Transition: Modified Retrospective Approach Issues Paper

Introduction

1 An insurer is required to account for its insurance and reinsurance contracts as if IFRS 17 had always been applied unless this is impracticable. When retrospective application (full retrospective approach or 'FVA') is impracticable, an insurer can measure existing insurance contracts when it first applies IFRS 17 using either:

(a) **a modified retrospective approach** ('MRA') - which can be used only if reasonable and supportable information is available; or

(b) fair value ('FVA').

Summary of IASB tentative decisions

2 The IASB tentatively decided to:

(a) retain the IFRS 17 transition requirements without making amendments that would reduce the **optionality included in those requirements**; and

(b) retain the IFRS 17 requirement to present restated comparative information for the annual reporting period immediately preceding the date of initial application of IFRS 17.

3 The IASB tentatively decided to:

(a) retain the transition requirements in the **modified retrospective approach** set out in IFRS 17 that:

(i) prohibit an entity from using a specified modification to the extent that the entity has reasonable and supportable information to apply the related IFRS 17 requirement retrospectively; and

(ii) permit an entity to use a specified modification only when the entity has reasonable and supportable information to apply that modification.

(b) retain the transition requirements in IFRS 17 for the **modified retrospective approach,** without an amendment that would permit an entity to develop its own modifications that it regards as consistent with the objective of the modified retrospective approach. However, the IASB Board noted the importance of the clarification in the paper that the existence of specified modifications does not preclude the normal use of estimation techniques.

(c) amend the transition requirements in IFRS 17 for liabilities that relate to the settlement of claims incurred before an insurance contract was acquired as follows:

(i) to add a specified modification to the **modified retrospective approach** so that an entity classifies such liabilities as a liability for incurred claims. Consistent with the other specified modifications, an entity would be permitted to use this specified modification only to the extent that it does not have reasonable and supportable information to apply a retrospective approach.

(ii) to permit an entity applying the fair value approach to choose to classify such liabilities as a liability for incurred claims.

(d) retain without amendment the specified modification in the **modified retrospective approach** relating to the use of cash flows that are known to have occurred, instead of estimating retrospectively cash flows that were expected to occur;

(e) retain the **modified retrospective approach** for insurance contracts with direct participation features, without an amendment that would permit an entity to apply to such contracts the specified modifications permitted for insurance contracts without direct participation features.

Concerns raised

4 EFRAG IAWG members expressed their concern that the modified retrospective approach is difficult to apply. Members noted the complexities in trying to find reasonable and supportable information in order to utilise the different modifications. Members specifically noted that data gaps forces them to use the fair value approach.

5 One EFRAG IAWG member noted that bringing no changes to the MRA would affect comparability between current and new business over time, as the use of FVA at transition will result in a different measurement attribute than FRA for the CSM to be reported going forward for the groups measured at FV at transition.

6 In addition, because a lot of insurers would be forced to a FVA at transition comparability would be lost between those applying the MRA approach and those that apply the FVA.

7 The issue in practice does not relate only to the freedom to make estimates, but also to approximate the inputs needed in case of data gaps, using proxies. One EFRAG IAWG member added the issue was not only about estimates but as data gaps existed, they wanted the possibility to apply the full or modified retrospective approach using approximations or proxies to fill for example the 5% of lacking data.

Different views presented

View 1– Agree with the decision to retain IFRS 17 requirements with the following specific comments

8 Express agreement with the IASB decision to retain the requirements in IFRS 17 for the MFA to (i) prohibit an entity from using a specified modification to the extent that the entity has reasonable and supportable information to apply the related IFRS 17 requirement retrospectively; and (ii) permit an entity to use a specified modification only when the entity has reasonable and supportable information to apply that modification.

9 Determination of whether reasonable and supportable information is available to apply the FRA or the MRA is an interpretative issue. Observe that the IASB noted the importance of the clarification in the paper that the existence of specified modifications does not preclude the normal use of estimation techniques. Therefore, a further clarification in the Standard is not needed.

10 In the absence of reasonable and supportable information available to apply the MRA (which is not considered to be a high hurdle), there is an important risk of earnings management and window dressing at transition.

11 Due to differences in current GAAPs IT-systems the available data differs from entity to entity. As a result, each entity will need a different solution in order be able to

apply the MRA. Defining a general extension of the relief implies continuation of current practices (the labels are the same, but the underlying calculations and data availability differ) and results in non-comparable information.

12 The application of the MRA at transition date includes the use of judgement and assumptions as does the application of IFRS 17 in general.

