change as practice continues to develop. Insurers should read this publication in conjunction with the actual text of the effective accounting standard and associated implementation guidance and consult their professional service advisors before concluding on accounting treatments for their own transactions. Given the forthcoming amendments to IFRS 17, those charged with governance should have a good understanding of how the forthcoming amendments may impact the entity and how the entity's project plan will respond to such changes when the amendments are finalised.

After publication of IFRS 17, the IASB has supported implementation through the formation of the IFRS 17 Transition Resource Group (TRG). The purpose of the TRG is to provide a public forum for stakeholders to follow the discussion of questions raised on implementation issues and inform the IASB about possible actions that may need to be taken to address those questions. Members of the TRG include financial statement preparers and auditors (from different countries) with both practical and direct knowledge of implementing IFRS 17. As a result, IFRS 17 interpretation is developing. While non-authoritative, these discussions should be considered by entities when making judgements and decisions about implementation. The TRG's last meeting was in April 2019. TRG material can be accessed on the IASB website: <https://www.ifrs.org/groups/transition-resource-group-for-insurance-contracts/>

This paper does not address the accounting requirements of IFRS 9 *Financial Instruments* (IFRS 9) although readers may wish to read "The implementation of IFRS 9 impairment requirements by banks" that was issued by the GPPC in 2016. While aimed at banks, we are of the view that this paper on IFRS 9 may be of use to insurers when it comes to implementing IFRS 9's impairment requirements. For many insurance groups, both IFRS 9 and IFRS 17 will be implemented at the same time, which increases the implementation risk of both standards. As part of their IFRS 17 implementation projects, insurers will need to understand the interaction between the accounting requirements of the two standards and make coordinated accounting policy choices to reduce or eliminate accounting mismatches which could otherwise arise.

IFRS 17 addresses the accounting for insurance contracts, so applies to all entities issuing insurance contracts, even if they are not insurance entities. This paper is intended primarily for insurance entities or groups that have significant insurance operations.

This Paper does not purport to in any way amend or interpret the requirements of IFRSs. The GPPC acknowledges that issuing and amending of IFRSs and International Financial Reporting Interpretations Committee (IFRICs) interpretation is reserved for the IASB and the IFRS Interpretations Committee.



2. Key judgements and accounting policy choices

The measurement method for insurance contracts required by IFRS 17 is a probability weighted discounted cash flow model, including a best estimate and an adjustment for non-financial risk calculated for groups of similar contracts. It relies heavily on actuarial modelling techniques and the quality of underlying data.

Those charged with governance need to be informed of, review and challenge key judgements including estimates and accounting policy choices made by management in applying IFRS 17. This includes understanding the classification and grouping, recognition and measurement, and presentation and disclosure principles of IFRS 17, as well as being informed of the various accounting options and local and group judgements management applies in the interpretation of the standard. There are several important issues relevant in applying IFRS 17 for the first time. These require special focus by those charged with governance. This section highlights some of these key issues and judgements that apply to insurance contracts. However, those charged with governance should ask management which of the key judgements are most critical to the entity and have the most significant impact on measurement and/or financial reporting.

2.1 Level of aggregation

The level of aggregation, or unit of account, is a critical aspect of the measurement of insurance contracts as it determines how individual contracts are grouped for measurement and reporting purposes. Contracts must be allocated to groups based on portfolio, date of issue, and expected profitability. For groups of contracts that are expected to be onerous at inception, IFRS 17 requires the immediate recognition of the expected loss, while the expected profit on other contracts is recognised over time.

Establishing the level of aggregation requires significant judgement. There are two key terms: “portfolio” and “group” of insurance contracts. Portfolios include insurance contracts with similar risks that are managed together. There is no explicit definition of “similar risks” in IFRS 17, however contracts within the same product line would generally be expected to have similar risks. There is also no specific guidance in IFRS 17 on what constitutes “managed together”. As such, activities such as pricing, underwriting, reporting, product development, claims management, portfolio management, risk management, etc. may be considered to determine if contracts or sets of contracts should be aggregated in the same portfolio. Depending on how the entity manages its business and defines similar risks the application of the portfolio concept has the potential to lead to differences between entities.

Portfolios need to be further disaggregated into groups based on the contracts’ expected profitability: a) onerous, i.e. loss making; b) profitable contracts, with no significant possibility of becoming onerous; and c) other profitable contracts. The grouping is not reconsidered after initial



recognition. For accounting purposes an entity is prohibited from grouping insurance contracts issued more than one year apart (exceptions are available on first-time application)³.

