IFRS 17 *Insurance Contracts* – Towards a DEA Appendix II

Introduction

1 This paper presents an updated assessment of the EFRAG Secretariat of IFRS 17 *Insurance Contracts* against the endorsement criteria relevance, reliability, understandability, comparability and prudence. Comments from the July 2017 EFRAG TEG meeting and both the July and September 2017 EFRAG IAWG meeting have been considered in this version. Additional cross-referencing between different components of Appendix II will be added later.

Relevance

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

3 EFRAG considered whether IFRS 17 would result in the provision of relevant information – in other words, information that has predictive value, confirmatory value or both – or whether it would result in the omission of relevant information. In its assessment of relevance, EFRAG has identified the following topics as being the most significant to this assessment:

(a) Measurement of insurance contracts;

(b) Different insurance accounting models;

(c) Level of aggregation;

(d) Risk mitigation;

(e) Sharing of risks;

(f) Performance of the insurance business;

(g) Presentation on the statement of comprehensive income;

(h) Presentation on the statement of financial position;

(i) Disclosures; and

(j) Transition requirements.

Measurement of insurance contracts

The components of the measurement requirements

4 The general measurement requirements comprise:

(a) the fulfilment cash flows which consist of (i) current expected future cash inflows and outflows, (ii) adjustment to reflect the time value of money and financial risks related to the future cash flows (discount rate) and (iii) an a risk adjustment for non-financial risk adjustment to reflect the time value of money and financial risks related to the future cash flows (discount rate); and

(b) the contractual service margin which represents the unearned profit that the entity will recognise as it provides services in the future.

Future cash flows

5 EFRAG considers that estimating cash inflows and outflows within the contract boundary will provide relevant information because it reflects the rights and obligations of an entity that arise from the contract, law or regulation.

6 IFRS 17 requires an entity to make an unbiased probability-weighted estimate of the future cash flows. Since the cash flows generated by insurance contracts are uncertain, entities will assess and capture a full range of foreseeable outcomes and their probabilities. As a result, EFRAG is of the view that this estimate will result in relevant information.

Financial options and guarantees

7 Many insurance contracts contain significant embedded options and guarantees. The cash flow estimates will incorporate the intrinsic value of embedded options and guarantees and the entity will also be required to look at all possible scenarios in estimating the options and guarantees. Therefore, incorporating options and guarantees in the cash flows will provide relevant information about when the options and guarantees will be 'in the money' and their corresponding value.

Treatment of acquisition costs

8 IFRS 17 requires an entity to include in the measurement of insurance contracts any directly attributable acquisition costs and these are recognised as an expense over the coverage period.

9 EFRAG considers it relevant that the direct acquisition costs are included in the measurement of insurance contracts because it is a cash outflow that is directly linked to the fulfilment of an entity's obligations towards the policyholder. Furthermore, an entity typically prices insurance contracts to recover these direct acquisition costs. Therefore, EFRAG considers that including these direct acquisition costs would be relevant in computing the entity's expectation of profit for the contracts (i.e. the contractual service margin).

10 In addition, in including the directly attributable acquisition costs in the fulfilment cash flows, any lack of its recoverability would be captured by remeasuring the fulfilment cash flows.

Updated estimates of future cash flows

11 EFRAG is of the view that the use of current updated estimates at the end of each reporting period for the fulfilment cash flows provides relevant information to users about the entity's contractual obligations and rights by reflecting information about the amounts, timing and uncertainty of the cash flows generated by those obligations and rights. Updated estimates also provide relevant information because these take into consideration current developments which may impact the fulfilment cash flows. Therefore, the analysts of financial statements can assess the predictability of cash flows and can also assess the adequacy of the liability.

Discount rate

12 As insurance contracts can run over many years, EFRAG considers that discounting the future cash flows, provides relevant information for users of financial statements on an entity's financial position.

Discount rate to be used

13 IFRS 17 requires entities to discount cash flows using market-consistent discount rates. The discount rates should include only relevant factors relating to the liability, i.e., factors that reflect the time value of money, the characteristics of the cash flows and the liquidity characteristics of the insurance contracts.

14 EFRAG assesses that the reflection of the time value of money provides relevant information. Incorporating liquidity characteristics is also considered to provide

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relevant information because an entity cannot usually immediately sell the contract liability. In addition, EFRAG considers that the discount rate chosen by entities will provide useful information on the characteristics of the cash flows because it will be focussed on the nature of the liability, for example, cash flows that vary based on returns from underlying items would use rates that reflect that variability.

15 Furthermore, the risk adjustment may be discounted to present value. Some have argued that a small change in interest rates can affect the amount of risk adjustment that would be recognised in profit or loss and therefore, the statement of comprehensive income would not provide relevant information on performance of the entity. EFRAG assesses that because of the long duration[1] of many insurance contracts, there would be some uncertainty on the timing and amount to pay-out to policyholders. Therefore, the time value of money aspect for the risk adjustment would be relevant for users because it reflects the present value of any additional amounts that could be paid and any potential different timing of the pay-outs and as a result, the user would be able to assess the overall obligation of the entity. Also, EFRAG considers that incorporating interest rates for the risk adjustment would be relevant to users as this would lead to prudent information, as argued in paragraph 244 because caution would be taken into account by the entity due to the uncertainty associated with insurance contract liabilities.

Risk adjustment

16 Incorporating an explicit risk adjustment will provide relevant information to users of financial statements because the users will be able to evaluate the entity's view of the economic impact imposed by the non-financial risk associated with the entity's insurance contracts. In addition, any subsequent changes in estimates of the risk adjustment will provide users with useful information relating to any change in the entity's views relating to non-financial risk.

17 In addition, EFRAG considers the risk adjustment includes the degree of diversification benefit when determining the compensation the entity requires for bearing the risk.

Contractual service margin

18 The contractual service margin is determined on initial recognition of a group of insurance contracts as the amount that eliminates any gains arising at that time.

19 EFRAG is of the view that having a contractual service margin provides relevant information because it provides a transparent view of the expected but unearned profit that the entity considers that it will make from the insurance contracts over the coverage period. If entities need to update their estimates of the fulfilment cash flows which relate to future periods, the contractual service margin is adjusted to reflect this change. Therefore, the contractual service margin is updated to reflect the current conditions or the current environment and this will provide relevant information.

20 In addition, the contractual service margin provides relevant information because it enables users to consider the distribution of the unearned profit over the coverage period.

Different insurance accounting models

21 IFRS 17 defines the principles for the measurement of insurance contracts as assessed above. Those principles are modified or simplified for:

(a) contracts with direct participation features;

(b) reinsurance contracts held;

[1] Duration is defined as weighted average maturity of cash flows within the contract boundary.

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(c) investment contracts with discretionary participation features; and

(d) contracts where the Premium Allocation Approach is applied.

Contracts with direct participation features

Distinction between contracts with and without direct participation features

22 IFRS 17 distinguishes between insurance contracts with and without direct participation features.

23 For contracts without direct participation features, EFRAG considers that the net gains the entity retains from invested premiums reflects the entity's ability to make decisions on the investment portfolio. Due to this ability, the net gains from the investment portfolio are similar to returns from a standalone investment and should be recognised in a similar way i.e., recognised in the statement of comprehensive income.

24 For contracts with direct participation features, rather than the entity's share being similar to the returns from a standalone investment, EFRAG assesses that a different treatment is justified because:

(a) there is a direct link between the fair value returns from the underlying items and the amount to be paid to the policyholder based on contractual terms. Therefore, the entity can be seen to be managing the underlying items on behalf of the policyholder.

(b) the entity is often constrained in its ability to make decisions on the notional underlying items as a result of the direct link with the underlying items because (i) the entity is expected to manage the policyholder's invested premiums for the benefit of the policyholder; (ii) the entity must generally follow the investment strategy specified in the contract; and (iii) the entity is usually required to act in a fiduciary capacity for the policyholder. Even if the entity does not hold the underlying items, the entity would still be bound by the investment strategy specified in the enforceable contractual terms; and

(c) the gains relating to the contractual underlying items are for the policyholder (which is not the case for contracts without direct participating features) and the policyholder pays a fee to the entity, which would vary with the fair value of the underlying items.

25 EFRAG considers that this fee is the compensation that the entity will receive from the policyholder for the investment service provided under an insurance contract with direct participation features. Any changes in the fair value of the underlying items will cause a change in the amount of the profit that the entity will get in the form of a fee. EFRAG considers that this change in amount of the fee relates to the future because the entity continues to provide investment services over the coverage period. Therefore, EFRAG considers it relevant that any changes that relate to the future should adjust the contractual service margin and be recognised in profit or loss as the investment services are provided over the coverage period.

26 Based on the above, EFRAG considers that the different measurement requirements between contracts with and without direct participation features provide relevant information about the differences in the nature of the entity's income or rewards from the contracts.

Scope of the approach for contracts with direct participation features

27 Hereafter EFRAG assesses the relevance of the conditions that determine the scope of the approach available to contracts with direct participation features. The issue whether contracts that contain a constructive instead of a contractual obligation should be accounted for in accordance with the approach applicable to contracts with direct participation features is assessed in paragraphs 182 to 183 below (comparability section).

Participation in a clearly identified pool of assets

28 The accounting for contracts with direct participation features permits entities to significantly reduce or entirely eliminate (when holding the underlying items) accounting mismatches between the insurance liability and the underlying items. EFRAG assesses that in order to address accounting mismatches, the underlying items need to be clearly and contractually identified as otherwise it is not clear which accounting mismatches are being targeted. If the entity's interest in the underlying items is not the equivalent of a direct holding, economic mismatches are likely to arise as changes that arise in the holding of assets are unlikely to match changes in the underlying items.

Payment to the policyholder a substantial share of the fair value returns from the underlying items

29 EFRAG notes that this criterion is relevant because it distinguishes situations in which the investment returns are viewed as being the policyholders', rather than the entity's returns. Therefore, since the entity can be seen to be managing the underlying items on behalf of the policyholder, and receiving a fee in exchange for that service, EFRAG considers it relevant that the policyholder receives a substantial part of the fair value returns on the underlying items.