13 Although many entities may not have sufficient information for a fully retrospective application, the IASB was told that in many cases entities may have much of the information needed, and that some entities may face only a small number of limitations on retrospective application. Therefore, the IASB decided that only some specific modifications were necessary in case an entity does not have reasonable and supportable information available. The modifications could be used to achieve the closest outcome to retrospective application that is possible.

14 The modified retrospective approach to transition to IFRS 17 provides entities with a hierarchy in terms of the information required to use that approach, which is:

(a) if an entity has reasonable and supportable information to apply an IFRS 17 requirement retrospectively, it shall use that information.

(b) to the extent that an entity does not have reasonable and supportable information to apply an IFRS 17 requirement retrospectively, it shall use reasonable and supportable information to apply the specified modification which is a proxy for applying that IFRS 17 requirement retrospectively

(c) if the entity does not have reasonable and supportable information to apply IFRS 17 retrospectively or to use the specified modifications it needs to, it cannot apply the modified retrospective approach for that group of insurance contracts and must use the fair value approach. An entity is not permitted to use a combination of the modified retrospective approach and the fair value approach for a group of insurance contracts.

15 The IASB staff acknowledge that determining whether information is reasonable and supportable when transitioning to IFRS 17 may require an assessment and careful consideration.

16 The IASB staff is of the view that permitting entities to use each specified modification even when the entity has reasonable and supportable information available is not justified and would result in an unacceptable loss of useful information. Applying aspects of IFRS 17 retrospectively maximises comparability between contracts written before and after the date of transition, which is the objective of the modified retrospective approach.

17 Although the specified modifications aim to be proxies for applying IFRS 17 retrospectively, the IASB staff observe that the IASB only intended those proxies to be used when necessary, because the Board views the information provided by retrospectively applying IFRS 17 as being the most useful for users of financial statements.

View 2 – Amendment needed to the standard to permit an entity to develop its own modifications to the MRA with the follow specific comments

18 FVA does not provide relevant information about future profitability.

19 Without further modifications (which could achieve an approach closer to the FRA, entities will be forced to use the FVA which will reflect a different measurement approach than the result of an FRA.

20 Comparability is an issue when applying both the FVA and the MRA to different groups within the same portfolio.

View 3 – Amendment needed to the standard to clarify that use of estimates is allowed

21 Amend the standard to clarify that the existence of specified modifications does not preclude the normal use of estimation techniques in the MRA and that the entity is not precluded to make estimates in the FRA.

IAWG conclusions

Can the issue be solved without amendments to the standard?

22 Most EFRAG IAWG members were of the view this is not possible.

23 EFRAG IAWG members expressed their concern that the modified retrospective approach is difficult to apply. Members noted the complexities in trying to find reasonable and supportable information in order to utilise the different modifications. Members specifically noted that data gaps force them to use the fair value approach.

24 One EFRAG IAWG member noted that bringing no changes to the MRA would affect comparability between current and new business over time, as the use of FVA at transition will result in a different measurement attribute than FRA for the CSM to be reported going forward for the groups measured at FV at transition.

25 In addition, because a lot of insurers would be forced to a FVA at transition comparability would be lost between those applying the MRA approach and those that apply the FVA.

26 The issue in practice does not relate only to the freedom to make estimates, but also to approximate the inputs needed in case of data gaps, using proxies. One EFRAG IAWG member added the issue was not only about estimates but as data gaps existed, they wanted the possibility to apply the full or modified retrospective approach using approximations or proxies to fill for example the 5% of lacking data.

27 The following comments were provided:

(a) There is a need to clarify the requirements in order to have more freedom in making estimates. For example, when historical information on experience adjustments or cash flows in general are only available at a very high level; clarification is necessary how allocations down to the unit of account are possible under IAS 8. One auditor noted that until now the issue was being thought of as applying hindsight, but it was now understood it was partly different from that;

(b) There is a need to modify the requirements for MRA so as to have a principles based objective to achieve the closest outcome to the full retrospective approach compared to making limited modifications that are available now in the standard;

(c) The changes that are available in the standard for the general model at transition should be made available for insurance contracts under the variable fee approach as well

Supporting View 1 or View 2

28 8 IAWG members composed of both preparers and auditors expressed the view to support *View 2*, i.e. changing the standard.

