EFRAG
European Financial Reporting Advisory Group

IFRS 17 *Insurance Contracts* as amended in June 2020
Final Endorsement Advice
Appendix II[1]

1 EFRAG has focused its assessment on the requirements it considered most significant in relation to each of the criteria, as per previous documents with Endorsement Advice. EFRAG has accordingly focused on aspects that:

(a) are fundamental to the accounting for insurance contracts;

(b) have been subject to substantial debate (evidenced by the comments EFRAG has received from constituents including participants in EFRAG's field-tests and the comment letter due process on the amendments to IFRS 17);

(c) may be problematic to apply, as evidenced in particular by the results of EFRAG's case-studies; and

(d) relate to the issues raised by the European Commission in its request for endorsement advice.

2 The technical criteria assessed in Appendix II are set out in the Regulation (EC) No 1606/2002 of the European Parliament and of the Council for the adoption of international financial reporting standards.

3 The assessment considers the views and concerns expressed by stakeholders in the debate. EFRAG notes that significant changes to accounting standards (such as expected credit loss versus incurred loss for IFRS 9) may take time to become entrenched and fully understood by stakeholders and so the full value of these changes will materialise after the first few periods of application.

4 EFRAG has assessed IFRS 17 requirements for each of the following topics against the technical criteria as set out in the table below. Note that content relating to the requirement to apply annual cohorts to intergenerationally-mutualised and cash flow matched contracts is in Annex 1 to the Cover Letter.

5 EFRAG notes that in the consultation on the draft endorsement advice, several constituents suggested to recommend considering some requirements for a post-implementation review of the standard. These requirements are: annual cohorts (suggested by constituents that support this requirement), the use of discount rates in general, the determination of the risk adjustment, CSM amortisation, scope of the VFA (amendment to paragraph B107), application of the contract boundary definition to reinsurance contracts held, treatment of reinsurance contracts, locked-in discount rates under the general model, disclosures of portfolios in an asset or liability position, equivalent confidence level disclosure for the risk adjustment, measurement of time value of options and guarantees, presentation of insurance premium receivables and claims payables, contracts acquired in their settlement period, separating components from an insurance contract, multi-component contracts, wider application issues relating to discount rates. Different constituents recommended different items.

[1] Paragraphs highlighted in grey denotes EFRAG conclusions or assessments.

	Topic	**Relevance**	**Reliability**	**Compar-ability**	**Understan-dability**	**Prudence**
1	Scope exclusions for loans and other forms of credit that transfer insurance risk	X		X		
2	Measurement of insurance contracts	X	X	X		X
3	Insurance acquisition cash flows	X	X	X		X
4	Separating components from an insurance contract	X	X	X		
5	Different insurance accounting models	X	X	X	X	
6	Mutual entities	X		X	X	
7	Annual cohorts[2]	X				
8	Treatment of investment components	X	X	X	X	
9	Risk mitigation option	X		X		
10	Contractual service margin	X	X	X	X	X
11	Contract boundaries	X				
12	Presentation in the statement of comprehensive income	X		X	X	
13	Presentation in the statement of financial position	X			X	
14	Disclosures	X	X		X	
15	Transition requirements	X	X	X	X	X
16	Business combinations	X		X	X	
17	Accounting policy options			X		
18	Interim reporting			X		
19	Reinsurance contracts held in a net cost position					X
20	Identification of onerous contracts					X

[2] Content relating to the requirement to apply annual cohorts to intergenerationally-mutualised and cash flow matched contracts is in Annex 1 to the Cover Letter.

Contents

IFRS 17 *Insurance Contracts* as amended in June 2020 1
Final Endorsement Advice 1
Appendix II 1
Relevance 5
Optional scope exclusions for loans and other forms of credit that transfer insurance risk 6
Measurement of insurance contracts 6
Insurance acquisition cash flows 10
Separating components from an insurance contract 10
Different insurance accounting models 11
Mutual entities 16
Annual cohorts 18
Treatment of investment components 18
Risk mitigation option 18
Contractual service margin 19
Contract boundaries 20
Presentation in the statement of comprehensive income 21
Presentation in the statement of financial position 22
Disclosures about future release of CSM 23
Transition requirements 24
Business combinations 28
Conclusion about the relevance of information resulting from IFRS 17 30
Reliability 34
Measurement of insurance contracts 34
Insurance acquisition cash flows 35
Separating components from an insurance contract 36
Different insurance accounting models 36
Treatment of investment components 38
Contractual service margin 38
Disclosures 39
Transition requirements 39
Conclusion about the reliability of information resulting from IFRS 17 41
Comparability 43
Scope exclusions for loans and other forms of credit that transfer insurance risk 43
Measurement of insurance contracts 44
Insurance acquisition cash flows 45
Separating components from an insurance contract 45
Different insurance accounting models 46
Treatment of investment components 48
Risk mitigation option 48
Contractual service margin 49
Presentation in the statement of comprehensive income 49

Transition requirements 51
Business combinations 52
Accounting policy options 53
Interim reporting 53
Conclusion about the comparability of the information resulting from IFRS 17 54
Understandability 57
Different insurance accounting models 57
Mutual entities 60
Treatment of investment components 60
Contractual service margin 60
Presentation in the statement of comprehensive income 60
Presentation in the statement of financial position 60
Disclosures 61
Transition requirements 62
Conclusion about the understandability of the information resulting from IFRS 17 63
Prudence 64
Measurement of insurance contracts 64
Insurance acquisition cash flows 64
Contractual service margin 65
Reinsurance contracts in a net cost position 65
Transition requirements - Setting accumulated OCI to nil on transition 65
Identification of onerous contracts 66
Conclusion about prudence 67
True and fair view principle 67

Relevance

6 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.

7 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.

8 EFRAG considers that the measurement of insurance liabilities (including options and guarantees) on current expectations and economic conditions will result in relevant information. EFRAG notes that for some entities, this would not be a major change from the current position, but in some cases it would be. The provision of consistent information on performance, separating underwriting activities from investment and financial activities would also improve the understanding of users of the performance of the insurer. Furthermore, the profit on the insurance contracts is to be recognised over the period of the coverage thus, acknowledging the often long-term nature of these contracts. IFRS 17 provides different models to reflect the position and performance of contracts with different contractual characteristics and therefore economic implications. EFRAG considers that risk management activities such as reinsurance held and risk mitigation are appropriately reflected in a way that provides relevant information. Lastly, the required disclosures are significant in terms of volume and content which will help users to understand better a complex industry.

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

(a) Scope exclusions for loans and other forms of credit that transfer insurance risk (optional and mandatory exclusions);

(b) Measurement of insurance contracts;

(c) Insurance acquisition cash flows;

(d) Separating components from an insurance contract;

(e) Different insurance accounting models;

(f) Mutual entities;

(g) Treatment of investment components;

(h) Risk mitigation option;

(i) Contractual service margin;

(j) Contract boundaries;

(k) Presentation in the statement of comprehensive income;

(l) Presentation in the statement of financial position;

(m) Disclosures;

(n) Transition requirements; and

(o) Business combinations.

Optional scope exclusions for loans and other forms of credit that transfer insurance risk

10 IFRS 17 provides an irrevocable option on a portfolio level, to apply either IFRS 17 or IFRS 9[3] to contracts that meet the definition of an insurance contract but limit the compensation for insured events to the amount required to settle the policyholder's non-insurance obligation created by the same contract (for example, loans with death waivers).

11 EFRAG considers that this option provides relevant information because more useful information for users of financial statements might be provided if an entity were to apply the same Standard to those contracts as it applies to other similar contracts it issues. For example, an entity that mainly issues insurance contracts may apply IFRS 17 to these loans while an entity that mainly issues financial instruments may apply IFRS 9.

Mandatory scope exclusions for loans and other forms of credit that transfer insurance risk

12 An entity is required to exclude from the scope of IFRS 17 credit card contracts (or similar contracts that provide credit or payment arrangements) that meet the definition of an insurance contract if, and only if, the entity does not reflect an assessment of the insurance risk associated with an individual customer in setting the price of the contract with that customer. However, if, and only if, IFRS 9 requires an entity to separate an insurance coverage component that is embedded in such a contract, the entity shall apply IFRS 17 to that component.

13 For the credit cards (and similar payment instruments), although the separation may be a complex exercise, EFRAG assesses that the separation is beneficial and relevant, as it results in comparability amongst the different sectors and reflects the economics of the transactions.

Measurement of insurance contracts

14 The contract boundary is analysed in paragraphs 98 to 104 below.

Measurement components

15 The distinction between contracts with and without direct participation features is discussed in paragraphs 45 to 51 below.

16 The insurance liability measured under the general model comprises:

(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) a risk adjustment to reflect the uncertainty about the amount and timing of future cash flows for non-financial risk; and

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

Future cash flows

17 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. EFRAG is of the view that this estimate will result in relevant

[3] *Financial Instruments*

information, as it incorporates in an unbiased way all reasonable and supportable information, together with the associated disclosure requirements as more fully discussed in paragraph 127.

18 EFRAG considers that including only the cash inflows and outflows within the contract boundary (see paragraphs 98 to 104) will provide relevant information because it reflects the rights and obligations that arise from the contract, law or regulation.

Embedded options and guarantees in insurance contracts

19 Many insurance contracts contain significant embedded options and guarantees. IFRS 17 requires the measurement of these options and guarantees to include the effect of financial risk either in the estimates of future cash flows or in the discount rate. The measurement approach in IFRS 17, therefore incorporates both the intrinsic value and the time value of embedded options and guarantees. EFRAG is of the view that incorporating options and guarantees in the measurement of the cash flows will provide relevant information.

Discounting

20 IFRS 17 requires entities to discount cash flows using observable current market data. 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. An entity may determine the appropriate discount rates using either a top-down[4] or a bottom-up approach[5].

21 As insurance contracts can run over many years, in general and notwithstanding the current environment of persistent low or even negative interest rates, EFRAG considers that discounting the future cash flows reflects the impact of the passage of time, thus providing relevant information for users of financial statements on an entity's financial position. EFRAG assesses that the reflection of the time value of money provides relevant information.

22 Some consider that reflecting in the measurement the liquidity characteristics of insurance contracts does not provide useful information, as an (il)liquidity premium would not help users with their analysis, for e.g., predicting earnings or profitability of insurance entities. Those supporting this view note that it is generally known that insurance business is conducted over a long time. EFRAG disagrees with this view because, in principle, the discount rate for a group of insurance contracts should reflect the liquidity characteristics of the items being measured.

23 EFRAG also notes that insurers are required to disclose the inputs, assumptions and estimation techniques used for (amongst others) discount rates and have to disclose the yield curves used to discount cash flows that do not vary based on the returns on underlying items. Hence, EFRAG considers that disclosing the discount rate applied together with the above-mentioned inputs and assumptions will provide useful and relevant information on the characteristics of the cash flows. The requirements in IFRS 17 will result in determining a rate that will reflect the nature

[4] This is where the discount rates of the liability reflect the current market rates of return implicit in a fair value measurement of a reference portfolio of assets. Then the entity would eliminate any factors that are not relevant to the insurance contracts (but is not required to adjust for differences in liquidity characteristics of the insurance contracts and the reference portfolio).

[5] This is where a liquid risk-free yield curve is adjusted to reflect the differences between the liquidity characteristics of the financial instruments that underlie the rates observed in the market and the liquidity characteristics of the insurance contracts.

of the liability. For example, for cash flows that vary based on returns from underlying items, an entity would either use rates that reflect that variability or adjust the cash flows for the effect of that variability and discount them at a rate that reflects the adjustment made.[6]

24 The analysis of the use of locked-in discount rate for the CSM is presented in paragraphs 32 to 34. The analysis of the accounting policy choice for insurance finance income or expenses to be recognised either in profit or loss or disaggregated between profit or loss and other comprehensive income is discussed in paragraphs 114 to 115.

Risk adjustment

25 The risk adjustment is the compensation an entity requires for bearing the uncertainty about the amount and timing of the cash flows that arises from non-financial risk. Accordingly, the risk adjustment reflects any diversification benefit entity considers when determining the amount of compensation it requires for bearing that uncertainty.

26 EFRAG considers that 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 due to 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.

Current measurement

27 EFRAG is of the view that the use of current updated estimates of the fulfilment cash flows at the end of each reporting period provides relevant information 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 by taking into consideration current developments that may impact the fulfilment cash flows. Therefore, the users of financial statements can properly assess the predictability of cash flows and can also better assess the adequacy of the liability.

Contractual service margin

28 The CSM is determined at the initial recognition of a group of insurance contracts as the amount that eliminates any gains arising at that time, reflecting the fact that the services have not yet been provided.

29 EFRAG is of the view that the CSM 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 remaining coverage period. If entities need to change the estimate of the fulfilment cash flows which relate to future periods (Paragraphs 44 and 45 in IFRS 17 specify what relates to future services), the CSM is adjusted to reflect this change. This updating to reflect the current conditions provides relevant information (see paragraphs 32 to 34 below for information about locked-in rate under the general model).

30 In addition, an entity has to disclose when it expects to recognise the CSM remaining at the end of the reporting period in profit or loss quantitatively, in appropriate time bands. EFRAG considers that this provides relevant information because it enables users to consider the allocation of the unearned profit over the

[6] As per paragraph B74 of IFRS 17.

reporting periods included in the coverage period and take into account the profit from services when they are rendered.