2.2 Combination and separation

IFRS 17 sets out the requirements for when multiple insurance contracts with the same counterparty (or a related counterparty) should be combined and measured as a single contract because the set or series of insurance contracts are designed to achieve an overall commercial effect. When making this assessment, relevant factors to consider include: a) whether the rights and obligations are different when assessed on a combined basis versus an individual basis; b) whether there is an interdependency between the contracts such that an entity is unable to measure one contract without considering the other; and c) whether the lapse or maturity of one contract will cause the lapse or maturity of another.

There may be cases where the legal form of having multiple contracts does not reflect the substance that there is a single economic arrangement. In the analysis of whether the contracts achieve, or are designed to achieve, an overall commercial effect, significant judgement and consideration all relevant facts and circumstances may be required. The fact that contracts were entered into at the same time with the same counterparty, or the existence of a discount, are not sufficient by themselves to conclude that contracts should be combined.

An insurance contract is generally considered the lowest unit of account even where the contract contains more than one type of insurance coverage. However, there may be circumstances where the legal form of a single contract would not reflect the substance of the contractual rights and obligations. This could be the case where clearly separate coverages are included within a single document simply for administrative convenience. In this case it would be necessary to separate insurance coverages within a contract.

Some insurance contracts contain components in addition to insurance coverage that would be within the scope of another accounting standard if the component were a separate contract. These distinct components fall into one of three categories: embedded derivatives; investment components; and promises to transfer distinct goods or non-insurance services. If certain criteria are met, a component is separated from the host insurance contract and accounted for under the related accounting standard. Determining, based on the qualitative characteristics of the contract and quantitative assessment of the impact of certain provisions, whether the criteria for separation are met requires judgement and may have a significant impact on the presentation and profitability of groups of contracts.

³ In applying the measurement requirements of IFRS 17, the calculation methodology for insurance liabilities may aggregate several annual cohorts where the contracts fully share risks over several years if doing so will give the same answer as using annual cohorts.



Finally, investment components which are not distinct require identification because IFRS 17 contains specific guidance on their accounting and presentation. The standard defines an investment component as “amounts that an insurance contract requires the entity to repay to a policyholder even if an insured event does not occur”⁴. Receipts and payments of non-distinct investment components are not included in insurance revenue or insurance service expense.

2.3 Contract boundary

The contract boundary is important because it (amongst other things) defines which cash flows are included in the measurement of a group of insurance contracts. It also defines the limit at which future cash flows should not be included, as they would be considered part of insurance contracts that are to be issued in the future (including certain contract renewals). Cash flows that arise from rights and obligations outside of the contract boundary are not considered when measuring a group of insurance contracts. Consideration needs to be given to the economic substance of options and riders within a contract, and whether these are measured as part of the original contract or represent separate contracts at initial recognition.

Cash flows are within the boundary of an insurance contract if they arise from substantive rights and obligations that exist during the reporting period, where the entity can compel the policyholder to pay the premiums, or in which the entity has a substantive obligation to provide the policyholder with services. When assessing the contract boundary, the entity must consider its substantive rights and obligations arising from the contract. Contractual terms include all terms written explicitly within the contract, as well as terms imposed by law or regulation.

If an entity has the practical ability to reassess the risk presented by a policyholder and has the right to fully reprice the risks without constraints, or to terminate the contract, then the cash flows related to premiums and resulting claims occurring after the repricing or termination date will be outside of the contract boundary unless there is a right to compel the policyholder to continue paying premiums. In addition, the contract boundary ends where the insurer has the practical ability to reprice the risks of the portfolio that contains the contract, and the pricing of premiums up to that date did not consider risks that relate to after the reassessment date.

Determining the boundary of the contract, based on its characteristics and various commercially substantive scenarios, requires judgement and may have a significant impact on its measurement and profitability.

⁴ The Exposure Draft proposes to change this definition to “amounts that an insurance contract requires the entity to repay to a policyholder in all circumstances, regardless of whether an insured event occurs”



2.4 General measurement model

The general measurement model is the default measurement model for all insurance contracts under IFRS 17 and is applied unless an insurance contract meets the requirements to apply the variable fee approach or an entity elects to apply the premium allocation approach.

The impact of applying the general measurement model will be most pronounced in jurisdictions where profits on long-term products are currently recognised at inception. IFRS 17 requires these profits to be deferred and recognised over the coverage period, which will significantly change the profit patterns for these products.

The general measurement model requires insurance liabilities to be determined using a current estimate (probability-weighted mean) of future cash flows; adjusted to reflect the time value of money and other financial risks (such as liquidity and currency risks); an explicit risk adjustment for non-financial risks; and a contractual service margin (CSM) representing the unearned profit from the groups of contracts.