Amounts to be paid to the policyholder vary with the change in fair value of the underlying items

30 EFRAG notes that this criterion is relevant because it allows to determine whether the return provided to the policyholder encompasses not only interest or dividends accrued but also (un)realised value increases on the principal amounts invested.

31 It is argued by some that the words 'fair value' are too restrictive because in some contracts with direct participation features, the return paid to the policyholder does not encompass realised and/or unrealised value increases on the principal amounts of the underlying items.

Question to EFRAG TEG

32 Do EFRAG TEG members think that the use of the words 'fair value' in the third eligibility criterion affects relevance?

Reinsurance contracts held

33 IFRS 17 modifies the requirements of the general model for reinsurance contracts held. The contractual service margin on initial recognition does not represent unearned profit but instead a net cost or net gain on the purchase of the reinsurance.

34 IFRS 17 treats insurance contracts issued and reinsurance contracts held as separate contracts with different counterparties. EFRAG assesses that this reflects the contractual positions. As far as EFRAG is aware, the contracts do not meet the offsetting conditions in IAS 1, and therefore EFRAG supports this approach.

35 It is argued by some that, from an economic perspective, reinsurance contracts held are highly dependent on the underlying insurance contracts. Those holding this view argue in favour of the same accounting treatment for both initial and subsequent measurement of the insurance liability and the reinsurance asset to avoid any accounting mismatches.

36 EFRAG acknowledges the high dependence between a reinsurance contract held and the underlying insurance contract(s). Nevertheless, EFRAG only partly agrees with the view that measurement for both types of contracts in accordance with IFRS 17 results solely in accounting mismatches.

37 In EFRAG's view, the following mismatches are economic mismatches:

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(a) Reinsurance contracts come in many forms. For example, proportional contracts (which reinsure a proportion of the underlying risks) can be divided between those providing coverage for a quota share (for example, an entity reinsuring 50% of all underlying risks) or providing coverage up to certain fixed limit (so called surplus treaties). EFRAG assesses that the portion of risk that is not reinsured or the portion of risk incurred above the fixed limit imposed by the reinsurance contract is an economic mismatch between the reinsurance contract held and the underlying insurance contracts;

(b) The conditions of the reinsurance contract held and the underlying insurance contracts may differ. For example, the reinsurer may exclude particular risks from coverage such as terrorist attacks or natural disasters. In cases where the underlying contracts provide coverage for these risks, an economic mismatch occurs; and

(c) Even when the insurance conditions between the two contract types are fully aligned, there may be a timing difference between changing the conditions by the reinsurer and the underlying insurance contracts. Such a temporary difference would result in an economic mismatch.

38 EFRAG is awaiting further information to describe the accounting mismatches that could occur.

39 To the extent such accounting mismatches exist, EFRAG assesses these to lead to a reduction in the relevance of the resulting information. This reduction is however balanced by the avoidance of additional complexity in separating economic mismatches from accounting mismatches.

Investment contracts with discretionary participation features

40 Investment contracts with discretionary participation features are not insurance contracts as they do not transfer significant insurance risk. These contracts are scoped into IFRS 17 and treated as if they are insurance contracts only to the extent they are issued by an entity that also issues insurance contracts. The general requirements for measuring insurance contracts are being modified for investment contracts with discretionary participation features as follows:

(a) The date of initial recognition is the date the entity becomes party to the contract;

(b) The contract boundary is modified so that cash flows are within the contract boundary if they result from a substantive obligation of the entity to deliver cash at a present or future date; and

(c) The allocation of the contractual service margin is modified so that the entity shall recognise the contractual service margin over the duration of the group of contracts in a systematic way that reflects the transfer of investment services under the contract.

41 EFRAG assesses that the changes to the general measurement requirements reduce the relevance of the resulting information because the measurement depends on whether the issuer is an entity that also issues insurance contracts. Other entities issuing investment contracts with discretionary participation features use IFRS 9 in measuring such contract types. This could create situations where two entities in the same group apply different standards (IFRS 17 or IFRS 9) for these types of contracts which are economically similar.

Premium Allocation Approach

42 The Premium Allocation Approach is a simplification of the IFRS 17 principles and can be applied in circumstances where the entity expects such a simplification would produce a measurement that is not materially different than a measurement following the general requirements or when the coverage period is one year or less.

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43 EFRAG assesses that the eligibility criteria ensure that the relevance of the information is not materially reduced compared to the general measurement requirements.

Level of aggregation

44 IFRS 17 requires an entity to identify portfolios of insurance contracts and then to divide that portfolio, at inception, into groups of insurance contracts. A group of contracts cannot include contracts issued more than one year apart. In assessing these requirements, EFRAG has considered the business characteristics of pooling of similar risks[2], risk diversification and the law of large numbers.

45 *Pooling of similar risks*: Insurance implies taking on risks. By spreading those risks amongst a large group of policyholders, the negative impact of any of those risks occurring becomes shared between all policyholders. For example, the claim as a result of a fire destroying a house, is financed not only by the premiums of the policyholder affected, but by the premiums of a large number of policyholders.

46 *Risk diversification*: The diversification effect of a portfolio of risks is the difference between the sum of the risk measures of stand-alone risks in the portfolio and the risk measure of all risks in the portfolio taken together. Risk diversification reduces the aggregate risk.

47 *Law of large numbers*: The law of large numbers used in probability and statistics states that the average of a randomly selected sample from a large population is likely to be close to the average of the whole population. Put more simply, the more units of something that are measured, the closer that sample average will be to the real average of all of the units. In insurance, it is applied to demonstrate that larger numbers of contracts written result in more accurate predictions of incidents resulting in loss.

48 EFRAG understands that pooling of similar risks and risk diversification are related but not identical.

(a) Pooling of similar risks (for example, aggregating a large number of similar insurance contracts) is a risk management tool allowing an entity to determine an average occurrence of the risk (as well as the size of the average claim) per policyholder. The larger the underlying set of contracts (i.e. application of the law of large numbers), the closer the average estimate will be to the actual average;

(b) In contrast, risk diversification is designed to take advantage of the correlation between different types of risk. For example, by providing life insurance and annuities, the entity is exposed to both mortality risk and financial risk, however these two risks are not correlated and an increase in one of these two risks, will not affect occurrence of the other risk. Risk diversification can be achieved by offering contracts with uncorrelated risks or in different geographies or by investing in different markets or asset categories.

49 In EFRAG's view, risk diversification reduces the possibility of all risks occurring at the same time while pooling of similar risks (through applying the law of large numbers) helps in estimating the average occurrence and height of the average claim.

Step 1: Portfolio level

50 IFRS 17 requires an entity to identify portfolios of contracts subject to similar risks and being managed together. Contracts within a product line would be expected to

[2] EFRAG notes the mechanism of risk pooling is not unique for insurance. For example, it is also applied by airline companies (codesharing) to optimise aircraft utilisation and avoidance of rerouting aircraft, thereby decreasing overall costs. Another example is the sharing of inventory between different retail outlets.

have similar risks and hence are expected to be in the same portfolio when being managed together. Contracts in different product lines are not expected to have similar risks and hence are expected to be in different portfolios.

51 In assessing the first step in aggregating insurance contracts, EFRAG:

(a) Understands that insurers issue a large number of insurance contracts knowing that, depending on the portfolio, some contracts will result in claims and others will not. EFRAG also understands that, as a result, entities generally manage contracts at a portfolio level;

(b) Agrees that contracts in different business lines are expected to be subject to different risks as it applies the business practice of pooling of similar risks;

(c) Expects that contracts in different business lines are managed in a different way because the underlying risks are different. For example, providing a price incentive on the premium required for house insurance when the policyholder installs a burglar alarm has no relevance when managing a portfolio of life insurance contracts; and

(d) Notes that aggregating insurance contracts at portfolio level does not prevent the application of the law of large numbers.

52 EFRAG considers that the first step of identifying portfolios of contracts provides relevant information for users to analyse the risks associated with portfolios as each portfolio contains contracts with similar risks.

Step 2: Group level

53 IFRS 17 requires an entity to divide portfolios of insurance contracts into a minimum of, where applicable, separate groups of (i) contracts that are onerous at inception, if any; (ii) contracts that have significant possibility of becoming onerous, if any; and (iii) contracts that have no significant possibility of becoming onerous subsequently.

54 Some insurers assess the profitability of their insurance contracts at portfolio level, thereby taking into account cross-subsidisation between different contracts through the use of mutualisation[3]. In pricing their contracts, insurers consider that some highly profitable contracts provide support to contracts with low or no profitability. In doing so, the statistical possibility of particular contracts becoming onerous is lowered. Grouping contracts is seen by some as changing these statistical calculation practices and is hence considered not to lead to relevant information.

55 In assessing the second step in aggregating insurance contracts, EFRAG:

(a) Notes that insurance contracts in one group can have different pricing margins;

(b) Notes that IFRS 17 does not require the tracking of individual contracts, although, in certain circumstances, a group of insurance contracts can consist of one single contract;

(c) Notes that grouping of insurance contracts results in a profitability distribution within one portfolio. More precisely, grouping provides information on:

(i) which contracts are onerous (if any);

(ii) contracts that may become onerous over time (i.e. contracts with small margins, if any), described as ‘remaining contracts’ in IFRS 17; and

(iii) contracts that have no significant possibility of becoming onerous subsequently (i.e. contracts that have large margins).

[3] Note from the EFRAG Secretariat: IFRS 17 does not mention the word ‘mutualisation’ but refers to ‘sharing of risks’ instead. However, the term ‘sharing of risks’ is to be read more narrowly than current mutualisation practices which includes non-contractual cross-subsidisation.

Entities are not required to disclose the profitability distribution (with the exception of onerous contracts), instead, the grouping is used to build a relevant contractual service margin for each group;

(d) Notes that separating groups of insurance contracts is designed (i) to identify onerous contracts at inception and (ii) to produce a contractual service margin which can be allocated to insurance revenue over time without the need to track insurance contracts individually. Consequently, grouping:

 (i) Limits cross-subsidisation between different groups of contracts within the same portfolio; and

 (ii) Prevents disproportionate amounts of the contractual service margin being released for contracts lapsing within the same group; and

(e) Considers that pooling of similar risks can be applied at group level. In this regard, EFRAG notes that the groups created by large entities may be significantly larger, both in number of contracts and overall size, than an entire smaller insurance entity. EFRAG notes that all entities, large and small, are able to apply this business practice. EFRAG acknowledges however that pooling of similar risks may result in more accurate results the larger the number of contracts it is applied to.