31 The analysis on the use of the locked-in rate as well as the release pattern of the CSM in profit or loss is reported in the paragraphs below.

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

32 IFRS 17 requires that, under the general model, the CSM is accreted using the same discount rate that was determined at the initial recognition of a group of contracts. This is modified for contracts with direct participation features, whereby 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 fair value of the underlying items, is recognised in the CSM. As a result, only for contracts with direct participation features, the CSM is remeasured at each reporting period on the basis of current discount rates.

33 Some argue that insurance contracts without direct participation features should also use current rates to accrete or remeasure the contractual service margin, because using locked-in rates is not responsive to changes in economic conditions in the same way as is the case with fulfilment cash flows. They observe that the fulfilment cash flows are updated for changes in the estimates of future cash flows at each reporting date. These changes in estimates adjust the CSM. However, the use of the discount rate defined at inception for accreting the CSM, results in a mixture of locked-in measurement (for the CSM) and current measurement (for the fulfilment cash flows) and creates an accounting mismatch, which ultimately results in artificial volatility in shareholder's equity and total comprehensive income. This is also the case when a change in non-financial assumptions is measured at a different rate to the locked-in interest rate at inception. The CSM would be impacted at the locked-in rate while the insurance finance income and expenses or other comprehensive income would be affected by the difference between the current and locked-in rate on the amount of those non-financial assumptions, creating volatility.

34 Although volatility is generated, for example in OCI, EFRAG disagrees that such volatility is artificial because:

(a) the CSM does not represent future cash flows; it represents the unearned profit in the contract, measured at the point of initial recognition and adjusted only for specified events (which do not include changes in the financial conditions);

(b) accreting interest for a period at a current rate without also remeasuring the CSM at the start of the period would create an internally inconsistent measurement of the CSM; and

(c) of the differing economics of these contracts without direct participation features and contracts with direct participation features for the reasons explained in paragraphs 45 to 51.

(d) If the changes in discount rates were absorbed by the CSM, the overall measurement of the insurance liability would no longer reflect changes in current rates (the change in the CSM would offset the change in the discounted fulfilment cash flows unless the group becomes onerous). So changes in current rate would no longer affect the measurement of the insurance liability but only the insurance revenue in future periods.

35 Furthermore, treating the CSM as a series of cash flows that are impacted by changes in financial factors could impact the financial statements with anomalous results. In the extreme circumstance in which only an interest rates would change (with no other parameter changing), the CSM and related amortisation would

change if the CSM were accreted at current rates instead of locked-in rates. This would not appear to provide relevant information (or be prudent). This would also mean that the changes in discount rate that ought to be treated as investment result would be reported in the underwriting result through the release of the CSM.

Insurance acquisition cash flows

36 IFRS 17 requires an entity to allocate, on a systematic and rational basis, insurance acquisition cash flows that are directly attributable to a group of insurance contracts to that group and to groups that include contracts that are expected to arise from renewals of the contracts in that group. This results in the entity allocating part of the contract acquisition costs to related expected contract renewals and recognising an asset in respect of those costs until the entity recognises the contract renewals. The entity is required to assess the recoverability of this asset at each reporting period if facts and circumstances indicate the asset may be impaired.

37 EFRAG considers that entities may incur substantial acquisition costs to obtain a contract, in the expectation that the contract will be renewed and that the acquisition costs will be recovered over the life of the contract and of its renewals. Therefore, the allocation of insurance acquisition cash flows to expected renewals will provide relevant information to users of financial statements by reflecting the economic substance and general understanding of these transactions.

38 In addition, the required impairment test will also provide relevant information to users for their decision-making, because these users will be provided with information regarding to what extent an entity considers the acquisition cash flow asset would be recoverable.

39 Other areas analysed relating to the contract boundary of insurance contracts are presented in paragraphs 98 to 104.

Separating components from an insurance contract

Contracts that contain multiple insurance elements but are bundled together into one contract

40 An insurance contract may combine different types of insurance coverage, thereby grouping different insurance risks into one legal insurance contract. Under IFRS 17, the lowest unit of account is the contract that includes all insurance components. It is argued by some that the Standard should permit the separation of different insurance risks contained in a single insurance contract.

41 EFRAG considers that entities would usually design contracts in a way that reflects their substance. Therefore, a contract with the legal form of a single contract would generally be considered on its own to be a single contract in substance.

Contracts that contain both insurance and non-insurance elements

42 An insurance contract may contain both insurance and non-insurance elements, for example, an investment component or a non-insurance service component. Under IFRS 17, an entity has to apply IFRS 9 to determine whether there is an embedded derivative to be separated. An entity also has to separate from a host insurance contract an investment component, only if the latter is distinct. An entity has to separate any promise to transfer to a policyholder distinct goods and services (other than insurance contract services and to apply other pertinent standards to the revenue recognition of these components). IFRS 17 is then applied to the remaining components.

43 EFRAG considers that this provides relevant information because it considers interdependencies between insurance and non-insurance components.

Different insurance accounting models

44 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;

(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

45 IFRS 17 distinguishes between insurance contracts with and without direct participation features, reflecting the different nature of rights and obligations.

46 Contracts with direct participation features are accounted for using the variable fee approach ('VFA') and are substantially investment-related contracts for which, on inception:

(a) the contractual terms specify that the policyholder participates in a share of a clearly identified pool of underlying items;

(b) the entity expects to pay to the policyholder an amount equal to a substantial share of the fair value returns on the underlying items; and

(c) the entity expects a substantial proportion of any change in the amounts to be paid to the policyholder to vary with the change in fair value of the underlying items.

47 EFRAG assesses that a specific treatment (the VFA) is justified for contracts with direct participation features because of the different nature of the fee in these contracts, i.e., the insurer earns a variable compensation for the services it provides. Therefore, the VFA enables to reflect the specific economic substance of such contractual arrangements. Direct participating contracts are creating an obligation to pay policyholders an amount that is linked to returns and value of specified underlying items, minus a variable fee for services provided. The underlying items shall be clearly identifiable which may not be the case for contracts without direct participation features.

48 Under IFRS 17, a change in the fair value of the underlying items will cause a change in the amount of the fee that the entity will receive in the future. EFRAG agrees that this change in the amount of the fee relates to the future because the entity continues to manage the pool of underlying items for the benefit of the policyholder over the coverage period. Therefore, EFRAG considers it relevant that any changes to the fee should adjust the CSM and be recognised in profit or loss as the investment services are provided over the coverage period.

49 For contracts without direct participation features, accounted for using the general model under IFRS 17, at least one of the criteria is not met in order to be classified as contracts with direct participation features. EFRAG assesses that for contracts without direct participation features, the nature of the profit is different from contracts with direct participation features. For contracts without direct participation features, the profit from investment activities arises from the difference between (i) the gains (or losses) from the investments and (ii) the change in the insurance contract liability depicted by the insurance finance income or expenses including the gains (or losses) the entity passes to the policyholder through any indirect participation

mechanism. Therefore, the approach to determining profit for contracts without direct participation features (i.e., those that do not meet the criteria for the VFA and are accounted for under the general model), reflects a separate accounting for the investment portfolio and the group of insurance contracts, regardless of any participation mechanism in the insurance contracts.

50 Some have argued that the scope of the VFA needs to be adapted to accommodate circumstances in which customary business practices provide for some form of participation that is not legally enforceable. Due to this lack of legal enforceability, such contracts do not qualify for the VFA. Those stakeholders have argued that these contracts were similar to those contracts that are in the scope of the VFA in terms of economics and asset/liability management. As it is often the case in standard setting, when the accounting boundary between two different groups of items has to be conventionally set, EFRAG acknowledges that there will be a grey area for some contracts that will be accounted for under the general model, despite having similarities to contracts under the VFA. EFRAG believes that the boundary as set in IFRS 17 is acceptable, as it assesses that (i) the contract[7] needs to specify the fee, i.e., the relationship between underlying items and the amounts payable to the policyholders; and (ii) such contracts cannot be regarded as in effect providing asset management services if the contractual terms do not specify a clearly identified pool of underlying items. Therefore, EFRAG considers that relevance is not negatively affected.

51 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 reflecting the underlying economic substance.

Unlocking of CSM for the changes in non-underlying cash flows for contracts with direct participation features

52 Paragraph B113(b) of IFRS 17 requires adjusting the CSM for a change in the effect of the time value of money and financial risks not arising from underlying items.

53 Some have indicated that there are contracts with direct participation features which contain an amount of cash flows that are non-participating and not covered by underlying items, for e.g., variable annuities with guarantees that are not covered by underlying items. The assets backing the liabilities that match the non-participating features are non-underlying items. The investment result from these assets is recognised in profit or loss applying IFRS 9. They reported that this accounting treatment results in an accounting mismatch in profit or loss, because the interest accretion and changes in the current discount rate on the liabilities covering the non-participating features decreases the CSM, while the investment result on the assets backing non-participating features is recognised in profit or loss. EFRAG notes that the risk mitigation option set forth in paragraph B115 of IFRS 17 can be used to address the mismatch occurring in CSM.

Contracts that change nature over time

54 Some have indicated that certain products change significantly in nature during their life, for example from participating to non-participating. Examples can be found in Germany, the Netherlands and the United Kingdom. Examples include:

[7] Applying paragraph 2 of IFRS 17, contract terms include all terms in a contract, explicit or implied. Implied terms in a contract include those imposed by law or regulation.

(a) policies with an initial savings phase with profit sharing may later become an annuity in payment or remain paid-up[8] without any participation if elected by the policyholder;

(b) annuities where, once the underlying items are depleted, a general fund (i.e. non-underlying items) may be used by the insurer to fund the contractual obligations;

(c) certain unit-linked contracts (under the VFA) with non-participating risk riders;

(d) group pension contracts with build-up phase, such as a five-year savings, and an option to extend the contract at the end of the period or to leave contract as paid-up. In some cases, these may have no contractually segregated assets or participation features during the latter phase.

55 IFRS 17 includes requirements on the modification[9] of insurance contracts that do not apply to the fact patterns above. This is because the change in the contracts' nature arises from the contractual terms of the contract rather than from changes subsequently made to the contractual terms. In addition, under IFRS 17 the classification between general model and the VFA[10] is done at the contract's inception and is irrevocable.

56 The stakeholders that reported these fact patterns are concerned that volatility would arise in reported measures, from the continued measurement under VFA of contracts that in their latter phase have no underlying items. This would result in the change in liabilities to be reported in the CSM (i.e., deferred to when the insurance service is provided), while the results of the related assets would be immediately reported in financial result.

57 Additionally, they have reported that some aspects of these requirements may be operationally complex: for example, some annuity contracts (without the participation features in their initial savings phase) may fall under the general model, whereas those with participation features during the savings phase would fall under the VFA. In many cases, this information has not been maintained once the annuity phase started. This is expected to result, at the transition date, in a significant burden to distinguish between annuities purchased outright (those under general model) and those that are the result from a savings phase that overall were classified under the VFA. After transition, this information will also need to be maintained on an ongoing basis for this purpose.

58 EFRAG notes that, before the issuance of IFRS 17, the IASB had previously considered requiring separate measurement of components of insurance contracts. However, stakeholders indicated that this would be difficult, and the separation of interrelated cash flows would be arbitrary and lead to different valuations depending on such arbitrary decisions. Therefore, under IFRS 17, all cash flows from interrelated components and within the boundary of an insurance contract are accounted for as a single contract and are prohibited from being separately accounted for.

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[8] A paid-up life insurance policy is one where all the premium payments have been made and the policyholder has no further payment obligations, but under the terms of the contract, the policy stays intact until insured's death or termination of the policy.

[9] IFRS 17 has specific considerations where the contractual terms are amended after inception of the policy in paragraphs 72 and 73.

[10] For the purpose of this advice, EFRAG assumes that these contracts are eligible for the VFA as reported by preparers that have highlighted the issue.

59 Where these contracts form a significant part of the entire population of the contracts on the entity's statement of financial position, the entity may and should provide further information to users in the notes to the financial statements, to enable their understanding of the specifics of the contractual terms. EFRAG considers that the information provided would still be relevant. EFRAG also notes that the risk mitigation option has been expanded in IFRS 17 to include non-derivative financial instruments at fair value through profit or loss, also to help minimising this issue.

Investment contracts with discretionary participation features

60 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 were insurance contracts, only to the extent they are issued by an entity that also issues insurance contracts. Otherwise, they fall in the scope of IFRS 9. The general requirements for measuring insurance contracts are modified for investment contracts with discretionary participation features as described in Appendix 1.

61 EFRAG assesses that the requirements relating to these contracts provide relevant and useful information for users as investment contracts and insurance contracts, that specify a link to returns on underlying items, are sometimes linked to the same underlying pool of assets. Also, there are some characteristics in these contracts which are similar to insurance contracts, e.g., long maturities, recurring premiums.

Premium allocation approach

62 The premium allocation approach ('PAA') is an optional simplification of the IFRS 17 measurement approaches and can be applied in circumstances in which the entity expects such a simplification would produce a measurement that is not materially different from a measurement following the general requirements or when the coverage period is one-year or less.