Estimates of future cash flows

IFRS 17 provides guidance on which types of cash flows within the contract boundary will be included in the measurement. However, judgement is needed to assess the appropriateness of including certain cash flows in contract measurement. These judgements include, for example, what constitutes acquisition costs whether acquisition costs are directly attributable to a portfolio and which overhead costs are directly attributable to fulfilling the insurance contracts⁵.

IFRS 17 also provides guidance on the principles for calculating estimates of future cash flows. Most insurers currently produce estimates of future cash flows for insurance liability valuation purposes by projecting cash flows and discounting these cash flows (although in some jurisdictions property and casualty claims are not discounted). Existing accounting models differ significantly in the extent to which these cash flows are updated for current information.

The estimates of future cash flows made for IFRS 17 purposes must be updated at each reporting period and must incorporate all reasonable and supportable information available to the insurer, without undue cost or effort. The insurer is required to estimate the expected value, i.e. probability-weighted mean of a range of scenarios that reflects the full range of possible outcomes. The insurer is not required to identify every possible scenario as long as the objective of the standard is met, i.e. there is no bias in the estimate.

Cash flows need to be determined at the required level of aggregation for IFRS 17 – namely at the group level. For many insurers, cash flow information has not previously been tracked and reported at this level of granularity.

⁵ The Exposure Draft proposes that insurers should allocate part of the insurance acquisition cash flows to expected contract renewals (outside of the existing contract boundary) and recognize those costs paid as an asset until the insurer recognizes the contract renewals



Discount rate

Discount rates should reflect the time value of money and financial risks. They should be consistent with observable market prices for instruments with similar characteristics (e.g. timing, currency and liquidity) as the insurance contract cash flows. Discount rates should not be adjusted for factors that influence market prices but do not affect the cash flows of the insurance contract. If cash flows include the effect of inflation, the discount rate should be a nominal rate and is not adjusted for inflation.

IFRS 17 introduces two methods of calculating discount rates: top-down or bottom-up. Either method may be used and there is no requirement to reconcile the rates established by these different methods. In applying the bottom-up method, an entity first determines a risk-free yield curve and then makes an adjustment for illiquidity. The illiquidity adjustment reflects the fact that policyholders often either cannot terminate the contract, or can terminate only subject to surrender penalties, whereas a risk-free curve usually reflects the yield on highly liquid debt instruments or swap curves. The determination of the risk-free rate beyond the last observable/liquid point and the illiquidity adjustment require significant judgement.

In applying the top-down method, entities need to identify a relevant reference portfolio and then adjust the yield curve implied by the reference portfolio to remove factors that do not reflect the characteristics of the insurance contract cash flows. The most significant adjustment is the removal of compensation for credit risk from the return on the reference portfolio (differences in liquidity do not need to be adjusted for). Estimating this adjustment, and identification of a relevant reference portfolio will both require significant judgement.

A locked-in interest rate, which is the discount rate established on initial recognition of a group of contracts, is used for the accretion of interest expense on the CSM under the general measurement model, which is discussed below. For estimating the discount rate on initial recognition, a weighted average discount rate over the period during which the contracts in a group are issued may also be used.

For the presentation of interest expense in the profit and loss account on future cash flows, there is an accounting policy choice. Entities may include the total discounting expense (including the effects of changes in market discount rates) and changes in financial risk in profit or loss as insurance finance income or expense; or they may elect to separate out the effects of changes in current discount rates and present that component of insurance finance income or expense in other comprehensive income (OCI). This policy choice is made at the level of portfolios of insurance contracts.

Risk adjustment

The risk adjustment for non-financial risk is defined as the compensation an insurer requires for bearing uncertainty about the amount and timing of future cash flows as it fulfils the contract. The risk adjustment is measured and presented separately from future cash flows and explicit disclosures will be required about the risk adjustment component, and movements of the balance.



There is no prescribed method in IFRS 17 for how to calculate the risk adjustment, however any method used must meet the definition. The risk adjustment can be calculated at the entity level (i.e. a higher level of aggregation) and allocated to groups based on a systematic and rational basis. The risk adjustment should consider a diversification benefit (e.g. risk is lower if different products issued are pooled or have offsetting risks) if diversification is taken into account when an entity estimates the compensation that it requires for bearing non-financial risks. A separate risk adjustment is calculated for direct insurance contracts issued and for reinsurance contracts held. The reinsurance contracts held risk adjustment is calculated as the amount of risk arising from the underlying direct contracts that is transferred to the reinsurer. If the risk adjustment is determined using a method other than a confidence level method, an equivalent confidence level for the risk adjustment must still be determined and disclosed in the financial statements.