29 An observer considered that this issue could be solved through implementation and practice. It was fair to rely on reasonable and supportable information. While it was expected this would result in negotiations between an entity and its auditor, there was a fear that the most strict interpretation would be retained. It would be helpful to provide a direction reducing the risk of an interpretation that is considered to be too strict.

Other comments

30 One EFRAG IAWG member noted that the MRA was not easier to apply than the FRA. There were a lot of practical challenges that occurred because of the lack of data or data not being available at the right level of granularity. It would result in a higher use of the FVA, which would result in inconsistent information and not allow for comparability between new and old business.

31 One user was in favour of a change to the standard in order to have more comparable information.

EFRAG TEG input April 2019

32 On transition, EFRAG TEG members discussed the IASB tentative decisions to retain IFRS 17 requirements on the extent of relief of the Modified Retrospective Approach (MRA) and the resulting challenges of applying the fair value approach (FVA):

33 One EFRAG TEG member noted that the two approaches are different in nature and should not be compared with each other.

34 EFRAG TEG highlighted that different transition approaches could be applied within one portfolio, e.g., applying MRA and FVA to different groups within the same portfolio.

35 EFRAG TEG considered the solution proposed by the CFO Forum (to extend the relief available under the MRA) and some members considered that this proposal should be debated. One member noted that further modifications would enable preparers to achieve an outcome closer to the Full Retrospective Approach and that without such modifications, preparers would be forced to use a fair value approach, which will reflect a different measurement than the Full Retrospective Approach.

36 A few members noted the view of the EFRAG IAWG that the available information on Market Consistent Embedded Value (MCEV) could be used as an initial datapoint to estimate CSM at day one (with possible adjustments) and then rolled forward in accordance with IFRS 17, using information sourced from the MCEV analysis of movements (adjusted as necessary). One member considered this as a Full Retrospective Approach (built using estimates sourced from MCEV results) rather than an alternative method.

37 In conclusion, EFRAG TEG members agreed that a key element of the debate was the interpretation of the “reasonable and supportable information” criterion.

EFRAG TEG input May 2019

38 EFRAG TEG members noted that the fair value approach and the retrospective methods were different in nature and that would remain an ongoing difference over time.

39 EFRAG TEG members considered the implementation challenges of both the full retrospective approach and the MRA. Also, IAS 1 *Presentation of Financial Statements*, paragraphs 50 to 53 and the *Conceptual Framework* were considered helpful for preparers to apply the MRA. They noted that instead of standard setting other ways of communicating were necessary such as a public discussion at the TRG.

40 Eight EFRAG TEG members supported the IASB tentative decisions not to allow entities to develop their own modifications, as they considered that there are too many transition methods and adding more options would further reduce comparability. One EFRAG TEG member noted as well that other industries did not benefit from the flexibility that IFRS 17 offers at transition.

41 In order to address the implementation challenges, six of these members supported asking the IASB to consider adding further clarifications in the final standard about the use of estimates and assumptions in case of lack of data. Other two EFRAG TEG members also supported the need for further clarification. A possible starting point for the suggested wording was to clarify that the existence of specified modifications does not preclude the normal use of estimation techniques in the MRA and that the entity is not precluded to make estimates in the FRA.

42 One EFRAG TEG member which supported the need for further clarification saw that it was so important to prevent that the strictest approach is used and to avoid unduly restrictions of the use of MRA that he could consider supporting an amendment to the standard.

43 One EFRAG TEG member did not explicitly express a view.

44 One EFRAG TEG member that was absent during the meeting provided subsequent written inputs supporting View 2.

Questions for EFRAG Board and TEG

45 Members are invited to note the views of IAWG (support view 2 - ask changes to the standard) and TEG preliminary views (support view 1 and support view 3 – ask for further clarifications in order to address the remaining interpretation challenges but do not ask for further standard setting).

46 Based on the technical discussions presented above, what are your comments and orientation at this stage of the process?

Appendix: background information

Input from CFO Forum

47 Extend relief available to enable widespread capability to use the MRA and remove requirements to allocate contracts between separate profitability groupings.

Input from ANC

48 There is no need for detailed guidance on how to apply the principle set in IFRS 17.C8.

49 The ANC is very supportive of the suggestion made in February's board meeting (IASB 2019-02.AP 2D §36) to explain that a retrospective approach (either FRA or MRA) does not prohibit from making estimates and further to clarify to which extent an estimates stops and becomes a departure to the retrospective approach. This explanation would be better placed in the standard itself.

50 For instance, applying a mixed approach on transition: full retrospective as long as reasonable and supportable information is available (i.e. for the last 10 years) and a FVA as initial value for the period before.