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

Reinsurance contracts held and issued

General assessment

64 IFRS 17 modifies the requirements of the general model for reinsurance contracts held. The CSM of these reinsurance contracts held measured at initial recognition does not represent unearned profit from rendering of future insurance services, but instead it is treated as a net cost or net gain on the purchase of the reinsurance.

65 IFRS 17 treats insurance contracts issued and reinsurance contracts held as separate contracts. EFRAG notes that the requirements set forth in IFRS 17 for issued insurance contracts are to be applied to purchased reinsurance contracts by analogy. Based on the EFRAG User Outreach in 2018, some specialist users indicated that reinsurance and insurance were not considered as separate businesses and the net effect was considered in their analysis.

66 It is argued by some that reinsurance contracts held are highly dependent on the underlying insurance contracts in that the insurer's claim on the purchased reinsurance contract must be related to claims on the underlying issued insurance contracts. These constituents consider that treating the two types of contracts separately would reduce the relevance of the information and would not reflect the underlying economic substance. They also argue in favour of a symmetrical accounting treatment for both initial and subsequent measurement of the insurance

liability and the reinsurance asset or of having the same amounts for both the insurance liability and the reinsurance asset, to avoid any accounting mismatches.

67 EFRAG acknowledges the interdependency between a reinsurance contract held and the underlying insurance contract(s) mentioned above. Nevertheless, EFRAG notes that such symmetrical accounting would require changes to, for example, the contract boundary for reinsurance contracts held. In addition, this would lead to additional complexity in the measurement. See the analysis in paragraphs 102 and 104.

68 In addition, in EFRAG's view, the extent to which a reinsurance contract provides economic offsetting, thus resulting in symmetric reported performance components, would depend on the economic mismatches that exist between the underlying insurance contracts and the reinsurance contract. The following are examples of residual economic mismatches:

(a) Reinsurance contracts come in many forms. For example, proportional contracts (which reinsure a proportion of the underlying risks), such as 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). As a result, some of the risk in the underlying contracts is not reinsured; and

(b) The terms of the reinsurance contract held and those of the underlying insurance contracts may differ, including any timing differences and the risk adjustment between the two. For example, the reinsurer may exclude particular risks from coverage (such as terrorist attacks or natural disasters) or the duration of the reinsurance contract may differ from the underlying insurance contracts.

69 Considering the above, EFRAG assesses that the separate treatment under IFRS 17 appropriately reflects the rights and obligations of different and separate contractual positions. This approach is consistent with the general principle in IFRS 17 that all expected future cash flows within the contract boundary are reflected in the measurement of an insurance contract.

Reinsurance contracts do not qualify for the VFA

70 Paragraph B109 of IFRS 17 specifies that reinsurance contracts issued and held do not qualify as contracts with direct participation features.

71 This treatment stated above reflects the nature of the reinsurance contracts. When an issued contract qualifies for the VFA, the returns to the entity from a pool of underlying items are viewed as part of the compensation that the entity charges the policyholder for the service provided according to the insurance contract. This is not applicable to reinsurance contracts issued because the view that the returns to the entity from a pool of underlying items should be viewed as part of the compensation that the entity charges the policyholder for the service provided by the insurance contract does not apply to reinsurance contracts issued. Some have argued that for reinsurance contracts held the prohibition to apply the VFA creates a mismatch with the underlying insurance contracts, when these are measured as contracts with direct participation features.

72 In EFRAG's simplified case study, some participants reported that the scope of the VFA should be extended to reinsurance contracts. From the results of the extensive case study, some of the respondents indicated that some reinsurance contracts would be eligible for the VFA as they share a substantial part of underlying items (direct participating contracts and their related assets) between the ceding company and the reinsurer (i.e., there is a participation feature between the reinsurer and the

insurer). These respondents mentioned that accounting volatility would arise in the ceding insurer's financial statements, when VFA contracts are reinsured purchasing reinsurance contracts that would in theory qualify for VFA.

73 EFRAG acknowledges that there may be reinsurance contracts issued or held that meet the variable fee criteria even though these contracts are not allowed to apply the VFA. EFRAG believes that the prohibition to apply the VFA to reinsurance contracts is acceptable, as it assesses that the risk mitigation option, which is also applicable to reinsurance contracts, would largely address the accounting mismatches, thereby balancing relevant information. EFRAG acknowledges that the risk mitigation option cannot be applied retrospectively, leaving mismatches at transition unaddressed. Which in itself is balanced by the avoidance of hindsight as explained in paragraphs 140 to 143 below.

Reinsurance contracts held — recovery of losses on underlying insurance contracts

74 When the entity recognises a loss on initial recognition of an onerous group of underlying insurance contracts, or on addition of onerous contracts to that group, the entity will determine the amount of a loss recovered from a reinsurance contract held and recognise it as income, therefore reducing the amount of net loss in profit or loss.

75 EFRAG considers that this requirement provides useful and relevant information, as it aims at reducing accounting mismatches between reinsurance contracts held and the related underlying contracts as the entity has the right to recover some or all the claims that contribute to these losses.

Mutual entities

Introduction

76 Mutual entities exist in different forms in Europe and not all of those entities apply IFRS Standards in their financial reporting, although some have listed debt instruments where IFRS is required for financial statements. There is no definition of a mutual entity in European law.[11] Van Hulle describes them, referring to a definition of the International Association of Insurance Supervisors, as follows: "Mutual insurance undertakings have the specific characteristics that they are collectively and indivisibly owned by their member-policyholders."[12]

77 The Association of Mutual Insurers and Insurance Cooperatives in Europe states that "the fundamental distinguishing feature of mutual and cooperative insurers, setting them apart from listed insurance companies, is that they operate for the benefit of their members/policyholders rather than for the benefit of external investors."[13]

78 Therefore, a fundamental difference between mutual entities and other corporate insurers is that the net return generated for mutual entities is accrued to the policyholders rather than the shareholders. Also, for corporate insurers, the risk is borne by shareholders as they take the first loss. Mutual entities may also have

[11] Directive 2009-138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) provides, in Annex III, a list of the legal forms of undertakings under the scope of this Directive, that includes Mutuals.

[12] Karel van Hulle, Solvency Requirements for EU Insurers - Solvency II is good for you, 2019.

[13] AMICE/ICMIF, Facts and figures: Mutual and cooperative insurance in Europe Vol 2, May 2018.

differences with respect to the contractual relationship between the policyholders/shareholders and the entity, as well as the role and set-up of collective buffer funds, and bonus allocation.

79 However, the legal form of the entity is not decisive of the types of contracts it issues, and a mutual entity may issue the same contracts as those by entities that are not mutuals. These may include the following insurance contracts:

(a) Contractual terms such that the residual interest of the entity is *due* to policyholders (current or future); or

(b) Contractual terms that do not give policyholders any rights to the residual interest.

In the latter case, there are also situations where any residual will not accrue to policyholders but other parties, for instance charitable institutions.[14]

Applying IFRS 17 to mutual entities

80 EFRAG has been made aware of a specific concern about the relevance of IFRS 17 reporting for mutual entities, i.e., the fact that some of these entities will have no or less equity compared to the position under either IFRS 4 or Solvency II.

81 Under IFRS 4, contracts with discretionary participating features could give rise to an equity component to reflect the discretionary disbursements under these contracts. Under IFRS 17, the fulfilment cash flows include the expected discretionary payments based on estimates as at inception or period end and so form part of the insurance liability.

82 When the entity is contractually required to distribute profits to current and/or future policyholders, this forms part of the fulfilment cash flows at inception of the contract. This could mean that for these contracts there would be no CSM for the year as those amounts are subsumed into the fulfilment cash flows. This would mean that revenue and profit of mutual entities having issued these contracts would differ from revenue and profit of other insurers with contracts with CSM, e.g., changes in estimates of the fulfilment cash flows relating to the future would not be adjusted against the CSM.

83 However, EFRAG notes that the issue of entities not having a residual interest under IFRS Standards is not new nor due to IFRS 17 specifically. EFRAG considers the requirements in IFRS 17 appropriate in providing relevant information about the best estimate of the amount to be paid under the insurance contract.

IAS 1 Presentation of Financial Statements

84 IAS 1 requires disclosures on objectives, policies and processes for managing capital. This includes a description of what the entity considers to be its capital, quantitative information about such amounts as well as information about any externally imposed capital requirements. Many entities provide information about what they manage as capital under such requirements and how this compares with the equity under IFRS.

85 IAS 1 also requires an entity to present additional line items, headings and subtotals in the statement of financial position (IAS 1 paragraph 55) and in the statement(s) presenting profit or loss and other comprehensive income (IAS 1 paragraph 85) when such presentation is relevant to an understanding of the entity's financial

[14] EFRAG notes that the IASB education material is not helpful in distinguishing and acknowledging these varying structures and contracts but recognises that the amendment to the basis for conclusions is useful.

position or financial performance. Furthermore, similar to the requirements in IAS 1, paragraph 117 of IFRS 17 specifically requires insurers (including mutual entities) to disclose the significant judgements and changes in judgement in applying this Standard, including changes in estimates of (expected) future cash flows arising from the exercise of discretion.

86 EFRAG considers that the conditions to meet the relevance criterion do not fundamentally differ between mutual entities and other insurers.

Annual cohorts

87 EFRAG agrees that the use of annual cohorts provides important information about profitability trends and losses on onerous contracts that are essential to understand an insurer's results thereby providing relevant information.[15]

Treatment of investment components

88 IFRS 17 requires any differences between expected and actual amounts of the investment component payable in the period to be recognised in the CSM[16]. This is because acceleration or delay in repayments of investment components only gives rise to a gain or loss for the entity to the extent that the amount of the repayment is affected by its timing. EFRAG considers that there are circumstances in which an investment component that becomes payable in a period may directly cause changes in estimates of the present value of other future cash flows. An example would be an acceleration in the repayment of an investment component because of policyholders who cancel their contracts.

89 EFRAG has been made aware that the application of this requirement is complex. EFRAG acknowledges the complexity of the requirement but notes that accelerations or delays in payment of investment components are inherent to insurance business models. EFRAG does not consider as useful information, for example, the recognition of a gain for a delay in repaying an investment component accompanied by a loss that adjusts the CSM for the expected later repayment. EFRAG concludes that the complexity is balanced by the relevance of the resulting information, in line with the insurance business models.

Risk mitigation option

90 IFRS 17 provides a risk mitigation option for contracts with direct participation features. In order to apply this approach an entity must have a previously documented risk-management objective and strategy for using derivatives, non-derivative financial instruments measured at fair value through profit or loss and reinsurance contracts held to mitigate financial risk arising from insurance contracts. If this risk mitigation option would not be applied, the changes of the entity's share of the fair value of the underlying items due to the effect of financial risk would be recognised in the CSM. However, the change in the fair value of the risk mitigation instrument derivative/non-derivative or the change in the financial risk of the reinsurance contracts held used to mitigate this financial risk would be recognised in profit or loss, giving rise to an accounting mismatch. EFRAG assesses that the risk mitigation option for contracts with direct participation features increases the

[15] EFRAG's observations on the requirement to apply annual cohorts to intergenerationally-mutualised and cash flow matched contracts are in the Cover Letter.

[16] Except where the investment component is part of the obligation to pay policyholders the fair value of underlying items under the VFA, or where the variance is due to either time value of money or financial risk under the general model.

relevance of the reported information, as it addresses a particular set of accounting mismatches.

91 Risk mitigation option at transition is discussed in paragraph 140 below.

Contractual service margin

Pattern of release of the CSM

92 IFRS 17 requires an entity to systematically recognise the CSM in profit or loss over the coverage period, thereby reflecting insurance contract services provided under the group of contracts. The amount is determined by identifying coverage units which consider, for each contract, the quantity of benefits provided under the contract and its expected coverage period. This is applicable for both contracts with and without direct participation features.

Contracts without direct participation features

93 Some insurance contracts without direct participation features provide policyholders with an investment return (investment-return service), in addition to insurance coverage, although they do not meet all the VFA criteria.

94 For insurance contracts without direct participation features, insurance contract services relate to both insurance coverage and investment-return services. Following the applicable IFRS 17 criterion, this investment-return service is reported as such only if either an investment component exists in contracts or the policyholder has a right to withdraw an amount.

95 Some have argued that the above criterion for investment-return service is too narrow as it does not take into consideration the investment service provided in certain types of contracts, e.g., deferred annuities without payment on death in the accumulation phase or the pay-out phase (or in both), and deferred capital during the term agreed (accumulation period) without death benefit. These constituents observe that they are providing investment related services under the terms of these contracts, but they will not be allowed to report the profit from such services when rendered by the insurer.

96 EFRAG acknowledges that, as for other conventional classification criteria adopted in standard setting, there will be a grey area, such as for some contracts under the general model for which the insurer considers it is providing investment services, but these services are not in scope of the investment-return service criterion. However, trying to capture all the contracts would result in additional complexity. Therefore, on balance, EFRAG considers that the allocation of the CSM considering the investment-return service, in addition to insurance coverage, provides useful and relevant information to users of financial statements.