56 Summarising, EFRAG assesses that grouping of insurance contracts results in profitability distribution which is subsequently used to build a relevant contractual service margin. The determination of the appropriate contractual service margin is a balance between the avoidance of the need to track individual contracts and reduction of cross-subsidisation between different levels of profitability of contracts with similar risks. EFRAG further assesses that grouping plays an essential role in the determination of unearned profit and its subsequent allocation to insurance revenue.

57 In addition, it is argued by some that entities should group contracts through the use of coverage units as it would be less burdensome. EFRAG considers that relying on coverage units alone – without grouping - would lead to showing an average result at portfolio level. EFRAG is of the view that the use of averages results in less relevant revenues and expenses because relying on coverage units alone allows for cross-subsidisation influencing the allocation of the contractual service margin to insurance revenue. Hence, it allows for earnings management.

Step 3: One year issuing period

58 IFRS 17 requires a group of contracts to be divided into contracts issued within one year.

59 EFRAG notes that, as the one year issuing period relates to a group of insurance contracts, the assessments provided for the second step (see paragraph 55 above) are equally valid for the third step of aggregation.

60 In addition, EFRAG assesses that the third step in aggregating insurance contracts provides relevant information as it would enable the users of financial statements to assess and evaluate the profitability of contracts over time because:

(a) Once all the contracts in a group are completed, the profit relating to that group would be fully recognised in profit or loss;

(b) The consecutive application of annual groups results in the development of trend information regarding the contractual service margin. The contractual service margin recognised in profit and loss is expected to vary over different annual periods. These changes over time result in a pattern that provides useful information about the increase or decrease in pricing power and cost management of the entity.

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(c) Profit (i.e. the contractual service margin) is appropriately recognised in profit or loss in the relevant reporting periods and on a timely basis; and

(d) The remaining contractual service margin relates to the contracts that are still in-force within a group.

61 Overall, EFRAG assesses that the aggregation requirements of IFRS 17 provide relevant information to users of financial statements through the recognition of insurance revenue. In EFRAG's view, the aggregation requirements are compatible with the insurance industry practices of pooling of similar risks.

62 Although some entities are concerned that the one year issuing period is an artificial boundary and would prevent transfers of cash flows between generations of policyholders (i.e. by way of sharing of risks), EFRAG notes that the one year issuing period is fully compatible with transfers of cash flows between generations of policyholders. This is discussed in paragraphs 69 to 72 below.

Impact of regulation

63 Situations occur when law or regulation constrains the entity's ability to set a different price or level of benefits for contracts or policyholders with different characteristics, such as requiring identical pricing for contracts for male and female policyholders even though the risks are known to be different. In grouping insurance contracts, IFRS 17 permits an exception to the overall grouping requirements, that in such cases insurance entities are allowed to include such contracts in the same group.

64 EFRAG is of the view that this enhances the relevance of the resulting information as it aligns the accounting treatment with the regulatory requirement.

Risk mitigation

65 IFRS 17 provides a risk mitigation approach for contracts with direct participation features but not for other contracts. In the absence of this specific risk mitigation, the changes in the effect of financial risk on the entity's share of the underlying items and on financial guarantees would be recognised in the contractual service margin. However, the derivative used to mitigate this financial risk would be measured at fair value through profit or loss giving rise to an accounting mismatch. Therefore, EFRAG assesses that the risk mitigation approach for contracts with direct participation features addresses a particular set of accounting mismatches.

66 EFRAG notes that the risk mitigation option is not available to indirect participation contracts (i.e. those that have some characteristics of participation contracts but do not meet the definition of contracts with direct participation features in IFRS 17). For these (and other contracts under the general model) the entity has the choice to recognise the impact of changes in the effect of financial risk in profit or loss rather than other comprehensive income if it so chooses. Furthermore, hedge accounting under IFRS 9 *Financial Instruments* is available to those who recognise these changes in other comprehensive income or where other risks are hedged.

67 It is argued by some that the hedge accounting requirements of IFRS 9 cannot be relied upon to address the accounting mismatches that can occur with contracts accounted for under the general model because:

(a) The risk component (hedged item) cannot be separately identified and neither be reliably measured for those contracts where investment and insurance components are highly interrelated. In addition, policyholder behaviour and other future expectations (for example lapses, surrenders, new business sales, mortality) are correlated with the impact of financial market variables and it is difficult to exclude these from the hedging relationship;

(b) Insurers hedge their risks on an open portfolio basis, not on a closed portfolio basis; and

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(c) Insurers hedge also changes in future mortality expectations that affect the contractual service margin rather than profit and loss or other comprehensive income.

68 In assessing the absence of a risk mitigation solution for indirect participation contracts, EFRAG notes that when risk components of insurance contracts cannot be separately identified or reliably measured, the creation of a hedge accounting relationship would not lead to useful information because it would be impossible to explain to users what is being hedged and how effective the entity's hedging strategy has been. Hence, EFRAG assesses that the absence of a hedge accounting solution for features of indirect participation contracts does not reduce relevance of the resulting information.

Sharing of risks

69 Some insurance contracts affect the cash flows to policyholders of other contracts by requiring the policyholder to share with policyholders of other contracts the returns on the same specified pool of underlying items. As a consequence, either of the policyholder groups may bear a reduction in their share of the returns because of payments to the other policyholder groups. Because such a sharing of risks between groups of policyholders is a normal insurance business practice, reflecting this business practice in the measurement of insurance liabilities enhances the relevance of the resulting measurement.

70 In determining the fulfilment cash flows of a group of insurance contracts, payments arising from the terms of existing contract to policyholders of contracts in other groups are considered, regardless of whether those payments are expected to be made to current or future policyholders. This effectively allows a transfer of cash flows between generations of policyholders (even when relying on closed groups of contracts).

71 Some argue that risk sharing as described by IFRS 17 does not reflect the economics of the insurance business and should include situations where cash flows are assigned to groups of insurance contracts based on discretion.

72 EFRAG considers that the risk sharing based on IFRS 17 should follow from the contractual terms of the insurance contracts. This would lead to relevant information as for some insurance contracts amounts based on discretion are not enforceable and their allocation may be subject to changes arising from internal and external factors. Further, the basis for any allocation may not be known to the affected group of policyholders and hence not be made available to users.

Performance of the insurance business

Current rate versus locked-in rate to accrete the contractual service margin

73 IFRS 17 requires that, for insurance contracts without direct participation features, the contractual service margin is accreted using the discount rate that was determined at initial recognition of a group of contracts. In contrast, for contracts with direct participation features, IFRS 17 requires that the contractual service margin is adjusted based on current discount rates.

74 EFRAG supports the use of a locked-in rate for contracts without direct participation features because at inception, the contractual service margin is a residual that represents unearned profit. As a result:

(a) the amount recognised in the statement of comprehensive income provides insight into the pricing power and cost control of an entity for a group of contracts; and

(b) when allocating the accretion of the contractual service margin to insurance revenue at a locked-in rate, a trend emerges that reveals an increase or decrease in pricing power and/or cost control of the entity.

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75 For contracts with direct participation features, the effect of changes in the entity's share of underlying items, which comprises both the effect of the passage of time, and the change in the value of the underlying items, is recognised in the contractual service margin. As a result, the contractual service margin is considered to be based on current discount rates. EFRAG considers that using current rates for these types of contracts provides relevant information because of the different economics of these contracts compared to the contracts without direct participation features.

76 Some argue that insurance contracts without direct participation features should also use current rates to accrete the contractual service margin as this would better reflect the estimate of unearned profit. In addition:

(a) Some propose that the difference between the current rate and the rate at inception could be recognised in other comprehensive income; whilst

(b) Others propose that the entire release of the contractual service margin should be recognised in profit or loss to avoid the complexities of permitting the option to recognise the release of the contractual service margin in other comprehensive income option as permitted in IFRS 17.

77 EFRAG does not agree with these views due to the reasons explained in paragraph 74. In addition, EFRAG supports both accounting options to present finance income or expenses either in profit or loss or disaggregated between profit or loss and other comprehensive income because they represent two business approaches of European insurers. Hence, EFRAG disagrees with the argument that complexity is created by introducing the option to use the other comprehensive income option without providing any compensating benefits.

Pattern of release of the contractual service margin

78 IFRS 17 requires an entity to systematically recognise the remaining contractual service margin in profit or loss over the coverage period thereby reflecting the provision of coverage as required by the contract. In order to determine the provision of coverage, an entity identifies the number of coverage units in a group. This is applicable for both contracts with and without direct participation features.

Release pattern of the contractual service margin for contracts without direct participation features

79 Some question whether the allocation of the contractual service margin to profit or loss under IFRS 17 provides relevant information about the performance of the insurance business. The contractual service margin is the unearned profit relating to the services to be provided. Therefore, the question arises as to what these services relate. This may be best explained by the following example: assume that Entity A provides annual hurricane[4] insurance in Florida. Hurricanes are more likely to occur in the third quarter. In assessing the release pattern, the EFRAG Secretariat has developed two views to be considered by EFRAG TEG.

View 1

80 Some view the service provided under an insurance contract as 'standing ready' to reimburse the policyholder for losses suffered as a result of the insured event. The entity 'stands ready' over the coverage period and not just when a claim occurs. 'Standing ready' would mean allocating the contractual service margin equally over the year, irrespective of the heightened risk of claims or actual claims in the third quarter. This is supported by IFRS 17, paragraph B119(b) requiring that the contractual service margin is allocated equally to each coverage unit over the coverage period. Refer to the Appendix where simplified examples reflect the systematic allocation of the contractual service margin over the coverage period.

[4] Whilst hurricane insurance would often be one of the risks covered by property insurance, for purposes of the example we focus only on this risk.