There is a risk adjustment for the liability for unexpired coverage and for the liability for incurred claims. These risk adjustments are re-measured each reporting period. The release of risk for past or current coverage is recognised in insurance revenue, while re-measurement relating to future coverage is recognised in the CSM described below. Insurers have an accounting policy choice whether to separately present the effect of discounting of the risk adjustment in the insurance service result or include it as part of insurance finance income or expenses.

Contractual service margin (CSM)

The CSM represents the unearned profit for a group of contracts. The CSM cannot be negative for insurance contracts issued. (See section 2.7 for CSM treatment for reinsurance contracts held). As a result, any contracts that are expected at issuance to be unprofitable result in the reporting of a loss at initial recognition. The CSM is adjusted for changes in future cash flows and the risk adjustment that relate to future services. However other types of changes in cash flows, such as those related to past or current service, are taken to profit or loss. If the CSM for a group of contracts is exhausted, the group becomes onerous. Any further change to fulfilment cash flows that would reduce the CSM below zero is recognised as a loss in profit and loss. The amount below zero is tracked as a loss component and in the event that future changes in assumptions make the group profitable again, the loss component is brought to zero first before a CSM is reinstated.

The CSM is released into insurance revenue based on coverage units, which reflect the quantity of benefits and the expected coverage duration of contracts within the group⁶. For many products (for example life insurance products with multiple coverages, credit life insurance, mortgage loss cover, universal life insurance, deferred annuities, extended product warranty, other bundled products and the reinsurance of adverse development of claims), the determination of quantity of

⁶ The Exposure Draft proposes that the CSM is released to insurance revenue based on both insurance and investment-return services (or investment-related services for contracts in the scope of the Variable Fee Approach)



benefits will require judgement. The coverage units are reviewed and updated at each reporting period.

The introduction of the explicit CSM is one of the key aspects of IFRS 17 that differs from the accounting policies previously applied and poses many implementation challenges. For most insurers, it requires new system solutions (or calculation models), many of which are currently being developed by third party vendors.

2.5 Premium allocation approach (PAA)

The PAA is an optional measurement model and a simplification of the general measurement model for the calculation of the liability for unexpired coverage, which represents the liability for unexpired coverage in an insurance contract. The PAA simplifies the measurement of the liability for remaining coverage by removing the need to calculate a CSM and a risk adjustment in the pre-claims period. The liability for remaining coverage at initial recognition is calculated as premiums received less acquisition cash flows at the inception of the group of contracts. There are two options under which the PAA model can be applied:

1. If an entity reasonably expects that the PAA would produce a measurement of the liability for remaining coverage for the group that would not differ materially from the one that would be produced applying the general measurement model. Materiality is not defined in IFRS 17 and therefore the application of this condition involves judgement. If significant variability is expected in the cash flows in the period before claims are expected to arise, then this eligibility criterion would not be met.
2. If at inception of a group of contracts the coverage period of each contract in the group (including coverage arising from all premiums within the contract boundary determined at the date) is one year or less.

Under the PAA, an entity may choose to expense acquisition cash flows at inception of the group of contracts rather than including them in the measurement of the liability for remaining coverage (but only for groups containing contracts with a coverage period of one year or less). An entity may also elect not to adjust the liability for remaining coverage to reflect the time value of money if it expects, on initial recognition, that the time between providing each part of the coverage and the related premium due date is one year or less. In addition, entities are not required to adjust future cash flows in the liability for incurred claims for the time value of money and the effect of financial risk if those cash flows are expected to be paid or received in one year or less from the date the claims are incurred.



2.6 Variable fee approach (VFA)

This approach has been designed to account for contracts with direct participation features, i.e. contracts that are substantially investment-related service contracts under which an entity promises a return to policyholders based on underlying items. Participating contracts (where an insurer shares the performance of underlying items with policyholders) that meet all the following criteria must use the VFA for measurement:

- a) The contractual terms specify that the policyholder participates in the share of a clearly identified pool of underlying items;
- b) The entity expects to pay the policyholder a substantial share of the fair value returns on the underlying items; and
- c) The entity expects a substantial portion of any change in the amounts to be paid to the policyholder to vary with the change in fair value of the underlying items.

The interpretation of “substantial” in criteria b) and c) above involves significant judgement. This could lead to diversity in the classification of participating contracts b entities and across jurisdictions.

When applying the VFA, the CSM is adjusted for changes in the entity's share of the fair value of underlying items and for the effects on fulfilment cash flows of changes in financial risks not arising from the underlying items (such as minimum guarantees). The CSM is adjusted using the current discount rate rather than the locked-in discount rate required by the general model.