51 The ANC consider that there is no need for a detailed guidance on how to apply the principle set in IFRS 17.C8.

52 IFRS 17.C8: To achieve the objective of the modified retrospective approach, an entity is permitted to use each modification in paragraphs C9–C19 only to the extent that an entity does not have reasonable and supportable information to apply a retrospective approach. In addition, the existence of specified modifications in the modified retrospective approach does not prohibit an entity from:

(a) making estimates that are necessary in retrospectively applying an accounting policy as described in paragraph 51 of IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors; or

(b) similarly, making estimates when applying a specified modification in the modified retrospective approach

53 The ANC's suggested amendment for the business combinations issue is as follows.

IFRS C5bis: On transition and regardless of the approach retained, an entity may depart from IFRS 17.B93 in applying the date when the contract was issued instead of the date of the transaction (e.g. business combination or portfolio transfer) to contracts acquired before transition.

Input received from the extensive case study

54 Q12 For each selected portfolio indicate the transition method you applied. When not applying the full retrospective method, explain the reasons why you have chosen the fair value or the modified retrospective method.

55 The transition methods applied in answering this question were for case study purposes only and do not necessarily represent the transition approaches that will be applied by the respondents when implementing IFRS 17.

56 For the portfolios selected, most respondents answered the question on an overall basis (i.e. one transition method used for all the selected portfolios). The transition methods applied for the selected portfolios were disaggregated into the following product categories:

Product category	Fair value	Modified Retrospective	Full Retrospective	N/A
GM: Annuities	X	X	X	

Product category	**Fair value**	**Modified Retrospective**	**Full Retrospective**	**N/A**
GM: Non-life	X		X	
GM: Protection	X	X	X	
GM: Reinsurance ceded and held			X	
GM: Savings/Protection	X			
GM: Unit linked			X	
GM: Indirect par			X	
GM: Other			X	
VFA: Annuities		X	X	
VFA: Savings / Protection	X	X	X	
VFA: Unit linked	X	X		
VFA: Other		X		
PAA: Motor		X		X
PAA: Other				X

57 Of the 40 portfolios selected where information on transition was provided:

(a) 9 used the full retrospective approach;

(b) 13 used the modified retrospective approach;

(c) 14 used the fair value approach; and

(d) 4 applied the PAA.

58 The approaches indicated by respondents represents the following percentage of the total IFRS 17 liability for the respective portfolios:

Proposed approach	**Percentage**
Fair value approach	30.46%
Modified retrospective approach	63.21%
Full retrospective approach	5.50%
Not applicable	0.83%
Total	100.00%

Variations of approaches used:

59 For the purposes of the case study, some respondents applied variations to the approaches in IFRS 17 such as:

(a) An approximation of the modified retrospective approach. The modifications were not specified.

(b) The new business value method (NBV) under the EEV framework as equivalent to the full retrospective approach.

60 Respondents had the following remarks on why they have not applied the full retrospective approach in the case study:

(a) The lack of historical data or outdated systems;

(b) Resource and timing constraints;

(c) Impracticability due to the:

(i) existence of a number of long-term contracts still in place

(ii) elimination of hindsight; and

(iii) application of judgments and assumptions.

61 The case study provides the following insights into the difficulties in applying the requirements of the modified retrospective approach:

(a) IFRS 17, paragraph C6 should permit the use of approximations/simplications when determining the initial cash flows and roll them forward using an approach that could be characterised as a fair value approach but using modified retrospective modifications in other areas such as discount rate, risk adjustment, etc (one respondent).

(b) The requirement in IFRS 17 paragraph C9(a) to split portfolios by profitability group (onerous, no significant possibility of becoming onerous, other) is likely to mean that they need to identify cash flows at a lower level than the portfolio level (i.e. individual contract or sub-groups within portfolios). This significantly increases the granularity of the data required (two respondents).

(c) The requirement in IFRS 17 paragraphs C8, C10 to produce transition figures by annual cohort is potentially significantly more onerous than if cohorts can be grouped together (two respondents).

(d) The requirements in IFRS 17 paragraphs C12, C17(c)(i) and C17(c)(ii) to make adjustments for amounts between initial recognition and transition (or earlier) date will prove to be very difficult (two respondents).

(i) Whilst it may be possible to identify actual cashflows for more recent years it will get progressively more difficult when progressing back in time. Application of the modified retrospective approach to more recent years and the fair value approach to later years would require the respondent to be able to split the actual cashflows between those arising on contract where the modified retrospective approach is being applied and those arising from contract where fair value approach is being applied.