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81 Supporters of view 1 also argue that the contractual service margin allocation is not the only revenue or profit recorded in the insurance service result. Revenue for insurance services arises from the:

(a) Allocation of the contractual service margin;

(b) Release of the risk adjustment for non-financial risk;

(c) Insurance service expenses incurred; and

(d) Amounts related to insurance acquisition cash flows.

82 This means that even though the contractual service margin is allocated evenly over the year, the revenue for the third quarter would be higher compared to the other quarters in the hurricane example above. For instance, since the entity had made a provision of the expected cash outflows for the period August to September, this would be recognised as revenue (excluding the investment component) once the claims occur in the third quarter, thereby increasing the revenue for that period. Also, there would be revenue in the form of the release of the risk adjustment that the entity would recognise as compensation for bearing the uncertainty arising from insurance risk. This higher revenue would compensate for the claims expenses recognised in profit or loss.

View 2

83 For others, the service provided is more than merely standing ready for the insured event and includes the processing and handling of claims as well as the reimbursement of successful claims. This is based on the wording of IFRS 17, paragraph BC279 that notes "The Board noted that an entity provides this service over the whole of the coverage period, and *not just* when it incurs a claim." [emphasis added] I.e., in accordance with this view, the claim handling is not entirely ignored when allocating the contractual service margin to profit or loss.

84 When considering the hurricane example, supporters of view 2 think that revenue should increase in the third quarter, allowing an offset with the higher claims incurred. This means that whilst the contractual service margin should be allocated to all four quarters, a higher proportion of contractual service margin should be allocated to the quarter where the policyholder derives most benefit from the service, i.e. third quarter, because the entity provides additional service when the claim is incurred compared to the other quarters.

Question to EFRAG TEG

85 Which of the views above does EFRAG TEG support?

Release pattern of the contractual service margin for contracts with direct participation features

86 Some hold the view that the method to release the contractual service margin is not relevant for contracts with direct participation features which are substantially investment-related contracts because the pattern of release would not lead to the correct reflection of the performance of the entity. They argue that the contractual service margin should be released over the expected variable fee each year. The value of the underlying items would increase over time and therefore the shareholder's share of the underlying items would also increase over time. As a result, EFRAG understands that the contractual service margin recognised in profit or loss would increase over time.

87 EFRAG notes that the investment component is accounted for as part of the insurance contracts only when it is highly interrelated with the insurance component and other services and hence cannot be accounted for as distinct components. Therefore, EFRAG considers that the entity provides multiple services, such as insurance coverage and investment services, over the coverage period in return for

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an expected fee based on the duration of the contracts. Since these services are provided throughout the coverage period, EFRAG considers relevant that the contractual service margin should be systematically recognised in profit or loss over the coverage period.

Identification of coverage units

88 Coverage units of the group are determined as the quantity of benefits provided by the contracts in the group and its expected coverage duration.

Note and question to EFRAG TEG

Note to EFRAG TEG:

89 IFRS 17 does not provide guidance on what the quantity of benefits are. The EFRAG Secretariat would like EFRAG TEG's view on what the quantity of benefits represents in order to assess whether the use of the coverage units is relevant for computing the release of the contractual service margin to profit or loss.

90 The EFRAG Secretariat is aware that for life insurance, the quantity of benefits could be the sum assured[5], the sum at risk[6] or the face amount of a contract[7]. However, the EFRAG Secretariat is not sure whether there are any additional interpretations of what the quantity of benefits represent. Some members of the EFRAG IAWG are considering raising this issue with the IASB's Transition Resource Group.

Question to EFRAG TEG:

91 What does EFRAG TEG consider to be the quantity of benefits provided by insurance contracts in a group?

Presentation on the statement of comprehensive income

92 IFRS 17 distinguishes two ways that entities earn profits from insurance contracts:

(a) the insurance service result, which comprises insurance revenue and incurred claims and depicts the profit earned from providing insurance coverage; and

(b) the financial result, which captures (i) investment income from managing financial assets and (ii) insurance finance expenses which are the effects of discount rates and other financial variables on the value of insurance obligations.

93 EFRAG is of the view that the insurance service result will provide useful information for users. This is because it will reflect insurance services that have already been performed by the entity and therefore will reflect profit on an earned basis for each reporting period. The insurance revenue and incurred claims excludes any deposit component because this represents amounts payable to the policyholder regardless of an insured event occurring. EFRAG considers that since the insurance revenue and incurred claims relates to insurance services, presenting the deposit component separately provides relevant information.

[5] The sum assured is the amount payable to the policyholder or beneficiaries on the occurrence of an event insured under an insurance contract (for example death of the policyholder). The EFRAG Secretariat considers that the sum assured may not be a stated monetary amount.

[6] The sum at risk is the monetary difference between (i) the amount to pay to the policyholder upon death and (ii) the accrued cash value which is equal to the total premiums paid by the policyholder less the cost of insurance and less other charges determined by the entity.

[7] The face amount is the stated monetary amount that the policyholder's beneficiaries receive upon the death of the policyholder.

94 Furthermore, EFRAG considers that the financial result, which consists of investment income and insurance finance expenses, will provide useful information because it will depict the effects of investments and of market interest rates.

95 When applying IFRS 17, an entity will recognise the effect of changes in financial assumptions in the period in which the changes occur. However, the entity can choose where to present this effect - either in profit or loss (under financial result), or disaggregated between profit or loss (under financial result) and other comprehensive income.

96 EFRAG expects that entities will choose the accounting policy choice that reflects the economics of their business. The choice of accounting policy provides relevant information because entities would reflect how they manage their business including aligning the accounting treatment of insurance contract liabilities with that of assets, thereby aligning investment income and investment finance expense.

97 Based on the reasons above, EFRAG assesses that, overall, the statement of comprehensive income will provide relevant information on the performance of the insurance business and also relevant information on the extent to which profit arises from underwriting and from financial activities.

Presentation on the statement of financial position

98 IFRS 17 requires that an entity presents separately the carrying amount of groups of insurance contracts issued that are assets and insurance contracts issued that are liabilities.

99 Some consider that this separate presentation does not result in relevant information because the timing of the cash flows could make the insurance contracts move from a liability to an asset position or vice versa, for e.g. for travel insurance being sold by an agent, by the time the premium is received by the entity, the claims may already have been paid out.

100 The IFRS 17 requirements are in line with IAS 1 *Presentation of Financial Statements,* which generally prohibits the offsetting of assets and liabilities. Insurance contracts could be in an asset position if, for example, claims are already being paid out by the entity but premiums have not yet been received from the independent agents the entity is involved with. Therefore, users of financial statements would consider separate presentation of contracts in an asset position to provide relevant information because they would be able to assess whether there are late payments of premiums by policyholders.

101 Therefore, from the above reasons, EFRAG is of the view that, on balance, this requirement of separate presentation of contracts in an asset and liability position leads to relevant information.

Disclosures

102 The objective of the disclosure requirements is to provide a basis for the users of financial statements to assess the effect of applying IFRS 17 on the entity's financial position, financial performance and cash flows. To meet this objective, IFRS 17 contains a range of qualitative and quantitative disclosure requirements. The relevance of the disclosures will be assessed after the user outreach. Disclosures have been assessed under the Understandability section from paragraphs 226 to 232.

Transition requirements

103 At transition, entities are required to apply IFRS 17 retrospectively unless impracticable. The full retrospective approach recognises and measures insurance contracts as if IFRS 17 had always been applied. When impracticable, entities can choose between applying either the modified retrospective approach or the fair value approach. Under the modified retrospective approach, an entity uses

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reasonable and supportable information to achieve the closest outcome possible to the full retrospective approach.

104 Under the fair value approach, an entity applies IFRS 13 *Fair Value Measurement* and would use reasonable and supportable information to determine the contractual service margin or loss component of the liability for remaining coverage at the transition date using the terms of the contract and the market conditions at the transition date.

105 EFRAG considers that each of the above transition approaches would provide relevant information. Whenever practicable, entities would use the full retrospective approach that provides the most complete and consistent information. In other cases, entities would be expected to choose the transition approaches which provides the most relevant information for different groups of contracts depending on the availability of information and on what best reflects the business. Therefore, an entity could apply different transition approaches to different groups of contracts and the transition approaches would provide relevant information on the future profitability of the groups of contracts. As a result, users would be able to adapt their models to assess the future impact of IFRS 17.

106 In addition, EFRAG considers that the transition disclosures provide information for users on how entities have made this assessment. For example, IFRS 17 requires entities to explain how it determined the measurement of insurance contracts at the transition date.

107 Finally, some have argued that when applying the fair value approach, the contractual service margin on transition does not represent, entirely, the profit for future services to be provided and therefore is not useful information. Refer to paragraphs 145 to 148 for EFRAG's analysis on this point.

Conclusion about the relevance of information resulting from IFRS 17

108 The general measurement requirements are assessed to lead to relevant information as the rights and obligations that arise from insurance contracts are considered. Also, the measurement captures a full range of foreseeable outcomes and their probabilities. Finally, time value of money is being considered through the use of discounting.

109 The general measurement requirements are modified or simplified for:

(a) Contracts with direct participation features: These contracts are assessed to be of an economical different nature and the conditions to apply the approach for contracts with direct participation features are assessed to lead to relevant information as they permit the aim of reducing or eliminating accounting mismatches between the insurance liability and the underlying items of the contracts within the scope;

(b) Reinsurance contracts held: any reduction in relevance is considered to be sufficiently balanced by a reduction in complexity that would be required to disentangle economic mismatches from accounting mismatches;

(c) Investment contracts with discretionary participation features: the measurement is assessed to reduce relevance as it depends on the nature of the issuer how the contracts are to be measured; and

(d) Premium Allocation Approach: the reduction in relevance is considered not to be material and is balanced by the simplification it represents for preparers.

110 The aggregation requirements are assessed to be compatible with the industry practices of pooling of similar risks and application of the law of the large numbers. In addition, grouping provides a meaningful contractual service margin to permit allocation to insurance revenue over the life of the group without the need to track individual contracts. Hence, application of the aggregation criteria is assessed to lead to relevant information for users. This also applies for the measurement of the

insurance liability because it will provide current updated information about the effect of insurance contracts on an entity's financial position and risk exposure, as well as transparent information on expected profitability.