Coverage units for contracts with direct participation features

97 For insurance contracts with direct participation features, the coverage units, which ultimately drive the path of reporting profit from rendering of insurance services, consider quantity of benefits and expected period of both insurance coverage and investment-related service (i.e. the management of underlying items on behalf of the policyholder). EFRAG considers that this represents the mixture of services provided under these contracts as these contracts are substantially investment-related service contracts. Hence EFRAG agrees that the allocation of the contractual service in accordance with the period of both the insurance coverage and investment-related services results in relevant information.

Contract boundaries

98 The measurement of an insurance contract is based on the cash flows that are considered to be in the boundary of the contract itself. Under IFRS17 cash flows are within the accounting boundary of an insurance contract if they arise from substantive rights and obligations that exist during the reporting period in which the entity can compel the policyholder to pay the premium or in which the entity has a substantive obligation to provide the policyholder with services.

Contract boundary of contracts with annual repricing mechanisms

99 The contract boundary ends when the insurer has the practical ability to reassess the risks of the underlying insurance contract or the portfolio that contains that insurance contract and, as a result, can set a price or level of benefits that fully reflects the risk of that portfolio. As a consequence, when an insurer uses annual repricing mechanisms the cash flows resulting from the renewal terms are not part of the boundary of the existing insurance contract, but accounting-wise belong to a new insurance contract instead.

100 EFRAG assesses that an entity is no longer bound by the existing contract at the point at which the contract conveys to the entity the practical ability to reassess the risk presented by a policyholder. Therefore, only including cash flows in the contract boundary if they arise from substantive rights and obligations that exist during a reporting period provides relevant information.

101 <u>As per the above, EFRAG assesses that accounting for this change as a new contract leads to relevant information because it reflects the changes in the contracts' economics.</u>

Contract boundary of reinsurance contracts held

102 IFRS 17 requires insurance and reinsurance contracts held to be treated as separate contracts. The contractual service margin for a group of reinsurance contracts held is adjusted for:

(a) the effect of any new contracts added to the group;

(b) interest accreted on the carrying amount of the contractual service margin;

(c) income recognised in profit or loss in the reporting period;

(d) reversals of a loss-recovery component recognised;

(e) changes in the fulfilment cash flows;

(f) the effect of any currency exchange differences arising on the contractual service margin; and

(g) the amount recognised in profit or loss because of services received in the period.

103 This implies that, in contrast to many current practices (e.g. where the measurement of the insurance contract is mirrored into the reinsurance contract), for accounting purposes the contract boundary of reinsurance contracts held is determined independently from the underlying insurance contracts. As a result, the contract boundary of reinsurance contracts held may be shorter or longer than the underlying insurance contracts.

104 EFRAG notes that situations may occur where contract boundaries differ between reinsurance contracts held and the underlying insurance contracts. For example, reinsurance contracts held may be repriced on a more frequent basis than the underlying insurance contracts. EFRAG notes that both rights and obligations need to be considered when assessing the boundary of a contract. <u>EFRAG assesses that</u>

determining the contract boundary of insurance and related reinsurance contracts separately provides relevant information as it reflects the different contractual terms of insurance contracts issued and reinsurance contracts held.

Presentation in the statement of comprehensive income

105 IFRS 17 distinguishes two ways for an entity to earn profits from insurance contracts:

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

(b) insurance finance income or expenses.

106 The insurance revenue includes amongst others the release of the CSM. EFRAG considers that, the revenue from the release of CSM provides relevant information as it depicts the transfer of promised services at an amount that reflects the consideration to which the entity expects to be entitled in exchange for those services. The analysis on the release pattern of the CSM is in paragraphs 92 to 97.

107 EFRAG is of the view that the insurance service result will provide useful and relevant information for users. This is because it will reflect insurance contract services that have already been provided and therefore will reflect profit on an earned basis for each reporting period.

108 The insurance revenue and incurred claims exclude any investment components. EFRAG considers this exclusion is relevant because the investment component does not depict revenue earned by the entity in exchange for services provided. It has a different nature as it is an amount that the entity has to pay back to the policyholder in all circumstances.

109 IFRS 17 requires a gross presentation of the insurance service result, i.e. insurance revenue and insurance service expenses are presented separately. EFRAG assesses this as adding relevant information as it provides users of financial statements with more granular information about the insurance service result.

110 For contracts without direct participation features, the insurance finance income or expenses arise from the effect of the time value of money and of financial risk and changes to these as well. Returns from assets will be reported following the requirements in IFRS 9. EFRAG considers that this financial result will provide relevant information because it depicts the effects of investments, of market interest rates, allowing as well to depict the entity's asset and liability management activities.

111 For contracts with direct participation features, the insurance finance income or expenses would also arise from the components identified in paragraph 110 above, but would exclude some changes relating to these components that would adjust the CSM, i.e. relating to the remeasurement of the variable fee. EFRAG considers that the remeasurement of the variable fee which adjusts the CSM provides relevant information because of the different nature of the contracts compared to contracts without direct participation features as explained in paragraphs 45 to 51.

112 A separate presentation of investment income and insurance finance income or expenses is assessed by EFRAG as adding relevant information as it provides users of financial statements more granular information about the net financial result.

113 Under IFRS 17, if insurance contracts are onerous at initial recognition, a loss is recognised in profit or loss for the net outflow for the group of onerous contracts. In addition, there is a reconciliation of any loss components in the disclosures. EFRAG considers that this provides relevant information for users of financial statements as it shows to what extent entities have onerous contracts.

114 When applying IFRS 17, an entity will recognise insurance finance income or expenses. The entity can choose where to present this effect - either in profit or loss or disaggregated between profit or loss and other comprehensive income on a portfolio basis. This is applicable for both contracts with and without direct participation features. Some stakeholders have criticised this requirement and propose that the insurance finance income or expenses should always be recognised in profit or loss, thus preventing accounting mismatches with finance income from assets measured at fair value through profit or loss.

115 EFRAG does not agree with this view. EFRAG considers that having both options represents two business approaches of European insurers that exist in practice depending on the tolerance to volatility in profit or loss. EFRAG expects that entities will choose the presentation that better reflects the economics of their business. In addition, users of financial statements may find the presentation of insurance finance income or expenses more useful when it is recognised in profit or loss for some contracts or more useful when disaggregating between profit or loss and other comprehensive income for other contracts.

116 As per EFRAG's 2018 User Outreach, specialist users indicated that the requirement to split the presentation between underwriting and investing activities, in the statement of comprehensive income, would provide useful information. In addition, most of the specialist and generalist users did not see volatility in profit or loss as a problem as long as it reflects economic substance, and the underlying causes were communicated clearly.

117 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 provide relevant information on the extent to which profit arises from underwriting and from financial activities.

118 The pattern of release of the CSM is analysed in paragraphs 92 to 97.

Presentation in the statement of financial position

Separate presentation of portfolios that are assets and that are liabilities

119 IFRS 17 requires an entity to present separately in the statement of financial position portfolios of insurance contracts issued that are assets and those that are liabilities. When developing IFRS 17 a more granular approach (at group level instead at portfolio level) was initially considered but subsequently amended, primarily to reduce operational complexity.

120 EFRAG understands that the switch between an asset and liability position is not necessarily related to the profitability of the insurance contract. Rather, contracts in an asset or liability position are affected by the timing of cash flows received and paid for insurance contracts.

121 As reported in the feedback received in the EFRAG's User Outreach, most users agreed with this separate presentation, because the portfolio level would not reduce useful information when compared to providing the information on a group level. EFRAG agrees with these remarks because EFRAG considers that entities manage their operations and systems at this level. Therefore, EFRAG assesses that this presentation requirement would not hinder relevance.

Non-separation of premium receivables and payables

122 Based on the requirement in paragraph 119 above, there is no requirement to disaggregate and hence no requirement to separately present in the statement of financial position insurance premium receivables and reinsurance premium

payables. EFRAG notes that payables due to claims incurred should be presented separately at least in the notes – similarly to current practice.

123 Some stakeholders argued that the principle of IFRS 17 to disclose a portfolio of insurance contracts as a bundle of rights and obligations (without separate presentation of premium receivables and payables) results in one aggregated amount reported on the face of the statement of financial position, rather than components of that bundle (such as premiums receivable) being presented separately. Those stakeholders are concerned that relevant information, in particular the information about premiums receivable and payable may be lost.

124 EFRAG's User Outreach revealed mixed views on this topic. Some users did not consider that there should be a separation of receivables, as it would not have any significant impact on their estimates when building their models. Fewer users were concerned about less information being visible in the statement of financial position or wanted the separate presentation of receivables.

125 EFRAG acknowledges the views above. However, EFRAG consider that the presentation requirements of IFRS 17 have the benefit of being consistent with its measurement principle i.e., a current estimate of all expected cash flows within the contract boundary. The statement of financial position reflects the combination of rights and obligations created by the contract as a whole. Furthermore, EFRAG has been advised that there normally is little residual credit risk in the receivables of primary insurers taken as a whole, which is supported by the limited disclosures currently provided in the discussion on credit risk by insurers. In addition, EFRAG notes that when separate presentation of components is deemed necessary, IAS 1 allows the disaggregation of various components of the insurance liability on the face of the statement of financial position and entities exposed to material level of credit risk may voluntarily provide disclosures on receivables. Therefore, based on this, EFRAG considers that the information arising from non-separation of receivables is still relevant.

Reinsurance contracts held and underlying contracts - presentation

126 EFRAG has been informed that IFRS 17 does not address the presentation of amounts exchanged between a reinsurer and the primary insurer. EFRAG observes that the Standard does not address this issue, but it is noted that a practical solution has been found for implementation purposes.

Disclosures about future release of CSM

127 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. Some argue that the quantitative disclosure requirements about the timing of future release of the CSM are more onerous and detailed than the disclosures in IFRS 15 *Revenue from Contracts with Customers* or IFRS 9 for other industries.

128 EFRAG acknowledges the efforts needed to prepare these disclosures. At the same time, EFRAG is aware of the fact that the information in paragraph 109 of IFRS 17 will only provide partial information on the potential future performance of the entity given the sensitivity of the CSM under the VFA to changes in the market environment. However, EFRAG considers that the quantitative disclosures about the amount of CSM expected to be recognised over time provide relevant information, as these disclosures enable users of financial statements to monitor the profitability pattern and any changes to that profitability pattern, allowing informed comparisons across entities.

129 Disclosures are further assessed under the Understandability section of this Appendix.

Transition requirements

Three different transition approaches

130 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 using IFRS 13 *Fair Value Measurement* to measure the insurance contracts.

131 As per EFRAG's User Outreach in 2018, some specialist users were unsure of the impact of the different transition approaches, e.g., concerns were raised that preparers would choose the option they want in terms of opening balances and window dressing and would not necessarily choose what is most reflective of the economic substance. In EFRAG's 2019 User Outreach, some users indicated that it was unclear how transition was managed and therefore when the numbers will normalise going forward. Some users also preferred the use of only one transition approach and not three, in order not to impair comparability between entities and portfolios.

132 EFRAG considers that each of the above transition approaches can provide relevant information, depending on the information available, because entities are implementing IFRS 17 from different starting points. Also, users will be informed of the effect of the transition method chosen and the movement of the figures going forward, as the CSM and insurance revenue for portfolios under each of the three transition methods adopted are disclosed separately and will continue to be presented separately, as long as the related insurance contracts are in force. Whenever practicable, entities would use the retrospective approach that provides the most complete information (the full retrospective approach), or an approximation thereof (the modified retrospective approach). The EFRAG extensive case study showed that all three approaches are likely to be used in practice.

133 Under the fair value approach, the insurance liabilities are measured at the date of transition at their fair value (in accordance with IFRS 13). The fair value is therefore driven by the relationship between two willing market participants and is determined by reference to the rate of return required by such market participants. As a result, when calculating the fair value, the measurement would include a compensation that market participants would require for taking on the obligation.

134 EFRAG has been made aware of concerns by some that if the fair value is used, the future profitability will not be consistent with the "real" performance, as an entity retaining the transition approach would account for the liabilities as they were issued at the transition date, rather than being the result of often long-term contracts already in place in previous periods. EFRAG observes that the availability of the fair value approach offers an alternative practical simplification to the development of the modified retrospective approach.

135 In addition, there are concerns that fair value may be difficult to measure reliably and generally pertains to level 3 valuations, that probably require a high level of judgment and assessments. EFRAG observes that there are appropriate requirements, including disclosure of measurement uncertainties, in IFRS 13 that will support the provision of relevant information.

136 Taking the above reasons into consideration, on balance, EFRAG is of the view that the existence of three transition requirements does not result in a lack of relevant information.

Modified retrospective approach

137 The objective of the modified retrospective approach is to achieve the closest outcome to retrospective application possible using reasonable and supportable information available without undue cost or effort. IFRS 17 provides a number of simplifications on transition that meet this objective.

138 EFRAG notes that paragraph 51 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* acknowledges the need for estimates in retrospective application which is also relevant for first-time adopters of IFRS 17 who will apply the modified retrospective approach. In order to achieve the above objective, EFRAG considers that an insurer may need to make use of information the entity gathered in the past for other purposes.

139 In light of the above, EFRAG considers that the modified retrospective approach, which offers alleviations compared to the full retrospective approach, as still leading to relevant information as it allows to achieve the closest outcome to a full retrospective application without undue cost or effort.