(ii) *UK with profits business*: To be able to comply with IFRS 17 paragraph C17(c)(i) and (c)(ii) it is necessary to be able to identify the amount of the following items that have occurred between initial recognition and transition:

- The charges deducted from the unit fund
- Benefit payments in excess of the unit fund (in respect of the sum assured on the base policy and the benefits under each rider)
- Costs incurred (e.g. commissions and expenses)

(iii) *Unit-linked business with protection riders*: To be able to comply with IFRS 17 paragraph C17 (c)(i) and (c)(ii) it is necessary to be able to identify the amount of the following items that have occurred between initial recognition and transition:

- The charges deducted from the unit fund
- Benefit payments in excess of the unit fund (in respect of the sum assured on the base policy and the benefits under each rider)
- Costs incurred (e.g. commissions and expenses)

(iv) Historically these amounts are only available for a limited number of past years and only in aggregate.

(e) The simplifications in respect of loss components in IFRS 17 paragraphs C11-C17 should be consistent between the VFA and general model (one respondent). The requirements in IFRS 17 paragraphs C13 should include an option allowing, at inception, that the discount rate can be set the same as the transition date discount rate.

(f) One respondent noted that the modified retrospective approach under IFRS 17 paragraph C6 would require taking into account the past margins, therefore it would not reflect a simple prospective vision of the insurance contracts profitability. This respondent considered the valuation of such past margins to be extremely heavy to perform precisely, looking at the reduced time available to implement IFRS 17.

62 One respondent suggested changes to address these concerns. Another respondent is still investigating whether this approach provides sufficient simplifications to make it operationally feasible.

63 Some respondents that used the PAA for their portfolios indicated that they have not calculated the CSM on transition and therefore indicated that the transition approaches are not applicable as the:

(a) overall impact should be limited due to the liability for remaining coverage (LRC) accounted for under the PAA is very close to their reserves calculated under current GAAP; and

(b) the coverage period is less than one year.

64 One respondent noted that the IASB review draft of the standard allowed in a principles based way to compare a prospectively determined CSM with a retrospectively determined CSM and calculate the difference between the two, considering how much of the CSM would have been released in past periods and how much would have been distributed to the entity. The respondent preferred this methodology above the current wording of IFRS 17.

Input received from the simplified case study

Only general comments were received in relation to transition

65 Regarding transition, applying a full retrospective approach will be difficult for some insurance contracts (especially life contracts). Given the requirements for using the modified retrospective approach, this approach might be difficult to apply, therefore only leaving fair value as transition approach (one respondent).

66 Although it is generally believed that IFRS 17 will improve transparency and comparability amongst insures, the retrospective transition, amongst others, impedes this.

67 Certain disclosures appear to be unnecessarily burdensome, for example the disclosure related to the modified retrospective approach and fair value approach which is required even years after the transition has occurred. Furthermore, the fair value option at transition should always be available to use. (one respondent)

68 One respondent noted that the following areas of judgement could undermine comparability within the insurance sector (one respondent):

(a) The use of discount rates;

(b) The different transition methods; and

(c) The CSM amortisation drivers.

Input received from the User Outreach

Transition approaches

Specialist users

69 Specialist users had the following comments:

(a) Nine users noted that the different transition methods would cause comparability concerns. Ideally only one transition method should be applied. Some users noted that disclosures could help users in understanding and making adjustments to the figures, but not everyone was convinced that the disclosures required by IFRS 17 were sufficient. One user was not particularly concerned by any impact on comparability;

(b) Six users had concerns or were not sure of the impact of the different transition approaches, e.g., concerns that people will choose the option they want in terms of opening balances and a window dressing, not necessarily choosing what is most appropriate (transition to Solvency II was used as an example) and concerns relating to taxation impacts. Two of these users also suggested that there was the potential for double counting of profits;

(c) One user expected that insurers will agree on a common approach; and

(d) One user noted that the restatement of in-force business would overwhelm users' understanding for a generation.

Generalist users

70 Generalist users had the following comments:

(a) Transition period will be long and will create confusion for analysts but investor days should take care of that;

(b) There is a need for additional disclosures in order to cope with the options on transition;

(c) There is no perfect solution to the problem. It will be an uncomfortable journey but they can live with the transition options;

(d) The transition measures are seen as a practical expedient. Ideally only one transition method would be permitted.