111 EFRAG has not completed its analysis yet with regard to how the performance of the insurance business is reflected and disclosures.

112 The statement of comprehensive income is expected to provide relevant information on the performance of the insurance business and distinguishes performance between underwriting activities and financial activities.

113 The requirement of separate presentation of contracts in an asset and liability position on the statement of financial position is assessed to be relevant as it is in line with IAS 1.

114 EFRAG's overall assessment is to be finalised.

Reliability

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

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

117 In its assessment of reliability, EFRAG has identified the following topics as being the most significant to this assessment:

(a) Measurement of insurance contracts;

(b) Risk mitigation;

(c) Performance of the insurance business;

(d) Reinsurance contracts held; and

(e) Transition requirements.

Measurement of insurance contracts

118 Measurement of insurance liabilities in IFRS 17 requires judgement in estimating the fulfilment value of an insurance contract. EFRAG acknowledges that judgement is inherent in the measurement of insurance contracts. Therefore, EFRAG considers that estimating future cash flows and the use of discount rates would not lead to reduced reliability but it would be enhanced when combined with disclosures. IFRS 17 requires disclosures on significant judgements and changes in judgements specifically relating to the inputs, assumptions and estimation techniques used.

119 In addition, EFRAG considers that reliability would not be reduced because entities have experience in applying judgement when applying other IFRS standards.

Discount rates

120 IFRS 17 requires entities to discount cash flows. Estimates of cash flows shall be consistent with other estimates used to measure insurance contracts to avoid double counting or omissions. Also, discount rates shall include only relevant factors, i.e. factors that arise from the time value of money, the characteristics of the cash flows and the liquidity characteristics of the insurance contracts. When such discount rates are not directly observable in the market, an entity shall use estimates.

121 IFRS 17 does not require a particular estimation technique for determining discount rates. However, in applying an estimation technique, an entity shall (i) maximise the use of observable inputs, (ii) reflect current market conditions from the perspective

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of a market participant, and (iii) use judgement in assessing the degree of similarity between the features of the insurance contracts being measured and the features of the instrument for which observable market prices are available and adjust those prices to reflect the differences between them.

122 In assessing the reliability of the use of discount rates, EFRAG:

(a) Acknowledges that no observable rates may be available for particular markets or very long durations, requiring the use of particular estimation techniques;

(b) Notes that dealing with estimates and uncertainty is inherent to the insurance business and the use of professional judgement is inherent to that; and

(c) Notes that an entity is required to disclose information about significant judgements and changes in judgements, including the approach used in determining the discount rates. Also the yield curve(s) used to discount cash flows that do not vary based on the return on underlying items are to be disclosed.

123 Overall, EFRAG assesses that the disclosures related to discounting mitigate any potential lack of reliability in estimation of the discount rates.

Risk mitigation

124 As noted in paragraph 65 above, IFRS 17 provides a particular risk mitigation approach for contracts with direct participation features but not for other contracts. It is argued by some that, by not providing a risk mitigation approach for all insurance contracts, accounting mismatches remain which affect the reliability of the information. In addition, the argument is raised that such a risk mitigation approach should be available retrospectively.

125 First, EFRAG points out that accounting mismatches need to be distinguished from economic mismatches. Showing economic mismatches provides useful information (for example different interest spreads between country A and B, when insurance liabilities in country A are covered with investments in country B) as they provide information on the risks the insurance entity is taking to achieve its business objectives.

126 Second, the asset and liability management techniques of the entity need to be considered when identifying accounting or economic mismatches. For example:

(a) An entity may promise the return on particular assets but decide not to hold these assets. When the real asset returns do not move in line with the promised returns, the resulting economic mismatch will have an impact on the statement of comprehensive income;

(b) Insurance entities hold different types of asset portfolios: (i) dedicated asset portfolios that support specific liability portfolios; (ii) a general fund, the assets of which support different insurance contract liabilities and (iii) surplus assets, which represent the overall excess of assets in relation to insurance liabilities;

(c) An insurance entity may want to achieve a targeted return on particular assets. When the assets in one of the portfolio described in (b) above do not achieve that return, they can be replaced (re-allocated) with other assets from another portfolio described in (b) above with better prospects without derecognition of the original assets (for example bonds can be replaced with equities or vice-versa); and

(d) Insurance contracts may affect the cash flows to policyholders of other contracts because risks are shared between the two classes of policyholders.

127 When, after consideration of these steps, accounting mismatches (as distinct from economic mismatches) arise, IFRS 17 and IFRS 9 provide the following techniques to address the accounting mismatches:

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(a) Unbundling of the investment components;

(b) Using discount rates for the insurance liability which reflect the characteristics of the underlying cash flows;

(c) Disaggregation of investment income and expenses;

(d) Allocation of the contractual service margin to profit or loss as services are provided;

(e) IFRS 9 hedge accounting; and

(f) IFRS 9 fair value option.

128 Overall, when some accounting mismatches remain after applying each of these steps, EFRAG considers that these may reduce the reliability of the information.

Performance of the insurance business

Use of coverage units for the contractual service margin

129 IFRS 17 requires the entity to recognise the contractual service margin in profit or loss over the coverage period based on the coverage units, reflecting the expected duration and size of the contracts in the group. The contractual service margin allocation based on coverage units implies the estimation of the number of contracts in force in each reporting period because the contractual service margin at the end of each reporting period should represent the amount to which the entity expects to be entitled in exchange for the services in the future.

130 If the number of contracts is expected to reduce over time, the contractual service margin recognised in profit or loss in each period will also reduce over time. Similarly, interest accreted on the contractual service margin will reduce over time as the contractual service margin reduces.

131 EFRAG acknowledges that the determination of the profit allocated in profit or loss based on the actual service provided over the expected duration and size of the contracts within a portfolio represents the use of significant estimates. For example, EFRAG understands that there could potentially be several coverage units for one insurance contract.

132 EFRAG's assessment is based on the use of coverage units within one group of insurance contracts. The use of coverage units without application of the grouping requirements of IFRS 17 is assessed in paragraph 57 above.

133 In assessing the reliability of the information resulting from the application of coverage units in allocation the contractual service margin to profit or loss EFRAG notes that:

(a) the estimation of coverage units is subject to professional judgement, the reliability of which is similar to other judgements used in applying IFRS 17; and

(b) the coverage units help an entity in reflecting its long-term business model over time as they allow unearned profit to be spread over the contract duration instead of recognising it entirely at day 1.

134 The conclusion on whether the use of coverage units provides reliable information will be assessed subsequently to EFRAG TEG's view on what the quantity of benefits represent as raised in paragraphs 88 to 91.

Use of locked-in rate for the contractual service margin

135 IFRS 17 requires that for insurance contracts without direct participation features, the contractual service margin is accreted using the discount rate that was determined at initial recognition of a group of contracts.

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136 Some argue that using current rates to accrete the contractual service margin would better reflect the best estimate of unearned profit. EFRAG has assessed the relevance of the use of the locked-in rate from paragraphs 73 to 77 above. The arguments used in that assessment are equally valid when assessing reliability.

137 In addition, for contracts without direct participation features, there is no direct connection between the liability and the underlying items. Therefore, the argument that the use of a current rate is necessary to avoid accounting mismatches with the assets is not supported by EFRAG. Finally, EFRAG notes that the relationship between the insurance liability and the assets held by the entity is not static but rather flexible due to the application of asset liability management techniques as described in paragraph 126.

138 Furthermore, some argue that using a locked-in rate would give rise to an accounting mismatch between the fulfilment cash flows in an asset position and the contractual service margin liability when interest rates change leading to misleading levels of and volatility in profit or loss and shareholder's equity. EFRAG notes that the contractual service margin liability would be accreted using a locked-in rate even if the fulfilment cash flows are in an asset or a liability position. Therefore, the arguments for using a locked-in rate for the contractual service margin are also valid here and are stated in paragraphs 73 to 77.

139 Overall, EFRAG assesses that accreting the contractual service margin at a locked-rate for contracts without direct participation features leads to reliable information.

Reinsurance contracts held

140 It is argued by some that there should be the same accounting treatment for both initial and subsequent measurement of the underlying insurance liability and the reinsurance contracts held to avoid any accounting mismatches.

141 EFRAG only partly agrees to the view that measurement for both types of contracts in accordance with IFRS 17 results solely in accounting mismatches. EFRAG's analysis under the 'Relevance' section also applies to the assessment of reliability and can be found in paragraphs 33 to 39.

142 To the extent accounting mismatches exist, EFRAG assesses these to lead to a reduction in the reliability of the resulting information. This reduction is however balanced by the avoidance of additional complexity in separating economic mismatches from accounting mismatches.

Transition requirements

Transition approaches

143 On transition, entities are required to apply IFRS 17 retrospectively unless impracticable. In the latter case, entities can choose between applying either the modified retrospective approach or the fair value approach

144 EFRAG assesses that the fully retrospective approach and the modified retrospective approach would result in the provision of reliable information based on the reasons explained in paragraphs 103 to 106. It is likely that retrospective application will be practicable for short-term contracts and recently issued long-term contracts. The comments below relate to long-term contracts that have been issued some time before the transition to IFRS 17.

145 When applying the fair value approach, the contractual service margin on transition will be the difference between the fair value of the group of insurance contracts at transition date and the fulfilment cash flows at that date.

146 In applying IFRS 13, entities will have to consider not only assumptions from a market participant perspective, but also the compensation that a market participant would require for taking on the obligation. This compensation will be part of the

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contractual service margin on transition and will be allocated to profit or loss consistently with IFRS 17.

147 It is argued by some that such an approach will not result in reliable information as the compensation that a market participant will require will differ in almost all cases from the contractual service margin that an entity would calculate otherwise. Thus, when applying the fair value approach, the contractual service margin on transition does not represent the profit for future services reported under the entity's previous accounting policies.

148 EFRAG notes that transitioning to a new standard changes previous recognition and measurement requirements. Applying a fair value approach allows entities to recognise the transition effect over the remaining duration of the contract portfolio. That is, the fair value approach (along with the other transition approaches) supports the notion of the entity's long-term business model.