The CSM is released to insurance revenue based on the concept of coverage units (consistent with the general model) over the expected coverage period.⁷

For contracts that offer guarantees, the amount payable to policyholders includes financial risks for an entity. An entity may use derivatives to mitigate such risks. While the derivatives are measured at fair value through profit or loss, the fair value changes in the guarantees are recognised in the CSM under the VFA. IFRS 17 therefore permits an entity to reflect these changes in profit or loss to offset the impact of the derivatives, rather than adjust the CSM, if the risk mitigation criteria are met⁸.

⁷ The Exposure Draft proposes to amend the concept of coverage units and to make it clear that it should include, in addition to insurance services, the benefits from investment services from contracts measured under the VFA and from contracts measured under the general measurement model when they offer an investment-return service

⁸ The Exposure Draft proposes expanding the scope of the risk mitigation option to include risk mitigation through reinsurance, and to extend the period to which the option can be applied.



2.7 Reinsurance

There are no separate requirements in IFRS 17 to account for reinsurance contracts issued. As such, insurers follow the general requirements of IFRS 17 to account for these. However, IFRS 17 explicitly states that the VFA model cannot be applied to reinsurance contracts issued or held. As a result, only the general measurement model or PAA are applicable. This could result in complex accounting where an entity obtains reinsurance on underlying issued insurance contracts accounted using the VFA model.

For reinsurance contracts held, IFRS 17 introduces new measurement and presentation requirements. In addition to these, the key areas of judgement highlighted for insurance contracts throughout this paper also apply to reinsurance contracts issued.

Under IFRS 17, reinsurance contracts held are measured and reported separately from the underlying contracts that have been written by the entity. Nearly all aspects of accounting for reinsurance contracts held will involve significant judgement: level of aggregation, combination and separation, contract boundary and coverage units, measurement and presentation, and disclosure. These items are discussed further below. Some of these items may trigger measurement differences between the accounting applied to the underlying reinsured contracts and that of the reinsurance held.

Measurement differences

The CSM is the net cost of, or gain made from, the reinsurance held. The CSM on reinsurance held can be either positive or negative. However, onerous underlying reinsured contracts trigger recognition of an immediate loss⁹.

Non-performance risk of the reinsurer needs to be included in the measurement of fulfilment cash flows on a probability weighted expected basis for reinsurance held, and changes in the non-performance risk should be immediately recognised in profit or loss.

The discount rate applied to cash flows from reinsurance contracts held could differ from the discount rate used for underlying direct contracts due to potential differences in liquidity characteristics between the underlying reinsured contracts and the reinsurance contracts held.

The risk adjustment for non-financial risk on reinsurance held is measured as the amount of risk that is being transferred from the insurer to the reinsurer.

⁹ The Exposure Draft proposes that an entity that recognises losses on onerous insurance contracts at initial recognition also recognises a gain on reinsurance contracts held that: a) were entered into before or at the same time that the onerous underlying contracts are issued and b) provide proportionate coverage. In December 2019 the IASB tentatively decided to remove condition (b).



Contract boundary and coverage periods

The contract boundary and/or coverage period for reinsurance contracts held could differ from the contract boundary and/or coverage period of the underlying reinsured contracts. For example, certain reinsurance contracts are “risk attaching”, which means the coverage period of the reinsurance contract is not the same fixed duration as defined in the underlying contract. Instead, it provides coverage for the full duration of the coverage period of the underlying reinsured contracts attaching to the reinsurance contract.

For multi-year proportional reinsurance contracts held measured under the general measurement model and open to new business at fixed terms, expected future new underlying direct business not yet written is reflected in the reinsurance contract asset held, whereas it will not be included in the underlying direct insurance contract liability.

Presentation

An insurer has an accounting policy choice to present reinsurance income and expense separately or combined in one-line item in the income statement. Where a separate presentation is selected, a sub-total equal to the single amount should be provided.

2.8 Transition

Transition should be a priority focus area for those charged with governance given the significant level of judgement involved in determining the approach to use on transition, and the fact that transition choices may have a large impact on equity and reported profits for many years after the date of initial application

On transition, an entity should apply IFRS 17 retrospectively unless it is impracticable to do so. An entity has a choice to apply a modified retrospective approach or fair value approach if it is impracticable to apply IFRS 17 retrospectively for a group of insurance contracts. When both approaches are available to restate prior periods for which the full restatement is impracticable, IFRS 17 allows the entity to choose the restatement approach without constraint. However, an entity should use the fair value approach if it does not have reasonable and supportable information to apply the modified retrospective approach.

IFRS 17 does not define “impracticable”, although the term is used in IAS 8: *Accounting Policies, Changes in Accounting Estimates and Errors* which defines ‘impracticable’ in part as when the entity cannot apply the specific requirements of the standard after making every reasonable effort to do so. Insurers might consider it impracticable to apply the full retrospective approach where:

- a) the effects of the retrospective application are not determinable;
- b) the retrospective application is not possible without the use of hindsight; or



- c) the retrospective application requires significant estimates of amounts, and it is impossible to distinguish information about those estimates that would have been available on the historic recognition, measurement and disclosure dates.