Not applying the risk mitigation option retrospectively at transition date

140 The risk mitigation option cannot be applied retrospectively. EFRAG is aware that the issue significantly impacts some insurers, while for other insurers, this is not a significant concern. Some preparers are concerned that if they were not allowed to apply the risk mitigation option retrospectively at transition, some or all changes in the effect of time value and financial risks would adjust the CSM. However, as retrospective application is not allowed, such changes are recognised in CSM rather than retained earnings on transition.

141 EFRAG acknowledges that for those who are significantly impacted, not being able to apply the risk mitigation option retrospectively reduces the relevance of the information as it would distorts the equity and CSM balances at transition and the related revenue recognition pattern subsequently.

142 However, EFRAG also acknowledges that if an entity were permitted to apply the option retrospectively, it could decide the extent to which to reflect risk mitigation activities in the CSM based on a known accounting outcome. The entity could do this in a way that would not reflect how the entity would have applied the option in previous periods, without hindsight, had it always applied IFRS 17. Such a risk would affect the credibility of information presented on transition to IFRS 17 and in subsequent periods in which those groups of insurance contracts continue to exist. This could also negatively impact the relevance of the information presented. Not all the required information may be available at the appropriate level of granularity.

143 Therefore, considering the above, on balance, EFRAG is of the view that not applying the risk mitigation option retrospectively will not negatively impact relevance.

Setting accumulated OCI to nil on transition

144 As part of the transition requirements, entities have the possibility of setting OCI[17] on the insurance liabilities to nil under the modified retrospective approach and under the fair value approach. This is not applicable for insurance contracts with direct participation features when the entity holds the underlying items.

Modified retrospective approach

145 Referring to paragraphs C18(b)(ii) of IFRS 17, some are concerned that the option to set accumulated OCI as equal to the cumulative amount recognised in OCI on the underlying items at transition is not available for some participating contracts (i.e., those that do not qualify for the current period book yield under the VFA). They note that, at transition, changes in discount rate to reflect current market conditions have not yet been recognised in retained earnings when assets are measured at amortised cost or FVOCI, whereas the insurance liability would be recognised on transition at a current value, e.g., implicitly considering that past changes in discount rates have been recorded in retained earnings. These stakeholders note that not considering any impact of the OCI carried forward on the liabilities could significantly impact equity at transition and the result of future periods, thereby not providing relevant information. Others note that solutions to overcome this would effectively extend the current period book yield[18] beyond the intention of the Standard and incorporate discount rates for the liability that do not relate to the relevant rates at inception or transition.

146 EFRAG notes that the IASB limited the current period book yield to specific contracts where there can be no economic mismatch with the assets held. Therefore, using a discount rate that has no relationship to the rate that is used to measure the group of insurance contracts does not provide relevant information. EFRAG supports that view.

Fair value approach

147 When the fair value approach is used at transition and OCI is recognised as nil, the amount that would have been accumulated as a liability OCI balance is immediately transferred to retained earnings. However, the asset OCI balance may only be transferred to retained earnings over time. As a result, this would affect the financial result in the profit or loss statement in future years subsequent to transition, thereby affecting relevance of information as indicated by some.

148 Some are concerned that this asymmetrical treatment may significantly distort equity at transition and future results: assets will generate a yield based on the historical effective interest rate, whilst liabilities will unwind at the market rate at transition date.

149 EFRAG identified a number of issues in setting the underlying asset OCI balance when applying the fair value approach at transition that may affect the relevance of information:

[17] This relates to the OCI component that may arise if an insurer elects to recognise the impact of changes to the financial assumptions on the insurance liability in other comprehensive income rather than profit or loss. Where an insurer elects to set OCI to nil on transition, it does not need to recalculate all the amounts that may form part of the amount in OCI, but it is subsumed into retained earnings to ease transition.

[18] The current period book yield is an option in IFRS 17 under VFA where the underlying items are held by the insurer whereby the amounts recognised as interest expense equals the amounts recognised as interest income with the remainder recognised in OCI.

(a) Setting the asset OCI balance to nil overrides the (long-term) business model of holding the related bonds which is based on collecting cash flows and selling. However, on transition there is no selling or derecognition of the bonds;

(b) As there is a duration mismatch between (shorter term) assets and (longer term) liabilities, the fair values of both have a different sensitivity to interest rate risk. Hence, the insurer cannot apply the same rate for both assets and liabilities at transition date, and this would result in different changes in both the asset and liability OCI balances at subsequent dates;

(c) When the assets are measured at FVOCI reflecting a holding and selling business model, assets are occasionally sold. Given the shorter duration of the debt assets compared to the liabilities, recycling of the asset OCI balance as required by IFRS 9 – post transition - may be difficult as the liability OCI balance on transition has been moved to retained earnings at transition;

(d) As the asset OCI balance of a bond pulls to par over the life of the bond (over and beyond the date of transition), the asset OCI balance (subsequent to transition) may have a different sign than the one of the corresponding insurance liabilities. It leads to desynchronization between the asset OCI balance and the liability OCI balance;

(e) Permitting entities to deem the cumulative amount in OCI related to corresponding assets to nil at transition to IFRS 17 would involve an amendment to IFRS 9, which would add complexity and would have to be assessed for possible unintended consequences;

(f) Permitting entities to deem the cumulative amount in OCI related to corresponding assets to nil would involve hindsight in order to determine which assets have been supporting the insurance liabilities. This would result in a loss of useful information and a loss in comparability between entities.

150 EFRAG has also identified issues with aligning the asset OCI balance to the liability OCI balance by means of the locked-in (or alternatively a market yield) rate at transition. Refer to Appendix III, Transition – Setting OCI to nil.

151 EFRAG understands the wish to match insurance finance income and expenses from assets and liabilities at transition and beyond and notes this may be helpful for a number of entities as they can match their asset OCI balance with their liability OCI balance (thus avoiding mismatches). However, from a conceptual and practical point of view, EFRAG notes there are a number of concerns as explained above that may affect the relevance of the information if other methods are used. Furthermore, setting the accumulated insurance liability OCI balance to nil is a practical expedient when no data is available to compute accurately the OCI balance. Accordingly, EFRAG considers that the treatment of the liability OCI balances at transition set forth in IFRS 17 does not impair the provision of relevant information.

Contracts that change nature over time on transition

152 In the limited update to the case study, one participant identified contracts that change nature over time, i.e., such contracts are saving contracts at inception and are then converted into annuities at a given point in time. This participant reported that for a contract that has become an annuity before transition, the participant would need to identify the contract inception date and not only the conversion date to use information from the savings period, in order to apply the full retrospective approach on transition. The current systems only record the date the savings contract was changed into an annuity and not the original inception date. Under the

modified retrospective approach, even though there is a lack of reasonable and supportable information to assess at inception date, the participant was concerned that it was unable to assess the contract for VFA eligibility. The participant was also concerned about the requirements in IFRS 17, since contracts converted to annuities would fall under the general model on transition. EFRAG observes that there is no specific relief in the modified retrospective approach to reassess the contracts at transition for VFA eligibility. EFRAG considers that a similar relief would add to the complexity of the Standard, and that the requirements in IFRS 17 do not impair the provision of relevant information.

Transfers that do not form a business and business combinations in scope of IFRS 3 at transition

153 At transition, entities are allowed to classify as a liability for incurred claims a liability for settlement of claims incurred before an insurance contract was acquired in a transfer of insurance contracts that do not form a business or a business combination in the scope of IFRS 3, to the extent that an entity does not have reasonable and supportable information to apply the full retrospective approach.

154 Some stakeholders noted that the preparers would not be able to benefit from this relief, as they would have reasonable and supportable information to apply a retrospective approach.

155 EFRAG notes that the application of the relief aligns the treatment of insurance contracts that have been acquired by means of a transfer of insurance contracts that do not form a business or a business combination in the scope of IFRS 3. Hence, EFRAG thinks this leads to relevant information.

156 For insurance contracts that are part of a transfer that does not form a business or a business combination in scope of IFRS 3, EFRAG notes this is a relief that has been granted because it may be often impracticable to apply IFRS 17 retrospectively due to a lack of data. EFRAG assesses that this practical expedient does not reduce the relevance of information because of this reason.

Business combinations

Contracts acquired in their settlement period

157 Applying IFRS 17, entities assess the classification of contracts using the general principles in IFRS 3, i.e., at the acquisition date. As a result, contracts acquired in a business combination which are in their settlement period could be classified as liability for remaining coverage and a CSM could be recognised as the difference between the fair value and the fulfilment cash flows at the acquisition date. This is because IFRS 17 considers that contracts acquired in their settlement period with claim amounts that are uncertain in timing or amount could meet the definition of an insurance contract at the acquisition date.

158 Some have argued that treating such contracts as liabilities for remaining coverage is likely to reduce comparability with other portfolios and other entities as it would lead to a difference in the consolidated financial statements and the separate accounts of the acquiree. They also argue that this treatment negatively impacts relevance, as the reported insurance result would not be generated by the initially insured risks, as the claims have already been incurred, thereby confusing these trends over a significant period of time and not reflecting the current business approach, which is not to provide insurance coverage but to process the claims. Complexity would be introduced in calculating the CSM and the corresponding insurance revenue on incurred claims. Similarly, some are concerned by the lack of a sound conceptual basis for this accounting treatment whereby absent any change in the contractual terms and other facts and circumstances at the acquisition date,

there could be differing assessments of whether an insured event has occurred or not from the acquiror and acquiree's perspectives.

159 Furthermore, some are concerned that the same contract is evaluated to have no remaining insurance risk in the acquiree's books whereas the opposite is true on consolidation as it would lead to a difference of classification of the same insurance risk. These stakeholders noted that such a difference in the classifications of contracts, solely on the basis of contractual terms as they exist at the acquisition date, are rare in practice. They indicated that such reclassifications are rather made because economic conditions or other pertinent conditions have changed since a contract was issued. Accordingly, they argued that, in the absence of any substantial changes in the terms of the contracts, requiring the reassessment of the classifications made by the acquiree with respect to the existence of an insured event is not relevant.

160 Given the difficulties involved, and the arguably confusing information provided, some also doubt that the requirement would pass the cost-benefit assessment.

161 EFRAG acknowledges that insurance contracts in their settlement period are of a different nature than contracts for which the insured event has not yet materialised. Hence, EFRAG has sympathy for the argument that such insurance contracts should not be treated in the same way. However, EFRAG is of the view that consistent with the general principle in IFRS 3, the insurance contract is evaluated at the acquisition date in order to consider whether there is remaining insurance risk on the basis of the principles in paragraph B5 of IFRS 17.

162 As highlighted in Appendix B of IFRS 17, contracts covering adverse claims development meet the definition of insurance risk, even if the insured event under the original contract has taken place. For these contracts, there is an uncertainty relating to the ultimate development of the claims. IFRS 3 also ignores transactions by the acquiree before the acquisition, therefore EFRAG acknowledges the existence of some purchased 'incurred' claims is an anomaly on acquisition date.

163 Therefore, for the new consolidated group, there is an insured event remaining for some claims and that is reflected as a liability for remaining coverage. On acquisition, the CSM is calculated as the difference between the fair value and the fulfilment cash flows and the related CSM is spread over time as insurance contract services are rendered under the general principles of IFRS 17.

164 Some argued that revenue on the same contract would be recognised twice, but this disregards that the recognition of CSM reflects the substance of the transaction from a consolidated perspective. EFRAG also notes that preparers may and are encouraged to disaggregate information or to provide additional disclosures when they deem appropriate to do so.

165 Therefore, on balance, EFRAG is of the view that accounting treatment for contracts acquired in their settlement period results in relevant information.

Conclusion about the relevance of information resulting from IFRS 17

166 With regard to the scope, the choice to apply IFRS 17 or IFRS 9 to loans that meet the definition of insurance contracts, relevant information is provided because entities would apply the same Standard to similar contracts that it issues.

167 For credit cards (and similar payment instruments), EFRAG acknowledges that the separation may be a complex exercise if this is required. However, EFRAG assesses that the separation is beneficial and relevant, as it results in comparability amongst the different sectors and reflects the economics of the transactions.

168 The general measurement requirements are assessed to lead to relevant information as the rights and obligations that arise from insurance contracts, including law and regulation are reflected including the effect of options and guarantees. The time value of money is being reflected through the use of discounting. The risk adjustment will provide relevant information for users to evaluate an entity's view of the economic impact of non-financial risk. Finally, the use of current updated estimates would provide relevant information as it includes current developments to help users assess the predictability of cash flows and adequacy of the liability.

169 The CSM provides relevant information as it provides a transparent view of the entity's expected unearned profit. EFRAG considers that for the general model contracts accreting at a locked-in rate provides relevant information as the CSM does not represent future cash flows. These contracts have different economics compared to contracts with direct participation features. Therefore, for such investment-like contracts as those under the VFA, updating the CSM with the changes related to financial factors is assessed to be appropriate.

170 The treatment of insurance acquisition cash flows, in cases in which renewals of insurance contracts are considered by the insurer, is assessed to lead to relevant information by reflecting the economic substance.

171 On contracts that contain both insurance and non-insurance elements, IFRS 17 provides requirements on what can be separated and what has to be accounted under IFRS 17. EFRAG considers that this provides relevant information because it reflects interdependencies between insurance and non-insurance components.