Risk mitigation relating to transition

149 In assessing the view relating to retrospective application of a risk mitigation approach on transition, EFRAG notes that:

(a) entities do not always have detailed historical information about their insurance contracts;

(b) some entities have historical information available for their hedging relationships but only at an aggregated level. Retrospective application would raise practical issues on how to assign such amounts to groups of insurance contracts being hedged; and

(c) concerns about retrospective application relate to the determination of the equity position when transitioning to IFRS 17.

150 EFRAG assesses that in applying risk mitigation retrospectively an entity could use hindsight when allocating the hedging gains or losses to those groups of insurance contracts with the aim of achieving a particular result in profit or loss and in their equity position at transition. The use of hindsight is reinforced because of the absence of detailed historical information and the use of hedging gains or losses at aggregated level. EFRAG assesses that such an approach would not lead to reliable information.

Conclusion about the reliability of the information resulting from IFRS 17

151 EFRAG notes that dealing with estimates and uncertainty is inherent to the insurance business and the use of professional judgements is part of that. Hence, the use of judgement when measuring insurance contracts is assessed not to reduce reliability. However, combined with disclosures relating to the inputs, assumptions and estimation techniques used, EFRAG considers the resulting information to be reliable.

152 EFRAG also points out that not all mismatches are accounting mismatches. Reporting economic mismatches provides useful information to users when shown in the financial statements. When, after disentangling economic from accounting mismatches and after applying the multiple techniques offered by IFRS 17 and IFRS 9 in reducing accounting mismatches, some remain, EFRAG considers these to reduce the reliability of the information.

153 The assessment of whether the application of coverage units provides reliable information is still to be assessed.

154 Finally, EFRAG acknowledges that when applying the fair value approach at transition date, the contractual service margin on transition does not represent the estimates of the profit for future services calculated under the entity's previous accounting policies. EFRAG points out however that the fair value approach avoids a day 1 impact on equity and it allows an entity to represent the long-term business

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model (along with the other transition approaches). These effects balance any reduction in reliability.

155 EFRAG's overall assessment is to be finalised.

Comparability

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

157 EFRAG has considered whether IFRS 17 results in transactions that are:

(a) economically similar being accounted for differently; or

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

158 In its assessment of comparability, EFRAG has identified the following topics as being the most significant to this assessment:

(a) Separating components from an insurance contract;

(b) Measurement of insurance contracts;

(c) Different insurance accounting models;

(d) Accounting policy options;

(e) Performance of the insurance business; and

(f) Transition requirements.

Separating components from an insurance contract

159 IFRS 17 includes requirements for the separation of distinct non-insurance components from the insurance components of a contract. That is, embedded derivatives and investment components are recognised under IFRS 9 and sales of goods and services are recognised by applying IFRS 15 *Revenue from Contracts with Customers*.

Embedded derivatives

160 Embedded derivatives are a component of a hybrid contract that also includes a non-derivative host. IFRS 17 relies on the requirements of IFRS 9 in imposing separation of embedded derivatives from the host insurance contract. That is, embedded derivatives are to be separated when their economic characteristics are not closely related to those of the host insurance contract. After being separated, embedded derivatives are measured at fair value in the same way as stand-alone derivatives.

161 EFRAG assesses that separation of embedded derivatives that are not closely related to the host insurance contract ensures that contractual rights and obligations that create similar exposures are treated alike whether or not they are embedded in a non-derivative host insurance contract. EFRAG assesses this leads to comparable information.

Investment components

162 An investment component is the amount an insurance contract requires the entity to repay to the policyholder even if an insured event does not occur. IFRS 17 requires an investment component to be separated only when it is distinct from the host insurance contract. When separated, the investment component is measured in accordance with IFRS 9.

163 Similarly as for embedded derivatives, EFRAG assesses that separation of investment components that are distinct from the host insurance contract ensures that contractual rights and obligations that create similar exposures are treated alike

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whether or not they are part of a host insurance contract. EFRAG assesses this leads to comparable information across industries.

164 However, EFRAG assesses that the separation of investment components has an additional advantage: the measurement in accordance with IFRS 9 allows the elimination of an accounting mismatch that could arise if the underlying financial assets were not measured in accordance with IFRS 9.

165 IFRS 17 also requires an adjustment to be made to the contractual service margin if there are differences between the actual and expected cash flows from an investment component that is not separated.

166 EFRAG assesses that the requirement to present insurance revenue in the financial statements increases complexity for preparers because they must keep track of the changes in the investment components and exclude them from insurance revenue and from incurred claims presented in the statement of profit or loss. The accounting treatment is in line with the long term business model of insurers.

167 However, EFRAG considers that distinguishing insurance revenue from investment components revenue provides a significant benefit for users of financial statements in terms of comparability between insurers and entities in other industries.

Service components

168 IFRS 17 requires separating the provision of goods and non-insurance services from the host insurance contracts and measuring these in accordance with IFRS 15.

169 EFRAG assesses that separation of service components reflects the economics of both the service and the insurance component of the insurance contract. EFRAG assesses this leads to comparable information.

Overall

170 EFRAG considers that separating these components provides useful information for users because it would allow them to better compare how entities in different businesses or industries provide similar services.

Measurement of insurance contracts

171 IFRS 17 requires the measurement of a group of insurance contracts to include the total of:

(a) the fulfilment cash flows which comprise (i) estimates of future cash flows; (ii) an adjustment to reflect the time value of money and the financial risks to the extent it is not included in the estimates of the future cash flows (the discount rate); and (iii) a risk adjustment for non-financial risk; and

(b) the contractual service margin.

172 On subsequent measurement, the liability will in addition to the liability for remaining coverage also include the liability for incurred claims.

173 EFRAG acknowledges that some of the estimates, such as the risk adjustment for non-financial risk, should reflect that perspective of the entity which could reduce the comparability of information through the use of judgements. However, EFRAG notes that such information should:

(a) incorporate, in an unbiased way, all reasonable and supportable information available without undue cost and effort;

(b) be current and reflect conditions existing at the measurement date; and

(c) include estimates of any relevant market variables which are consistent with observable market prices for those variables.

174 Therefore, EFRAG considers that, although comparability may be impaired for the measurement of the risk adjustment, IFRS 17 requires explicit disclosures to be

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made which can mitigate to some extent the reduction in comparability of the recognised amounts, for example, entities have to disclose the confidence level used to determine the risk adjustment.

175 Furthermore, entities will apply judgement in order to determine the discount rates for the fulfilment cash flows. Therefore, the discount rates will be entity-specific because they reflect the characteristics of the insurance contract cash flows. EFRAG does not consider that this affects comparability as the same principles will be applied to estimates of different fact patterns.

Different insurance accounting models

176 IFRS 17 defines the principles for the measurement of insurance contracts. Those principles are modified for:

(a) contracts with direct participation features;

(b) reinsurance contracts held;

(c) investment contracts with discretionary participation features; and

(d) contracts where the Premium Allocation Approach is applied.

177 As discussed below, these differences do not create a material reduction in comparability, but rather reflect the characteristics of different types of insurance contracts.

Contracts with direct participation features

178 The contractual service margin for contracts with direct participation features is updated for more changes than those affecting the contractual service margin for other insurance contracts. In addition to the adjustments made for other insurance contracts, the contractual service margin for insurance contracts with direct participation features is adjusted for the effect of changes in:

(a) the entity's share of the underlying items; and

(b) financial risks other than those arising from the underlying items, for example the effect of financial guarantees.

179 EFRAG assesses that this is not so much a reduction in comparability as an adjustment to the IFRS 17 principles to reflect the special features of contracts with direct participation features.

180 Furthermore, comparability among contracts with direct participation features would be achieved.

181 One of the characteristics of an insurance contract with direct participation features is that the contractual terms should specify that the policyholder participates in a share of a clearly identified pool of underlying items. Therefore, the rights and obligations arising from the discretionary payments could fail the definition of an insurance contract with direct participation features, if they are not considered to form part of the 'contractual terms'.

182 Some argue that certain contracts with discretionary payments made to the policyholder, are economically similar in nature to insurance contracts with direct participation features even though the obligation to make payments is not contractual. Therefore, assuming that the other requirements in IFRS 17 are met, these types of contracts should be accounted for under the approach for contracts with direct participation features.

183 EFRAG assesses that a contract can arise because of a constructive obligation but that not all constructive obligations would give rise to contract conditions and, therefore, do not necessarily result in financial liabilities. EFRAG acknowledges that whether an enforceable contractual right or obligation exists is a question to be considered within the context of the relevant legal framework. Consequently, the

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factors that determine enforceability may differ between jurisdictions. Therefore, in order to demonstrate that discretionary payments made to the policyholder are within the scope of the approach for contracts with direct participation features, EFRAG acknowledges that it should have contractual terms that are enforceable. As a result, EFRAG assesses that, if contractual terms are not enforceable, the fact that the approach for contracts with direct participation features would not be able to be applied does not hinder comparability.

Reinsurance contracts held

184 For a group of reinsurance contracts held there is no unearned profit but instead a net cost or net gain on purchasing the reinsurance. That net cost or net gain at initial recognition is recognised as a contractual service margin, with specific requirements for subsequent measurement. Also, the risk adjustment for non-financial risk reflects the amount of risk being transferred by the holder of the group of reinsurance contracts to the issuer of those contracts.

185 EFRAG acknowledges the high dependence between a reinsurance contract held and the underlying insurance contract(s). However, EFRAG is of the view that these are different contracts with different counterparties. Furthermore, IFRS Standards do not generally permit the offsetting of contracts with different counterparties.

186 For reinsurance contracts held, any net cost on purchasing the reinsurance is recognised as a debit to the contractual service margin unless the reinsurance contracts cover events that have already occurred. However, for insurance contracts issued by the primary insurer, the contractual service margin can never be negative and any amount below zero would be recognised in profit or loss. One could argue that the measurement is not consistent between the reinsurance contracts held and insurance contracts issued.