Full retrospective approach

The full retrospective approach requires entities to recognise and measure each group of insurance contracts that are in force at the transition date¹⁰ as if IFRS 17 had always applied. For insurance products with long coverage periods, this requires a significant amount of data, estimation and calculations.

Modified retrospective approach

Applying the modified retrospective approach, entities should achieve the closest possible outcome to the full retrospective approach using reasonable and supportable information. Entities should maximise the use of information required for full retrospective application and are permitted to use modifications only if there is no reasonable and supportable information available, without undue cost or effort, to apply the full retrospective approach. There are simplifications available for the CSM for insurance contracts (including simplifications for future cash flows, discount rates and risk adjustment), and for the determination of insurance finance income or expenses. Most of these simplifications allow entities to approximate historic amounts by using current estimates and actual historical data, such as actual cash flows.

To the extent that an entity does not have reasonable and supportable information available to divide groups of contracts, they may include contracts issued more than one year apart in a single group when applying the modified retrospective approach.

Fair value approach

An entity can elect to use the fair value approach if the full retrospective approach is impracticable, and it must use the fair value approach if it does not have reasonable and supportable information to apply the modified retrospective approach.

Using the fair value approach, the CSM is determined as the difference between the fair value of a group of insurance contracts and its fulfilment cash flows at the transition date. The fair value of insurance contracts should be measured applying IFRS 13, *Fair Value Measurement*. The valuation of insurance contract liabilities at transition using the requirements of IFRS 13 will involve significant judgement, especially where there is a lack of market observable transactions for similar contracts for an insurer to use to estimate the fair value for its in-force business

Entities can identify groups of contracts using information at the transition date rather than the inception date, and they could include contracts issued more than one year apart in a single group

¹⁰ The transition date for a December 31 year-end would currently be 1 January 2020 given the effective date of IFRS 17 is currently 1 January 2021. The Exposure Draft proposes an effective date of 1 January 2022, thus these dates would be postponed by one year.



when applying the fair value approach. When using the fair value approach, IFRS 17 requires the recognition of CSM in future insurance revenue from the restated contracts to be from a single unit of account. The subdivision of the CSM into individual groups of contracts issued no more than one year apart is only possible if an entity has reasonable and supportable information to do this.

2.9 Presentation

Entities have an accounting policy choice on a portfolio basis to present all insurance finance income or expense in profit or loss, or to include insurance finance income in profit or loss using locked-in discount rates and present the effect of changes in discount rates separately in other comprehensive income (OCI). For contracts under the VFA, entities are allowed to disaggregate insurance finance income or expenses for the period to include in profit or loss an amount that eliminates accounting mismatches with income or expenses included in profit or loss from the underlying items held.

2.10 Disclosure

Disclosures prepared in accordance with IFRS 17 are expected to provide more transparency about insurers' financial results and provide more granular information to the users of financial statements than under existing practice. In particular, the reconciliations of the movements in the components of insurance contract assets and liabilities during the reporting period will provide additional information to users on the key drivers of profit.

Disclosures should be provided separately for insurance contracts issued and reinsurance contracts held. Financial statement disclosures will need to be disaggregated to provide users with an appropriate level of detail. Entities may determine an appropriate basis of aggregation for disclosure purposes by product line, geographic area, operating segment or some other basis.

The entity needs to explain when it expects to recognise in profit and loss the CSM remaining at the end of the reporting period. This information can be provided either quantitatively or qualitatively¹¹. If the PAA is used, insurers will disclose which eligibility criteria the group met and other options elected under the PAA. Other accounting policy choices that have been availed of will need explaining as well.

In addition to the above, significant judgements, sensitivity analysis, accounting policy choices, and risk exposures will have to be disclosed in the financial statement notes. Several disclosures (e.g. those relating to risk) are expected to be broadly similar to today's disclosures.

¹¹ The Exposure Draft proposes requiring quantitative disclosures.



3. Major changes to presentation and disclosure requirements

IFRS 17 requires all rights and obligations from a group of insurance contracts to be presented as a single asset or liability in one line in the statement of financial position, unless distinct components of the insurance contract (that is, embedded derivatives and distinct investment and service components) are separated. Under IFRS 4, various rights and obligations from insurance contracts are presented separately in the financial statements, such as insurance liabilities, policyholder loans, insurance premiums receivable, reinsurance funds withheld, deferred acquisition costs and insurance intangible assets. For many insurers, this is a significant change.