172 The general measurement requirements are modified or simplified for:

(a) Contracts with direct participation features:

(i) These contracts are assessed to be of an economical different nature due to the different nature of the fee in these contracts. Therefore, conditions to apply the approach for contracts with direct participation features are assessed to lead to relevant information;

(ii) The accounting boundary in IFRS 17 for the VFA and general model is appropriate and relevant. The extended risk mitigation option with respect to non-derivative financial instruments at fair value through profit or loss can be used to address the accounting mismatch in profit or loss for contracts with direct participation features that contain a material amount of cash flows that are non-participating and that are not covered by underlying items.

(b) For contracts without direct participation features:

(i) EFRAG notes that, for contracts that are accounted for under the general model but have strong similarities to contracts with direct participation features, the nature of the profit is different from contracts with direct participation features;

(ii) EFRAG considers that relevance is not negatively impacted by contracts that will fall under the general model when customary business practices of participation are not enforceable from a legal point of view. For these contracts the contract does not specify a fee nor a clearly identified pool of underlying items. Accordingly, the accounting conventional boundary set forth in IFRS 17 does not regard these contracts as providing asset management services.

(c) For contracts that change nature over time, EFRAG considers that preparers would have to provide further information to users to help them understand the specifics of the contractual terms. EFRAG considers that the information provided would still be relevant and notes that the risk mitigation option has been expanded to include non-derivative financial instruments at fair value through profit or loss to minimise this issue.

(d) Investment contracts with discretionary participation features: the measurement is assessed to provide relevant information as these are accounted for under IFRS 17 if the entity also issues insurance contracts. These investment contracts often have similar characteristics to insurance contracts.

(e) Premium allocation approach: the relevance of the information is not materially reduced compared to the general measurement requirements.

(f) On reinsurance contracts held:

(i) EFRAG assesses that the separate treatment under IFRS 17 reflects the rights and obligations of different and separate contractual positions.

(ii) For reinsurance contracts held that do not qualify for the VFA while the underlying contracts do qualify, EFRAG assesses that the risk mitigation option would largely address the accounting mismatches, thereby balancing relevant information.

(iii) For reinsurance contracts held that are used to recover losses from the underlying contracts, EFRAG considers that this provides relevant information as it aims at reducing accounting mismatches.

173 On mutual entities EFRAG considers the requirements in IFRS 17 appropriate in providing relevant information about the best estimate of the amount to be paid under the insurance contract, therefore, the conditions to meet the relevance criterion do not fundamentally differ between mutual entities and other insurers.

174 The treatment of investment components is complex, but that complexity is balanced by the relevance of the resulting information in line with the insurance business models.

175 The risk mitigation option of IFRS 17 addresses adequately particular accounting mismatches for contracts with direct participation features when derivatives, non-derivative financial instruments at fair value through profit or loss and reinsurance contracts held are used.

176 On the release pattern of the CSM for contracts without direct participation features, EFRAG considers that there would be additional complexity to capture the investment-return service. However, on balance, EFRAG considers that the release pattern of the CSM provides useful information. The release pattern of the CSM for contracts with direct participation features results in relevant information as it represents the mixture of services provided.

177 On contract boundary of contracts with annual repricing mechanisms, the accounting leads to relevant information because it reflects the changes in the

economics of the contracts. The treatment of contract boundary for reinsurance contracts held, provides relevant information as it reflects the different contractual terms of insurance contracts issued and reinsurance contracts held.

178 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. EFRAG considers that having the option to report either in profit or loss or other comprehensive the finance component enables insurers to appropriately represent two business approaches of European insurers.

179 The requirement for separate presentation of contracts, at a portfolio level, of contracts in an asset position and contracts in a liability position in the statement of financial position is assessed not to hinder relevant information. EFRAG considers that the combination of rights and obligations created by an insurance contract should be reflected as a whole, without separate presentation of receivables and payables. Therefore, EFRAG assesses that information resulting from non-separation is still relevant also taking the disclosure requirements into consideration.

180 The disclosure requirements would provide information that is most relevant for the circumstances of entities. Note that disclosures are also assessed under the Understandability section.

181 The transition requirements are applicable in a situation in which an insurer has all, partly or an insufficient amount of information available to apply the Standard retrospectively. In addressing each of these situations and considering the extent of the information available for each particular group of insurance contracts at transition, the existence of three transition requirements does not result in a lack of relevant information. The alleviations granted under the modified retrospective approach are still leading to relevant information as they allow to achieve the closest outcome to a full retrospective application without undue cost or effort. The impossibility to retrospectively apply the risk mitigation at transition for those entities that are significantly impacted, reduces the relevance of the information. However, given the risk of hindsight, EFRAG assesses that, on balance, such a prohibition will not impair the relevance of the resulting information. EFRAG agrees with the approach to allow setting OCI on the insurance liabilities to nil, when the modified retrospective approach and the fair value approach are applied, as this will not, on balance, impair the relevance of the information provided.

182 With regards to business combinations, in particular to contracts acquired in their settlement period where these would be classified as liability remaining coverage, some have argued that this treatment negatively impact relevance as the claims have already been incurred, thereby confusing trends over a significant period of time and not reflecting the current business approach. EFRAG is of the view that there is remaining coverage risk for the acquirer. Therefore, on balance, EFRAG is of the view that accounting treatment for contracts acquired in their settlement period results in relevant information.

183 EFRAG agrees that the use of annual cohorts provides relevant information as they provide important information about profitability trends and losses on onerous contracts.[19]

184 **EFRAG provides its observations on how the requirement to apply the annual cohorts requirement to intergenerationally-mutualised contracts and cash**

[19] EFRAG's observations on the requirement to apply annual cohorts to intergenerationally-mutualised and cash flow matched contracts are in the Cover Letter.

flow matched contracts impacts relevance directly in the Cover Letter. For the other requirements in IFRS 17, EFRAG's overall assessment is that they result in the provision of relevant information.

Reliability

185 EFRAG has 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.

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

187 EFRAG considers that the maximum possible use of market information will provide reliable information. In Europe, the underlying information used for IFRS 17 such as the expected cash flows is the same or similar to the information used for Solvency II. European insurers are obviously familiar with these principles and accordingly this would lead to reliable information. EFRAG also considers that the principles-based nature of IFRS 17 along with the disclosures about inter alia judgement and estimates would provide reliable information. EFRAG notes that while the determination of the amounts is often complex, this reflects the industry as well as the array of products provided against the backdrop of differing legal, economic and social environments. Accountancy Europe provided their feedback on the auditability of IFRS 17 and a summary is provided in Appendix 3. In essence, IFRS 17 is auditable and Accountancy Europe has not received any evidence to the contrary.

188 **Many of the concerns, including EFRAG's conclusions, addressed in the relevance section also affect reliability.** These issues are not repeated. EFRAG has identified the following topics as being the most significant to the assessment of reliability:

(a) Measurement of insurance contracts;

(b) Insurance acquisition cash flows;

(c) Separating components from an insurance contract;

(d) Different insurance accounting models;

(e) Treatment of investment components;

(f) Contractual service margin;

(g) Disclosures; and

(h) Transition requirements.

Measurement of insurance contracts

189 Measurement of insurance liabilities in IFRS 17 requires judgement in estimating the fulfilment value of an insurance contract. As judgement and interpretation could be required it may affect the reliability of information. EFRAG observes that while dealing with estimates and uncertainty it is inherent to the insurance business, so is the use of professional judgement. As a result, judgement is also inherent in the measurement of insurance contracts. In addition, EFRAG considers that reliability would not be reduced, because entities have experience in applying judgement when applying other IFRS Standards and in managing their business.

190 Therefore, EFRAG considers that the use of judgement in estimating future cash flows would not lead to reduced reliability.

191 Also, IFRS 17 is a new standard and as a certain market practice will develop over time, this would further increase the reliability of information.

Discount rates

192 IFRS 17 requires entities to discount cash flows. Under IFRS 17, discount rates 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 uses estimates.

193 IFRS 17 does not require a particular estimation technique for determining discount rates. However, in applying an estimation technique, an entity (i) maximises the use of observable inputs, (ii) reflects current market conditions from the perspective of a market participant, and (iii) uses 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.

194 An entity may determine the appropriate discount rates using either a top-down (where the entity does not need to make an adjustment for differences in liquidity characteristics between the reference portfolio and the insurance contracts) or a bottom-up approach (where liquidity characteristics are explicitly considered). In principle, EFRAG considers that the discount rate reflecting the liquidity characteristics of the group of insurance contracts being measured reflects the nature of the liabilities. EFRAG notes that insurers have extensive experience in managing large amounts of different kinds of assets, hence EFRAG is confident that insurers will be able to identify the different factors of the discount rate including liquidity premiums on assets that can be useful when determining the liquidity premium on their liabilities.

195 In assessing the reliability of the use of discount rates, EFRAG notes that:

(a) observable rates may not be available for particular markets or for very long durations, requiring the use of particular estimation techniques;

(b) dealing with estimates and uncertainty and the use of professional judgement is inherent to the insurance business and in accounting in general; and

(c) 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.

196 The level of judgement required for determining the discount rate does not seem to be materially different from that required and used in other industries or in applying other IFRS Standards.

197 <u>Therefore, EFRAG considers that the requirements to determine the discount rate provide reliable information.</u>

Insurance acquisition cash flows

198 As discussed under relevance, EFRAG notes that insurers have to allocate these cash flows and assess the recoverability of an asset for insurance acquisition cash flows when it may be impaired.

199 EFRAG acknowledges that such allocation and recoverability assessment require the use of judgement to be exercised, especially the expectation with regards to renewals of contracts.

200 An entity has to exercise judgement about the expected renewals of contracts, and EFRAG assesses that this judgement is inherent in the insurance business because the entity pays the acquisition cost, e.g. commissions, in the expectation of it being

recovered via renewals. Therefore, EFRAG considers that the entity has taken into consideration the extent of renewals in its business decision to pay a given amount of acquisition costs. This managerial information would also be used when assessing for accounting purposes the recoverability of the acquisition cash flow asset.

201 EFRAG also notes that in order to help users of financial statements assess such judgement exercised, extensive disclosure is required for the asset recognised that arises from the expected renewals and for the recognition and reversal of impairment losses.

202 Therefore, EFRAG considers that the exercise of judgement would not *per se* reduce reliability.

Separating components from an insurance contract

203 EFRAG assesses that there may be cases where the legal form of a single contract would not reflect the substance of its contractual rights and obligations. For example, this may be the case where an entity combines in one single legal contract for the convenience of the policyholder several insurance components and the price is the total of the standalone prices for the different insurance components provided. Therefore, EFRAG considers that, in this case, separating the components would faithfully represent the economics of the transactions and considers that these components would be able to be separated reliably.

204 However, EFRAG considers that in assessing whether insurance components should be separated reliably, the entity would need to consider the interdependency among the insurance components and whether the components can be priced and sold separately. Judgement may be required in determining the extent of the stand-alone pricing.

205 EFRAG assesses that the use of judgement in this circumstance does not impair reliability.

Different insurance accounting models

206 EFRAG notes that the measurement of the fulfilment cash flows is the same for both types of contracts: contracts with direct participation features and contracts without direct participation features. The differences are limited to the treatment of the CSM. EFRAG also notes that those differences are necessary to provide a faithful representation of the different nature of the types of contracts.

Scope of contracts with direct participation features

207 EFRAG assesses the reliability of the conditions that determine the scope of the approach available to contracts with direct participation features in the following paragraphs. Reinsurance contracts not eligible for the VFA are discussed under relevance in paragraphs 70 to 73.

Participation in a clearly identified pool of assets

208 The requirement that contracts with direct participation features relates to a clearly identified pool of underlying items ensures that the accounting treatment of the VFA is applied when the link between the insurance contract liability and the associated underlying items is contractually[20] determined and enforceable. This provides

[20] EFRAG notes that the term contractually used here can also mean by law or regulation as per paragraph 2 of IFRS 17.

reliable information because the contract specifies a determinable amount that can be linked to the underlying items that are contractually defined.

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

209 EFRAG assesses that this criterion provides reliable information because the link between the insurance contract liability and the associated assets allows to specify a determinable amount based on a clearly identified pool of underlying items. EFRAG acknowledges that this assessment includes judgement but notes that insurers exercise this judgement based on extensive experience of managing different kinds of assets over a long time period.

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

210 EFRAG assesses that this criterion provides reliable information because it provides a faithful representation to depict an obligation to pay an amount equal to a share of the fair value of the underlying items including any changes to that fair value.

Premium allocation approach

211 EFRAG considers that the measurement under the PAA provides information that is reliable because the information is expected to provide a reasonable approximation of the general requirements, i.e. would not be materially different from the general requirements.

Reinsurance contracts held

Recovery of losses on underlying insurance contracts

212 An entity is required to determine the amount of a loss recovered from a reinsurance contract held by multiplying the loss recognised on underlying contracts by the percentage of claims on underlying insurance contracts the entity expects to recover from the reinsurance contract held.