187 EFRAG acknowledges that the treatment of reinsurance contracts held and reinsurance contracts issued is not identical. However, EFRAG considers that the contractual service margin for a group of reinsurance contracts held is different from that for a group of insurance contracts issued. This is because the contractual service margin for the group of reinsurance contracts held depicts the expense that the entity incurs when purchasing reinsurance coverage rather than the profit it will make by providing services under the insurance contract. EFRAG does not consider that an entity would expect to make a profit on reinsurance contracts held, rather these contracts are purchased in order to share risks or to transfer the risks to the reinsurer. Therefore, the different treatment reflects the different economics of the groups of contracts.

Investment contracts with discretionary participation features

188 Investment contracts with discretionary participation features do not transfer significant insurance risk. Hence, IFRS 17 changes the general requirements so that cash flows are within the contract boundary if they result from a substantive obligation of the entity to deliver cash at a present or future date.

189 EFRAG assesses that the changes to the general requirements reflect the fact that such contracts do not transfer significant insurance risk, which justifies the difference from the accounting for insurance contracts without discretionary participation features.

190 EFRAG notes that IFRS 17 applies only to investment contracts with discretionary participation features that are issued by an entity that also issues insurance contracts. Other companies apply IFRS 9 to such contracts. This could create situations where two entities in the same group apply different standards (IFRS 17 or IFRS 9) for these types of contracts which are economically similar. The difference in treatment and thus the reduction in comparability between different types of entities, depending on whether the issuer is an insurer or for example a

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bank, can in EFRAG's view be justified by the difference in business model each type of entity relies upon.

Premium Allocation Approach

191 The Premium Allocation Approach, which is a simplification of the IFRS 17 principles, can be applied in circumstances where the entity expects such simplification would produce a measurement that is not materially different than a measurement following the general requirements or when the coverage period is one year or less.

192 EFRAG assesses that this should not lead to a material reduction in comparability because of the eligibility criteria and is balanced by the fact that this approach provides a simpler way for entities to measure insurance contracts with a shorter duration.

Accounting policy options

193 For contracts with direct participating features for which the entity does not hold the underlying items and for contracts without direct participating features, IFRS 17 offers an accounting policy choice for presenting insurance finance income or expenses either in profit or loss or disaggregating it between other comprehensive income and profit or loss.

194 Also, for insurance contracts with direct participation features, for which the entity holds the underlying items, an entity shall make an accounting policy choice between:

(a) including insurance finance income or expenses for the period in profit or loss; or

(b) disaggregating 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 on the underlying items held.

195 EFRAG assesses that these accounting policy options reduce comparability between entities because it will require additional effort from users to understand the business model of the entity. However, that reduction in comparability is balanced by the relevance of the resulting information because it permits entities to reduce or eliminate accounting mismatches between the insurance liabilities and the investment assets supporting those insurance liabilities.

Own debt or equity instruments as underlying items

196 An accounting policy choice is available under IAS 32 *Financial Instruments – Presentation* for entities who issue groups of insurance contracts with direct participation features and who also hold the underlying items. If such underlying items include the entity's treasury shares, an entity may elect not to deduct from equity the treasury share when, and only when an entity reacquires its own equity instrument for such purposes. Instead, the entity may elect to continue to account for that treasury share as equity and to account for the reacquired instrument as if the instrument were a financial asset and measure it at fair value through profit or loss in accordance with IFRS 9. That election is irrevocable and made on an instrument-by-instrument basis.

197 A similar accounting policy choice is available for own debt instruments that serve as underlying items whereby an entity may elect not to derecognise its financial liability that is included in such a fund or is an underlying item. Instead, the entity may elect to continue to account for that instrument as a financial liability and account for the repurchased instrument as a financial asset at fair value through profit or loss.

198 EFRAG assesses that such accounting policy choices for both own debt or equity instruments as underlying items may reduce the comparability of information

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between entities. However, any loss in comparability is balanced by the relevance of reflecting the entity's business model. EFRAG also notes that separate disclosure is required for treasury shares held under both IAS 1 and IAS 24 *Related Party Disclosures* which mitigate any impact on comparability.

Performance of the insurance business

199 IFRS 17 requires entities to present revenue for insurance contracts determined in a way that is broadly consistent with the general principles in IFRS 15. Consistent with IFRS 15, an entity depicts revenue for the transfer of promised coverage and other services at an amount that reflects the consideration to which the entity expects to be entitled in exchange for the services. This means that the entity:

(a) excludes from insurance revenue any investment components; and

(b) recognises insurance revenue in each period as it satisfies the performance obligations in the insurance contracts.

200 EFRAG assesses that determining insurance revenue in this way makes the financial statements more comparable not only between insurance entities but also across other industries.

201 IFRS 17 also allows entities not to disaggregate the change in the risk adjustment for non-financial risk between the insurance service result and insurance finance income or expenses. If an entity does not make such a disaggregation, it shall include the entire change in the risk adjustment for non-financial risk as part of the insurance service result.

202 EFRAG considers that although such a choice may reduce the comparability of the insurance service result between entities, it would increase complexity to require entities to identify the effect of a change in discount rate on the risk adjustment given the different techniques that are available for measuring the risk adjustment. EFRAG also acknowledges that the reduction is mitigated by requiring entities to disclose the confidence level to which the risk adjustment for non-financial risk corresponds in order to allow users to understand how the assessment of risk aversion might differ from entity to entity.

Transition requirements

203 At transition, entities are required to apply IFRS 17 retrospectively unless impracticable. In the latter case, entities can choose between applying either the modified retrospective approach or the fair value approach.

204 EFRAG acknowledges that the use of three different transition methods reduces comparability among entities and, in the case of very long-term contracts, over a considerable period. However, for long-term insurance contracts, it may be difficult to gather the necessary data to apply a retrospective method without undue cost or effort or entities may not have the necessary data. Therefore, EFRAG considers that in order to help with or mitigate the reduced comparability, separate disclosures are required for each transition approach that an entity applies. For example, at transition date, reconciliations are required of the contractual service margin and insurance revenue of insurance contracts groups, separately for each of the transition methods used.

Restatement of comparatives for 2020 for IFRS 17

205 IFRS 17 requires entities to present comparative information for at least one reporting period before transition, i.e. 2020 if an entity applies IFRS 17 at its effective date. EFRAG notes that this will require entities to present comparative information during 2020 for insurance liabilities while entities that have elected to defer IFRS 9 *Financial instruments* are not required to do so for their financial assets.

206 EFRAG is of the view that, given the significant changes to insurance accounting introduced by IFRS 17 providing comparative information for 2020 enhances the

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comparability of the information over time and is justified by the high degree of diversity in current accounting for insurance contracts.

207 EFRAG additionally notes that the requirement to provide comparative information for 2020 treats all entities alike, irrespective of whether they have elected to defer IFRS 9 or not, thereby avoiding issues of comparability.

Conclusion about the comparability of the information resulting from IFRS 17

208 EFRAG has assessed that the separation requirement under IFRS 17 for components which are distinct and not closely related to an insurance contract, will increase comparability amongst entities in different businesses and industries.

209 IFRS 17 requires the exercise of judgement in a number of areas. Judgements are inevitable in principles-based standards and may be necessary in order to achieve comparability rather than uniformity (which in some instances disregards the substance of a transaction or event). However, EFRAG considers that the extensive disclosure requirements that have to be provided mitigate the reduction of comparability introduced by judgement.

210 EFRAG acknowledges that the general measurement model under IFRS 17 are modified under four different scenarios which could affect comparability. However, EFRAG's assessment is that the different treatment is justified as it reflects the:

(a) economic substance of the different groups of contracts; and

(b) business model of each type of entity.

211 The requirement under IFRS 17 to exclude from revenue, any amounts received for deposits are assessed by EFRAG to increase comparability of financial performance amongst insurance entities and other industries.

212 EFRAG considers that limitations to comparability arise in relation to:

(a) accounting policy options on risk adjustment for non-financial risk (see paragraphs 201 - 202);

(b) the transition requirements caused by the allowance to choose between two transition methods when retrospective application is impracticable (see paragraphs 203 - 204);

(c) accounting policy options on discounting (see paragraphs 193 - 195); and

(d) own debt or equity instruments as underlying items (see paragraphs 196 - 198).

213 These limitations to comparability are however balanced against the overall relevance of the resulting information, the extensive disclosure requirements and the reduced costs and complexity for preparers.

214 With regards to the restatement of comparatives for 2020, EFRAG also assesses that comparability is increased over time through the reduction in the diverse treatment of current accounting and the requirement to treat all entities in the same manner, irrespective of whether or not they have elected to defer the application of IFRS 9.

215 EFRAG's overall assessment is to be finalised.

Understandability

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

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217 Although there are a number of aspects related to the notion of ‘understandability’, EFRAG considers that most of the aspects are covered by the discussion above about relevance, reliability and comparability.

218 As a result, EFRAG is of the view that the main additional issue it needs to consider is assessing whether the information resulting from the application of IFRS 17 is understandable and whether that information will be unduly complex.

219 In its assessment of understandability, EFRAG has identified the following topics as being significant to this assessment:

(a) Remaining accounting mismatches;

(b) Presentation on the statement of financial position;

(c) Reinsurance contracts held: existence of accounting mismatches; and

(d) Disclosures.

Remaining accounting mismatches

220 The accounting policy options in IFRS 17 to account for insurance finance income or expenses either in profit or loss or disaggregating it between other comprehensive income and profit or loss allows entities to reduce or fully eliminate accounting mismatches with the assets invested in. Any remaining accounting mismatches reduce the understandability of the resulting information and hinder the understanding of economic mismatches. However, as stated in paragraph 127, EFRAG considers that several techniques are available to address any accounting mismatches.

Presentation on the statement of financial position

221 EFRAG has assessed the relevance of presentation on the statement of financial position in paragraphs 98 to 101 above.

222 EFRAG notes that IFRS 17 requires disclosure on the reconciliation of the net carrying amount from the beginning to the end of the period. This reconciliation is to be provided separately for those groups of contracts that are assets and those that are liabilities. The totals should equal the amounts presented on the statement of financial position.

223 EFRAG assesses that these disclosures will help users understand to which extent the entity is subject to late payment of premiums from policyholders.