On the statement of financial position, insurers need to separately present the carrying amount of:

- a) groups of insurance contracts issued that are assets;
- b) groups of insurance contracts issued that are liabilities;
- c) groups of reinsurance contracts held that are assets; and
- d) groups of reinsurance contracts held that are liabilities.¹²

Acquisition cash flows relating to recognised insurance contracts are not presented separately as assets or liabilities, but they are included in the carrying amount of the related insurance contracts.

In the statement of financial performance, an insurer will separately present:

- a) insurance service result, containing insurance revenue and insurance service expenses; and
- b) insurance finance income or expenses.

Insurance revenue will reflect the consideration an insurer expects to be entitled to in exchange for providing insurance coverage and other services.

Insurance service expenses include incurred claims, other incurred insurance service expenses, amortisation of insurance acquisition cash flows, changes relating to past services and changes relating to future services (if not adjusted in the CSM). Insurance finance income or expenses reflect changes in the carrying amount of a group of insurance contracts for the effect of the time value of money, as well as the effect of financial risk and changes in financial risks.

¹² The Exposure Draft proposes that an entity present insurance contract assets and liabilities in the statement of financial position determined using *portfolios* of insurance contracts rather than *groups* of insurance contracts.



Some of the additional quantitative disclosures required by IFRS 17 were not required under IFRS 4. In practice, providing these numbers and collecting all the necessary information is likely to present operational challenges and should be considered when designing the system architecture. This will especially be the case, for example, for the requirement to provide detailed reconciliations of the opening and closing balances of net insurance and reinsurance assets or liabilities; to present the equivalent confidence level that the risk adjustment for non-financial risks represents; and the requirement to disclose the yield curve (or range of yield curves) used to discount cash flows.



4. Questions for management related to key judgements and accounting policy choices during implementation of IFRS 17

Technical area	Suggested questions
Level of aggregation	<ol style="list-style-type: none"> 1. How has management established the portfolios and groups? Has internal reporting been taken into consideration? 2. Are portfolios of contracts consistent with current business practice and management/underwriting/pricing of the contracts? 3. Is the grouping of contracts reflective of their expected profitability? 4. What is the estimated impact that the level of aggregation will have on results, e.g. will there be onerous contracts that will have to be recognised immediately and explicitly disclosed? 5. Have groups of contracts been identified as onerous at initial recognition without using hindsight? 6. What impact does the level of aggregation have on the ability to extract appropriate information from IT systems? 7. For multi-national companies, has management identified differences between the group policies and the local entity's policies for level of aggregation (for statutory reporting purposes)?
Separation and combination	<ol style="list-style-type: none"> 1. Has management assessed the guidance for combination and are there any sets or series of contracts that will have to be combined? 2. Has management evaluated whether separation of components of insurance contracts is a significant issue for the entity? 3. What is management's process to identify and separate the distinct investment components? 4. Has management considered the impacts of separating insurance coverages from contracts / combining contracts on systems?
Contract boundary	<ol style="list-style-type: none"> 1. Has management identified products where the contract boundary will require judgement (such as whether the insurer has the right to reassess the risk only at the level of a portfolio of contracts)? 2. How has management assessed whether options and riders impact the initial contract boundary?



Technical area	Suggested questions
General measurement model - Estimates of future cash flows and contractual service margin (CSM)	<ol style="list-style-type: none"> 1. Will there be a significant change from existing practice in how acquisition cash flows are defined and allocated¹³? 2. Does management expect significant changes in its modelling approach for its products? If so, what is the impact on the processes and systems, as well as on the financial results? 3. How did management determine coverage units (expected quantity of benefits and expected coverage duration) for release of CSM in revenue? 4. What systems have been considered for the calculation of the CSM? 5. What pattern of profit recognition does management expect and how does that differ from the current pattern? 6. How are experience adjustments assessed to determine whether they relate to past or to future service?
Discount rate	<ol style="list-style-type: none"> 1. How has management determined the discount rates for insurance contract liabilities, i.e. what method was applied? 2. What are the main objectives that have driven the choice (e.g. consistency with regulatory reporting, reduced volatility)? If a bottom-up method was used, how was the illiquidity adjustment determined? How frequently will the illiquidity adjustment be updated? 3. If a top-down method was used, how has the reference portfolio been determined? How has the credit risk from the return of this reference portfolio been determined and adjusted for? 4. What accounting policy choices has management made for the presentation of the effects of discounting in profit or loss? Will the OCI option be applied and what are the key drivers for management's choices? 5. What are the processes and systems impacts associated with the application of the OCI option?
Risk adjustment	<ol style="list-style-type: none"> 1. How has management ensured that the risk adjustment is reflective of the uncertainty in the amounts and timing of future cash flows that are associated with fulfilling the obligations arising from the groups of contracts it has issued? 2. Does the risk adjustment reflect the compensation that the entity requires for bearing uncertainty from non-financial risk and does it differ by portfolio?