213 EFRAG acknowledges that the such loss-recovery calculation requires judgement, and the extent of judgement may depend on the type of reinsurance contracts held. More judgement may be required for reinsurance contracts where there is no one-to-one relationship between the underlying contract and the reinsurance contract held, e.g., where an 'excess of loss' reinsurance contract held covers multiple underlying contracts. However, EFRAG considers this is required, anyway, for the purpose of determining the cash flows in the measurement of the reinsurance contract held.

214 EFRAG acknowledges that the expected loss recovery is based on claims only and does not consider other cash flows such as premiums, commissions or other expenses. EFRAG notes that the proposed calculation is a simplification with the aim of reducing operational complexity that would otherwise occur in identifying each of the other types of cash flows.

215 EFRAG notes that basing the calculation on claims only may to some extent reduce the reliability of the resulting information, but this is balanced by the overall reduction in operational complexity.

Contract boundary of reinsurance contracts held

216 EFRAG understands that the cash flows within the boundary of the reinsurance contract held depends on the substantive rights and obligations of the underlying contracts issued by the primary insurer. The substantive right of a purchased reinsurance contract is to receive services from the reinsurer. The substantive obligation is to pay premiums to the reinsurer. Therefore, a substantive right to

receive services from the reinsurer starts once a reinsured contract is written and ends when the reinsurer has the practical ability to reassess the risks transferred to the reinsurer and can set a price or level of benefits for the contract to fully reflect the reassessed risk.

217 EFRAG understands that one implication of this is that the boundary of a reinsurance contract held could include cash flows from underlying contracts covered by the reinsurance contract that are expected to be issued in the future. Under IFRS 17, the direct insurance contracts and the reinsurance contracts held by a primary insurer are measured separately.

218 Some stakeholders have expressed concerns that there may be a reduction in reliability in estimating contracts expected to be written in the future. However, EFRAG considers that the estimation of these contracts would follow the same measurement principles as required by IFRS 17. The fact that estimates of future contracts entail the use of different techniques than when estimating cash flows of existing contracts is counterbalanced by the use of probability-weighted estimates. Hence EFRAG considers that this does not lead to a reduction in reliability of the resulting information.

Treatment of investment components

219 As discussed in paragraphs 88 and 89, IFRS 17 requires changes to expected amounts of the investment component payable in the period to be adjusted to the CSM for contracts under the general model. Some consider that the application of this requirement is complex.

220 EFRAG acknowledges the complexity of the requirement but notes that accelerations or delays in payment of investment components are inherent to insurance business models. EFRAG also acknowledges that some judgement may be involved that in turn may impact the reliability of the numbers presented. However, EFRAG concludes that the complexity is balanced by the importance of this information as well as the applicability to all relevant insurers.

Contractual service margin

Use of coverage units for the contractual service margin

221 EFRAG acknowledges that the determination of the profit allocated in profit or loss based on the actual service provided over the expected coverage period and quantity of benefits provided by contracts in a group requires the use of significant judgement. Nevertheless, EFRAG assesses that the use of coverage units results in reliable information as insurers have extensive experience in applying judgement.

Coverage units for contracts without direct participation features

222 For insurance contracts without direct participation features, the coverage units reflect the quantity of benefits and expected coverage period of investment-return service, if any, in addition to insurance coverage. EFRAG considers this generally leading to reliable information as the profit recognised in profit or loss from contracts accounted for in accordance with the general model faithfully represents both the insurance and investment services provided. EFRAG acknowledges that the estimation of coverage units is judgemental but there are disclosures relating to the weighting between insurance and investment-return service which would help with the reliability of the information.

Coverage units for contracts with direct participation features

223 For insurance contracts with direct participation features, the coverage units reflect the quantity of benefits and expected period of both insurance coverage and investment-related service.

224 EFRAG considers that the estimation of coverage units is judgemental, but entities would still be able to reliably measure them. This estimation is made easier because these contracts are substantially investment-related contracts, i.e., the investment-related service components clearly surpass any insurance service entailed. As a result, the weighting between insurance and investment would faithfully represent these types of contracts. Furthermore, the entity has to disclose the approach used in determining the weighting which would help users to assess the weighting.

Use of locked-in rate for the contractual service margin

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

226 Some disagree with this requirement and argue that using current rates to accrete the CSM would better reflect the best estimate of unearned profit. EFRAG has assessed the relevance of the use of the locked-in rate from paragraphs 32 to 34 above. The arguments used in that assessment are equally valid when assessing reliability.

227 Hence, EFRAG assesses that accreting the CSM at a locked rate for contracts under the general model leads to reliable information.

Disclosures

228 As part of the disclosures, IFRS 17 requires disclosing:

(a) quantitative information about when the entity expects to recognise in profit or loss the CSM remaining at the end of a reporting period; and

(b) the approach used to determine the relative weighting of the benefits provided by insurance coverage and investment-return service or investment-related service.

229 EFRAG assesses that this adds to the reliability of the information on the CSM for insurance contracts that provide either an insurance service or both investment and insurance service.

Transition requirements

Transition approaches

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

231 EFRAG assesses that applying the full retrospective approach would result in the same level of reliable information as new contracts assessed under IFRS 17 because insurance contracts would be identified, recognised and measured as if IFRS 17 had always been applied. EFRAG understands that the retrospective application is likely to be practicable for short-term contracts and recently issued long-term contracts.

232 However, on transition it may be impracticable to apply the full retrospective approach to other contracts. One of the transition approaches that can be applied is the modified retrospective approach. It offers alleviations to the full retrospective approach as stated in paragraphs 137 to 139.

233 The objective of the modified retrospective approach is to achieve the closest outcome to retrospective application possible using reasonable and supportable information available without undue cost or effort. IFRS 17 provides a number of simplifications on transition which meet this objective.

234 EFRAG notes that paragraph 51 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* acknowledges the need for estimates in retrospective application which is also applicable to first-time adopters of IFRS 17. In order to achieve the above objective, EFRAG considers that an insurer may need to make use of information the entity gathered in the past for other purposes.

235 Referring to the above, EFRAG considers the modified retrospective approach, which offers alleviations compared to the full retrospective approach, as still leading to reliable information as it enables to achieve the closest outcome to a full retrospective application without undue cost or effort.

236 EFRAG has not identified issues leading to possible reduced reliability of the fair value approach on transition in the context of it being an alternative to when reasonable and supportable information is available.

Not applying the risk mitigation option retrospectively at transition date

237 The risk mitigation option cannot be applied retrospectively on transition. EFRAG acknowledges that this issue is significant for some insurers and would reduce the relevance of the information as it distorts the CSM and related equity balances at transition and also distorts future profit or loss. On the other side, this also fosters reliability in that general hedging and risk mitigation principles on transition continue to be adhered to with a limit on the use of hindsight.

238 In addition, as explained in paragraph 142, entities could freely decide the extent to which to reflect risk mitigation activities in the CSM based on a known accounting outcome thus impacting the reliability of the resulting information.

239 Therefore, on balance, EFRAG is of the view that not applying the risk mitigation option retrospectively will not impair the reliability of the resulting information.

Conclusion about the reliability of information resulting from IFRS 17

240 It is acknowledged that use of judgement is inherent in the insurance business and therefore in the measurement of insurance contracts. Therefore, the use of judgement would not *per se* impair reliability. On discount rates, EFRAG considers that both approaches to determine the discount rate provide reliable information within the bounds of cost.

241 On the treatment of insurance acquisition cash flows, judgement is required for the allocation, expected renewals and impairment testing. However, extensive disclosure would help users assess the judgement used.

242 In assessing whether insurance components are separated reliably, the entity would need to consider the interdependency among the insurance components and whether the components can be priced and sold separately.

243 On different insurance accounting models:

(a) The criteria of contracts with direct participation features are found to provide reliable information because the link between the insurance contract liability and the associated underlying items allows the specification of a determinable amount. The conditions also provide a faithful representation to depict an obligation to pay an amount equal to the fair value of the underlying items.

(b) Information from using the PAA is considered to be reliable as it provides a reasonable approximation of the general requirements.

244 On reinsurance contracts held:

(a) Regarding the recovery of losses from reinsurance contracts held, EFRAG acknowledges that judgement is required on the calculation of the expected loss-recovery. However, this is already required when the entity has to determine the cash flows for the reinsurance contracts held for measurement purposes. In addition, EFRAG notes that basing the calculation on claims only reduces the reliability of the resulting information but this is balanced by the overall reduction in operational complexity.

(b) Judgement is required to estimate contracts expected to be written in the future. The related estimates would use the general measurement principles of IFRS 17. EFRAG therefore disagrees that this leads to reduced reliability of information.

245 EFRAG acknowledges the complexity of the requirement relating to investment component changes adjusted to CSM but notes that accelerations or delays in payment of investment components are inherent to insurance business models. EFRAG also acknowledges that some judgement may be involved and that this impacts the reliability of the numbers presented. However, EFRAG concludes that the complexity is balanced by the importance of this information as well as the applicability to all relevant insurers.

246 On the contractual service margin:

(a) For both insurance contracts without direct participation features and with direct participation features, the estimation of the coverage units is judgemental. However, EFRAG considers that the disclosures relating to the weighting between insurance and investment-return service / investment-related service would help users to assess the reliability of the information.

(b) With regards to accreting the CSM at a locked-in rate for contracts under the general model, some argue that using current rates better reflects the best estimate of unearned profit. However, EFRAG assesses that using a locked-

in rate leads to reliable information for the same reasons as in the relevance section.

247 In respect of disclosures, EFRAG assesses that the disclosures add to the reliability of the information on the CSM for insurance contracts that provide either an insurance service or both investment and insurance service.

248 Regarding transition approaches, the full retrospective approach would provide reliable information because the contracts are measured as if IFRS 17 had always been applied. EFRAG considers the modified retrospective approach, which offers alleviations compared to the full retrospective approach, as still leading to reliable information as they allow to achieve the closest outcome to a full retrospective application without undue cost or effort. EFRAG has not identified issues in the context of reliability around the fair value approach especially in the absence of reasonable and supportable information to use the retrospective approaches.

249 The risk mitigation option cannot be applied retrospectively on transition. EFRAG acknowledges that this reduces the relevance of information for some insurers impacted as it distorts the CSM and related equity balances at transition and also distorts future profit or loss. However, given the risk of entities deciding without restrictions, the extent of reflecting the risk mitigation activities, EFRAG, on balance, assesses that not applying the risk mitigation option retrospectively will not impair the reliability of the resulting information.

250 EFRAG provides its observations on how the requirement to apply the annual cohorts requirement to intergenerationally-mutualised contracts and cash flow matched contracts impacts reliability directly in the Cover Letter. For the other requirements in IFRS 17, EFRAG's overall assessment is that they result in the provision of reliable information.

Comparability

251 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.

252 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.

253 EFRAG considers that the principles-based requirements in IFRS 17, including the different accounting models for different contracts, will lead to comparable information over time by different insurers in different territories. Furthermore, unlike IFRS 4, it requires the same accounting policies for the same transactions. It would therefore lead to a significant improvement in information comparability. This may benefit EU insurers when raising funds in international markets. EFRAG notes that some transactions[21] may be in the scope of either IFRS 9 or IFRS 17 depending on the nature of the issuer which is discussed in further detail below.

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

(a) Scope exclusions for loans and other forms of credit that transfer insurance risk;

(b) Measurement of insurance contracts;

(c) Insurance acquisition cash flows;

(d) Separating components from an insurance contract;

(e) Different insurance accounting models;

(f) Mutual entities;

(g) Treatment of investment components;

(h) Risk mitigation option;

(i) Contractual service margin;

(j) Presentation in the statement of comprehensive income;

(k) Transition requirements;

(l) Business combinations;

(m) Accounting policy options; and

(n) Interim reporting.

Scope exclusions for loans and other forms of credit that transfer insurance risk

255 For entities issuing credit cards (and similar payment instruments), although the separation may be a complex exercise if this is required, EFRAG assesses that the separation is beneficial, as it results in comparability amongst the different sectors and reflects the economics of the transactions.

256 Some loan contracts may transfer significant insurance risk such as a mortgage with a waiver upon death (sometimes referred to as equity release mortgages). IFRS 17

[21] Investment contracts with direct participating features.

allows lenders to apply either IFRS 17 or IFRS 9 to loans for which the only insurance cover is for the settlement of some or all of the borrower's obligations under the loan. Lenders would make this choice irrevocably at the portfolio level.

257 While such an option may reduce comparability due to the possibility that entities apply two different standards to the same type of contracts, EFRAG assesses that on balance it is acceptable as it allows the reflection of the relevant business model and reduces complexity for preparers.

Measurement of insurance contracts

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

(a) the fulfilment cash flows, including the risk adjustment; and

(b) the CSM.

259 EIOPA highlighted in its analysis of IFRS 17 *Insurance Contracts*[22] that "the introduction of IFRS 17 can be described as a shift in paradigm to bring comparability to insurers' financial statements and to allow for consistent accounting practices beyond different jurisdiction, compared to its predecessor IFRS 4.

Notwithstanding that and whilst IFRS 17 regulates the accounting relatively prescriptively in a number of areas, its principle-based nature allows scope for interpretation and judgement in other cases, which may affect the comparability of the financial statements." EIOPA mentions specifically the impact of the choice around discount rate as an example.