Reinsurance contracts held: existence of accounting mismatches

224 EFRAG has assessed the relevance of the accounting for reinsurance contracts held in paragraph 38 above.

225 EFRAG notes that the disclosure requirements provide separate reconciliations for insurance contracts issued and reinsurance contracts held. In addition, an entity shall adapt the disclosure requirements to reflect the features of reinsurance contracts held that differ from insurance contracts issued. EFRAG assesses that these disclosures contribute to the understandability of the information for reinsurance contracts held.

Disclosures

Assumptions and judgements made in measuring the insurance liability

226 Insurance implies dealing with uncertainty. When concluding an insurance contract, the entity has no certainty if and/or when a claim will be made. As a result, entities need to rely on assumptions and apply judgements at all stages until the contract is completed. EFRAG notes that such assumptions and judgements may affect the understandability by users of amounts being recognised.

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227 To compensate, IFRS 17 requires entities to disclose the inputs, assumptions and estimation techniques used in developing their judgements. These disclosures can mitigate to some extent the reduction in understandability of the recognised amounts.

Accounting policy options on finance income and expense

228 For contracts with and without participating features, IFRS 17 offers an accounting policy choice for presenting insurance finance income or expenses either in profit or loss or disaggregating it between other comprehensive income and profit or loss.

229 EFRAG assesses that this accounting policy option reduces the understandability for users of the financial statements in that users often focus more on items recognised in profit or loss than items recognised in other comprehensive income. However, the reduction in understandability is countered by the extensive disclosure requirements in IFRS 17 if such a disaggregation has been applied.

Insurance revenue

230 Insurance revenue depicts the provision of coverage and other services arising from a group of insurance contracts at an amount that reflects the consideration to which an entity expects to be entitled in exchange for those services.

231 EFRAG notes that the disclosures require an entity to provide reconciliations showing how the net carrying amounts of contracts changed during the period because of cash flows and income and expenses is recognised in the statement of financial performance. In addition, EFRAG notes that disclosures require information about the inputs, assumptions and estimation techniques relating to significant judgements taken in applying IFRS 17. EFRAG will conclude on whether these disclosures provide sufficient information after its outreach with users.

Transition requirements

232 At transition date, the disclosures identified in paragraph 204 will mitigate the reduction in understandability when applying different transition methods.

Conclusion about the understandability of the information resulting from IFRS 17

233 EFRAG is cautious in the identification of accounting mismatches as (i) many mismatches are in fact economical mismatches, (ii) consideration is to be given to the asset and liability management of insurers and (iii) both IFRS 17 and IFRS 9 provide many techniques for reducing or eliminating accounting mismatches. In the situations where accounting mismatches remain, EFRAG is of the view that these reduce the understandability of the information.

234 However, in the particular case of reinsurance contracts held, the disclosures for these contracts contribute to the understandability of the relation between insurance and reinsurance contracts.

235 The disclosures also help in understanding the presentation of insurance contracts that are in an asset or in a liability position.

236 EFRAG has assessed that the requirements in IFRS 17 result in understandable information even if IFRS 17 introduces assumptions and judgements made in measuring the insurance liability, includes accounting policy options and practical expedients upon transition. However, EFRAG has assessed that these assumptions and judgements, options and practical expedients would not impair understandability as they are supported by the disclosure requirements in IFRS 17.

237 EFRAG's overall assessment is to be finalised.

Prudence

238 For the purpose of this endorsement advice, prudence is defined as caution in conditions of uncertainty. In some circumstances, prudence requires asymmetry in

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recognition such that assets or income are not overstated and liabilities or expenses are not understated.

239 Prudence is different from and unrelated to prudential reporting. The former is a qualitative characteristic used in accounting standard setting and is applicable to the financial statements of all companies. The latter refers to the reporting by individual financial institutions to regulators in order to meet the regulator's objectives (such as capital adequacy and liquidity).

240 EFRAG has considered in its assessment whether the following requirements in IFRS 17 are consistent with the concept of prudence:

(a) Recognition of liabilities arising from insurance contracts;

(b) Measurement of insurance contracts;

(c) Level of aggregation; and

(d) Performance of the insurance business.

Recognition of liabilities arising from insurance contracts

241 By requiring the recognition of liabilities arising from all insurance contracts corresponding to the unavoidable payments to be made under the insurance contract, EFRAG assesses that IFRS 17 is consistent with the concept of prudence.

Measurement of insurance contracts

242 To provide transparent and timely information about insurance risks, and changes in those risks, IFRS 17 requires the use of current estimates based on the most up-to-date information available.

243 Similarly, IFRS 17 requires an entity to include all financial options and guarantees embedded in insurance contracts in the measurement of the fulfilment cash flows, in a way that is consistent with observable market prices for such options and guarantees.

244 It may be argued that measuring insurance liabilities relying on fulfilment value (i.e. an entity-specific current value) affects the prudence of the measurement. EFRAG disagrees with this view for the following reasons.

(a) Although entities will rely on assumptions and estimates in defining the measurement, the fulfilment cash flows incorporate two factors dealing with the uncertainty that follows from using such assumptions and estimates:

(i) The insurance contract liability is increased by a risk adjustment for non-financial risk, defined as the compensation an entity requires for bearing the uncertainty about the amount and timing of the cash flows that arise from non-financial risk as the entity fulfils the insurance contracts; and

(ii) Adjustments are made for time value of money and financial risk.

(b) The contractual service margin, which represents unearned profit, is only released to profit or loss as and when services are provided under the insurance contracts.

(c) The expected present value of cash flows is determined by looking at all possible scenarios without undue cost or effort. Thereby, caution is incorporated by looking at the possible scenarios.

245 IFRS 17 requires an entity to disregard its own credit risk when measuring the fulfilment cash flows. EFRAG acknowledges that excluding own credit risk could lead to mismatches, because the fair value of the items viewed as backing insurance contracts includes changes in credit risk on those assets, while the measurement of a group of insurance contracts would exclude changes in the credit risk of the issuer of the group of contracts. However, EFRAG assesses that such mismatches will

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more often be economic in nature, because the credit risk associated with the insurance contracts differs from the credit risk of the items held by the entity.

246 Taking into account the above, EFRAG considers that measuring insurance liabilities at a fulfilment value does not raise concerns about prudence.

Level of aggregation

247 IFRS 17 requires an entity to identify onerous contracts at initial recognition. The entity is required to recognise losses on those contracts immediately in profit or loss. Subsequently, the entity is required to regularly update the fulfilment cash flows and for:

(a) groups of onerous contracts: recognise in profit or loss any additional losses; and

(b) other groups of contracts: adjust the contractual service margin. If the contractual service margin for those groups of contracts is reduced to zero, changes relating to additional expected outflows are recognised in profit or loss.

248 EFRAG considers that these requirements will avoid understating liabilities and thus lead to prudent accounting.

Performance of the insurance business

249 IFRS 17 requires an entity to recognise profit according to the source of the profit being:

(a) the contractual service margin: recognised as profit as the entity provides services over the coverage period; and

(b) the risk adjustment: recognised in profit or loss as the entity is released from risk over the coverage period and the settlement period.

250 The contractual service margin represents unearned profit. That profit is uncertain as it may be affected by changes in future estimates and differences in actual outcomes. Consequently, EFRAG assesses that recognising the profit only when services are provided is a prudent approach.

251 In addition, for contracts without participation features, EFRAG assesses that discounting the contractual service margin at the locked-in rate leads to prudent accounting. EFRAG notes that accreting the contractual service margin at a current rate would allow an entity to change the finance expenses from period to period even if there was no change in expected cash flows. In EFRAG's view, such an approach is not consistent with prudent accounting.

252 The risk adjustment for non-financial risk is the compensation an entity requires for bearing the uncertainty about amount and timing of cash flows, i.e. it is an additional profit buffer. Allocating that buffer to profit or loss when the entity is released from risk is assessed to lead to prudent accounting.

Conclusion about prudence

253 EFRAG has concluded that:

(a) measuring insurance liabilities at a fulfilment value does not raise concerns about prudence;

(b) identifying onerous contracts at initial recognition and subsequently updating the fulfilment cash flows for measurement purposes will avoid understating liabilities;

(c) recognising profit only when services are provided is a prudent approach;

(d) for contracts without participation features, the unlocking of the contractual service margin at the locked-in rate leads to prudent accounting; and

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(e) allocating a risk adjustment for non-financial risk to profit or loss only when the entity is released from risk is assessed to lead to prudent accounting.

254 EFRAG's overall assessment is to be finalised.

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Appendix – Simplified examples of the release of the contractual service margin to profit or loss as per IFRS 17

Assumptions

1 At inception, the contractual service margin is CU100 and 1 contract is 1 coverage unit;

2 There are 100 coverage units per year, adjusted for any expected claims per year; and

3 All expected claims are estimated to occur at the end of the year and all unexpected claims occur also at the end of the year.

Explanation of the linear allocation of the contractual service margin

4 For the examples below, the allocation of the contractual service margin is linear because even though there is a claim (expected or unexpected), all the contracts remain in-force till the end of the coverage period. Since all the contracts remain in-force, service is provided to all 100 coverage units each year.

Example 1 - No claims estimated and no claims actual occur

		20X1	20X2	20X3	20X4	20X5
number of coverage units (estimated and actual)		100	100	100	100	100
CSM Actual roll-forward	Inception	20X1	20X2	20X3	20X4	20X5
Opening balance (Euro)	100	100	80	60	40	20
P&L allocation (Euro)	-	(20)	(20)	(20)	(20)	(20)
Closing balance (Euro)	**100**	**80**	**60**	**40**	**20**	**-**

Example 2 - Expected claims in years 20X2 (at end of year) and 20X4 (at end of year) which actually occur[8]

		20X1	20X2	20X3	20X4	20X5
Unexpected claims at end of year		-	-	-	-	-
Expected claims at end of year		-	20	-	10	-
CSM Actual roll-forward	Inception	20X1	20X2	20X3	20X4	20X5
Opening balance (Euro)	100	100	80	60	40	20
P&L allocation (Euro)	-	(20)	(20)	(20)	(20)	(20)
Closing balance (Euro)	**100**	**80**	**60**	**40**	**20**	**-**

[8] This pattern of allocation of the contractual service margin would be the same as Example 2 even if the claims are unexpected.

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