¹³ The Exposure Draft proposes to account for an asset for insurance acquisition cash flows if these relate to future renewals.



Technical area	Suggested questions
	<ol style="list-style-type: none"> 3. What is the expected pattern for the release of the risk adjustment and how will that impact profit recognition? 4. What is the basis/justification for any differences of methodology between different products/segments? 5. How does the risk adjustment for non-financial risk compare to other measures of risk the company uses for other reporting? Can management explain any differences? 6. What data has been used to support the computation of the disclosed level of confidence? Has management made use of <ol style="list-style-type: none"> a. estimates, b. external or market data, or c. extrapolations?
Premium allocation approach eligibility	<ol style="list-style-type: none"> 1. Has management determined that any contracts are eligible for the PAA? 2. Is management intending to apply the PAA to contracts with a coverage period of longer than 12 months? How did management determine that the measurement of the liability for remaining coverage would not differ materially from the one that would be determined applying the general model? 3. Has management elected to expense acquisition cash flows (or not) at inception of any group of contracts accounted for under the PAA? What is the basis for management's choice?
Variable fee approach (VFA)	<ol style="list-style-type: none"> 1. The VFA is mandatory when certain criteria are met. How was judgement applied to assess whether these criteria were satisfied? Notably, how has the term "substantial" in the criteria been defined? 2. Has management elected to use the risk mitigation option? 3. What approach has been adopted to allocate the fulfilment cash flows from and to groups of contracts that affect or are affected by cash flows to policyholders of contracts in other groups (sometimes referred to as mutualisation)¹⁴
Reinsurance held	<ol style="list-style-type: none"> 1. Has management identified differences in the contract boundaries between direct contracts and the related reinsurance coverage held?

¹⁴ While the term mutualisation is not referred to in IFRS 17, some of the effects associated with features of mutualisation are addressed in IFRS 17. These include estimating fulfilment cash flows at a higher level than groups of insurance contracts and factoring in cross-subsidisation across groups of insurance contracts over financial reporting periods (refer to para B67-B71 of IFRS 17)



Technical area	Suggested questions
	<ol style="list-style-type: none"> 2. What are the business implications of these differences (such as expected contractual changes)? 3. How will risk adjustment for reinsurance contracts held be calculated? 4. What processes/controls are in place to appropriately estimate the cash flows associated with the underlying insurance contracts yet to be issued but covered by the reinsurance contracts held?
Transition	<ol style="list-style-type: none"> 1. The different transition approaches and related judgements could have a major impact on the CSM at the transition date and on earnings in future periods. If the modified retrospective or fair value approach is selected, how did management determine that the full retrospective approach is impracticable? 2. Where the full retrospective approach is deemed impracticable, what were the factors management considered when making the decision whether to apply the modified retrospective or fair value approach at transition? 3. If the modified retrospective approach is applied, what are the main judgements, challenges or difficulties encountered (e.g. in availability, quality, and selections of historical data)? 4. If the fair value approach has been chosen: <ol style="list-style-type: none"> a. what assumptions and judgements will be applied to establish the fair values of groups of insurance contracts? b. what are the main differences in terms of valuation (discount rate, expenses, risk adjustment) compared with the other two approaches? c. What are the main judgements, challenges or difficulties encountered? 5. During the implementation process, has management uncovered any errors in the application of previous accounting principles? If so, how is management dealing with those issues?
Presentation and Disclosure	<ol style="list-style-type: none"> 1. What key decisions has management made to meet the presentation requirements of IFRS 17? 2. What are the key judgements management has made in applying IFRS 17 that are required to be disclosed under IAS 1? 3. Has management decided not to include any required disclosures due to materiality? 4. What is the expected level of disaggregation for the disclosure of information about insurance contracts?



Technical area	Suggested questions
	<ol style="list-style-type: none"><li data-bbox="523 510 1326 595">5. Has management considered the additional internal information requests that may be required to comply with the additional disclosure requirements, and the resulting impact on reporting timelines?<li data-bbox="523 618 1326 674">6. How will the required granularity of disclosure impact current and future IT systems?<li data-bbox="523 696 1326 752">7. What are management's plans for calculating the appropriate IAS 8 disclosures and when will these be produced?<li data-bbox="523 775 1326 860">8. To what degree has management engaged its external stakeholders, including investors, in relation to the impacts of IFRS 17 on accounting, disclosure, profit recognition and KPIs compared to current reporting?