260 EFRAG acknowledges that IFRS 17 is a principles-based standard and entities would use entity-specific information to apply it. Judgement may have a negative impact on comparability however this effect is inevitable in a principles-based standard. EFRAG considers that this is balanced by the relevance of the resulting information as it reflects an entity's specific view. In addition, IFRS 17 requires that such information (which is similar to other IFRS Standards) should, while being specific to the entity:

(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.

261 In this context, EFRAG considers that entities will apply judgement for the measurement of the risk adjustment. IFRS 17 requires explicit disclosures to be made that can mitigate, to some extent, the possible reduction in comparability of the recognised amounts. For example, entities have to disclose the confidence level used to determine the risk adjustment irrespective of the technique used to estimate the risk adjustment. This information will enable users to compare entities in order to assess how the entity-specific risk assessment might differ from entity to entity. Furthermore, while multiple techniques can be used to estimate the risk adjustment, these techniques need to result in similar outcomes in similar situations, thereby contributing to comparability.

262 EFRAG notes that the IASB confirmed that the confidence level disclosure is to assist with comparability of the entity-specific measure for the risk adjustment for

[22] https://www.eiopa.europa.eu/content/eiopa-analyses-benefits-ifrs-17-insurance-contracts

non-financial risk. EFRAG acknowledges that the confidence level of disclosure may be burdensome to prepare and at the same time not directly comparable. However, other approaches, such as ranges of key inputs or size of risk adjustment compared to liabilities, would also not achieve an objective of perfect comparability. Other approaches such as the cost of capital approach may not be easy to implement or for users to understand. Therefore, EFRAG assesses that the disclosures around the confidence level are an appropriate practical approach that will provide useful information to users. The confidence level disclosure would allow the users to compare how the risk aversion may differ from entity to entity, thereby supporting comparability.

Discount rates

263 An entity may determine the appropriate discount rates using either a top-down approach (where the entity does not need to make an adjustment for differences in liquidity characteristics between the reference portfolio and the insurance contracts – it is part of the spread) or a bottom-up approach (where liquidity characteristics of the insurance contracts are considered). Theoretically for insurance contracts where the cash flows do not vary based on the performance of the underlying items, both should result in the same discount rate, but differences may arise in practice depending on the estimates of credit risk relating to the assets or the liquidity premium on the liabilities. Some are concerned that this will impair comparability as the result of the two approaches would not necessarily be the same.

264 EFRAG notes that the IASB intended to use only a bottom-up approach as this is conceptually the purest approach. However, some insurers were concerned about the difficulty of identifying the appropriate liquidity premiums. The use of a top-down approach has been allowed in the Standard in order to address these concerns. For the top-down approach, an entity need not make an adjustment for any remaining differences in liquidity characteristics between the reference portfolio and the insurance contracts. Therefore, combined with the relevant disclosures on the topic, on balance, EFRAG does not consider the dual approach as an impairment to comparability.

Insurance acquisition cash flows

265 Under IFRS 17, non-refundable acquisition costs paid at inception are allocated to the related current and future groups of insurance contracts. EFRAG observes that acquisition costs related to future periods are based on internal estimates and this judgement may affect comparability. However, a principle exists that this allocation is to be done on a systematic and rational method of allocation. In addition, due to the fact that the allocation of acquisition costs is mandatory and not optional, EFRAG considers that this will mitigate the potential comparability issue because the accounting would be done in a consistent way. In addition, more relevant information is being provided, as the acquisition costs relate to future renewals.

266 On the other side, as entities are allowed to choose to expense such costs under the PAA (on a portfolio-by-portfolio basis) where the related coverage period of each contract in the group at initial recognition is no more than a year, EFRAG assesses that such accounting policy choice could impair comparability but this would, in essence, be limited for those types of contracts and the potential loss of comparability is compensated by the benefit in providing a practical simplification.

Separating components from an insurance contract

267 IFRS 17 includes requirements for the separation of 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.

268 EFRAG assesses that separating these components provides information that enables users to better compare entities providing similar services even though in different businesses or industries.

Different insurance accounting models

269 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 PAA is applied.

270 As discussed below, the different models allow to reflect the characteristics and economic nature of different types of insurance contracts. EFRAG considers that, as there are different categories of contracts corresponding to different definitions, the existence of different models does not hinder comparability.

Contracts with direct participation features

271 The CSM for contracts with direct participation features is updated for more changes than those affecting the CSM for insurance contracts under the general model. EFRAG assesses that the additional adjustments are 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 (also refer to paragraph 47 above). Furthermore, comparability among contracts with direct participation features would be achieved.

272 Some argued that certain contracts with indirect participation features (also called indirect participation contracts) are economically similar in nature to insurance contracts with direct participation features even though there may not be a contractual obligation to make payments linked to the underlying items and so they may not qualify for the VFA. Therefore, assuming that the other requirements in IFRS 17 are met, they argued that these types of contracts should be accounted for under the VFA. However, EFRAG notes that the coverage units for insurance contracts without direct participation features (which includes contracts with indirect participating features) are identified by considering the quantity of benefits and expected period of investment-return service, if any, in addition to insurance coverage. This is similar to the coverage units for contracts with direct participation features. The main difference in measurement between these two types of contracts is that changes in financial risk adjust the CSM for contracts with direct participation features (eligible for VFA) while these are recognised in the income statement for contracts with indirect participation features (not eligible for VFA). As explained in paragraphs 45 to 51 under relevance, the boundary as set in IFRS 17 is regarded as appropriate. Hence, EFRAG is of the view that the differences between accounting for contracts with and without direct participating features do not hinder comparability.

Investment contracts with discretionary participation features

273 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 would create situations where groups with and without insurance contracts apply different

standards (IFRS 17 or IFRS 9) for economically similar contracts. This requirement has been added for cost-benefit reasons. In EFRAG's view, this is a justifiable difference, also considering the differences in business model between insurers and other industry players.

Premium allocation approach

274 The PAA, which is an optional simplification of the general model in IFRS 17, can be applied in circumstances where the entity expects such simplification to 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.

275 EFRAG assesses that this will not impact comparability, as the eligibility criteria limit the scope of this simplification to instances where the measurement would not materially differ.

Reinsurance contracts held and issued

276 IFRS 17 does not allow reinsurance contracts held and issued to be accounted for under the VFA even if criteria are met. Referring to this some argue that the resulting accounting will not lead to comparable information, i.e. when looking at comparability between insurance contracts that are eligible for the VFA and reinsurance contracts that theoretically could be eligible for the VFA. EFRAG acknowledges this argument as there may be reinsurance contracts that meet the VFA criteria. Refer to paragraphs 70 to 73 under the relevance section for further information.

277 EFRAG considers that this does not impact comparability where the reinsurance contracts do not qualify for the VFA. Where the reinsurance contracts qualify for the VFA, EFRAG believes the prohibition to apply the VFA to reinsurance contracts is acceptable, as it assesses that the risk mitigation option, which is also applicable to reinsurance contracts, would largely address the accounting mismatches, thereby balancing comparability of the information.

Contracts that change nature over time

278 As discussed in paragraphs 54 to 57, some preparers have indicated that certain products change significantly in nature during their life. The concern is that for example where annuities fall in the scope of the VFA[23] due to the participation features in their initial savings phase, they would continue to be accounted for using the VFA also in their subsequent annuity phase. As such and despite being similar in nature, these contracts would be treated in the second phase differently to those annuities issued without a savings phase or without participation features during such initial phase.

279 EFRAG notes that IFRS 17 requires to assess the economic characteristics of contracts at inception and to leave unchanged the resulting accounting approach. EFRAG also notes that as mentioned in paragraph 58, previously stakeholders considered that unbundling of interrelated components (treating them separately under different accounting approaches) would have resulted in arbitrary separation and unreliable measurement of such components. Allowing the subsequent reassessment of contracts would add complexity to the Standard. Therefore, EFRAG considers that on balance the current requirements and consequences are appropriate, noting that preparers may provide additional disclosures to assist users of the financial statements to better understand when contracts that have changed

[23] For the purpose of this advice, EFRAG assumes that these contracts are eligible for the VFA but EFRAG has not performed any assessment of the appropriateness of such assumption.

nature overtime are accounted differently from contracts that did not have an initial saving phase.

Mutual entities

280 Under IFRS 17, the legal form of the insurer is not a determinant factor and all entities in the scope of this Standard have to measure and report their fulfilment cash flow (expected payments to existing and future policyholders) in a similar way. This means that the comparability criterion with respect to mutual entities is met in general.

281 However, the interaction between the nature of some of these entities and IFRS 17 may impact revenue, CSM and profit recognised on some contracts as discussed in paragraph 82 above. EFRAG considers that this reflects the different contractual relationship between the policyholder and the mutual entity when compared to those where the insurer earns a variable fee for contracts with direct participating features. That is, when a mutual entity is contractually required to distribute profits to current and/or future policyholders, this results in no CSM whereas for contracts under the VFA, the entity has a CSM as the entity receives a fee for services provided. EFRAG observes that this reflects the particular economic and contractual characteristics of the mutual entity and assesses that comparability is not impaired.

Treatment of investment components

282 As discussed in paragraph 88 and 89, IFRS 17 requires changes to expected amounts of the investment component payable in the period to be adjusted to the CSM for contracts under the general model. Some have noted that the application of this requirement is complex.

283 EFRAG acknowledges the complexity of the requirement but notes that accelerations or delays in payment of investment components are inherent to insurance business models; the complexity is inherent to it. EFRAG also acknowledges that some judgement may be involved and this may impact the comparability of the reported numbers. Nonetheless, EFRAG concludes that the complexity and potential impact on comparability due to the use of judgement is balanced by the relevance of this information as well as the applicability to all relevant insurers.

284 For insurance contracts without direct participation features, IFRS 17 requires adjustments to the CSM for differences between the actual and expected cash flows from an investment component that is not separated. Although this creates tracking activity for preparers, EFRAG considers that excluding investment components from insurance revenue provides a significant benefit for users of financial statements in terms of comparability between insurers and entities in other industries.

Risk mitigation option

285 As discussed under relevance above, IFRS 17 provides a risk mitigation option for contracts with direct participation features. This is an option with less stringent eligibility requirements than for the application of hedge accounting per IFRS 9 or IAS 39. Judgement may be required to determine the amount of the CSM to be adjusted. EFRAG considers that this impacts comparability to some extent, but this is balanced by the resulting relevance of addressing the accounting mismatch.

286 Some preparers have observed that this approach should also be available for contracts with participation features that do not meet all the eligibility requirements for the VFA and that not having this option results in non-comparable information or less relevant information.

287 However, the availability of the risk mitigation option in the VFA is consistent and justified by the fact that adjustments in respect of financial changes impacts the variable fee and therefore the CSM. This is not the case under the general model, where changes relating to the effect of time value of money, financial risk and changes therein for both factors do not adjust the CSM but affect profit or loss (or OCI depending on the accounting policy choice made by the insurer)[24]. EFRAG acknowledges that a conventional dividing line has been defined between the scope of the two models and, as often in standard-setting, there is a grey area of contracts that despite having some similarities with the population in scope of one of the two models, are to be accounted for using the other model. However, EFRAG believes that IFRS 17 has defined an acceptable dividing line and assesses that the use of different models, required to deal with the different economic characteristics, supports both relevance and comparability.

288 In addition, the application of hedge accounting offers a solution to mitigate mismatches that arise from using risk mitigation techniques. EFRAG acknowledges that hedge accounting may be suitable for some but not all cases for contracts under the general model and assesses that if offers on balance an appropriate solution. Further information on this is in Annex 5 of Appendix III.

Contractual service margin

289 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 measures 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.

290 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. It also brings revenue recognition for insurers in line with the *Conceptual Framework for Financial Reporting* ("the *Conceptual Framework*").

Identification of coverage units

291 The coverage units of the group are determined as the quantity of benefits provided by the contracts in the group and its expected coverage period. Judgement will be required for entities to determine the services provided, the related coverage units as well as the weighting of such coverage units to calculate the allocation of the CSM. This may impact comparability between entities. However, EFRAG considers that this is balanced by the relevance of the resulting information as described in paragraphs 92 to 97.

Presentation in the statement of comprehensive income

292 Regarding contracts with direct participating features for which the insurer 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

[24] EFRAG notes that B98 of IFRS 17 has defined a specific treatment for contracts without direct participating features, where adjustments to discretionary cash flows (based on a fixed interest rate or on returns that vary based on specified asset returns), are recognised in CSM.

or expenses either in profit or loss or disaggregating it between other comprehensive income and profit or loss.

293 For insurance contracts with direct participation features, where the insurer holds the underlying items, IFRS 17 requires the entity to make an accounting policy choice on a portfolio basis 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 with the remainder recognised in OCI.

294 EFRAG considers that these accounting policy choices may affect comparability between entities and will require additional effort from users to assess the use of these options. However, EFRAG assesses that this possible 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 based on their business models.

Separating components

Embedded derivatives

295 Applying the requirements in IFRS 9 for financial liabilities, embedded derivatives are separated from an insurance host contract when their economic characteristics are not closely related to that of the host. After being separated, embedded derivatives are measured at fair value through profit or loss, similarly to stand-alone derivatives.

296 EFRAG considers that separation of such embedded derivatives 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.

Service contracts and components

297 EFRAG considers that the separation of service components[25] reflects the economics of both the service and the insurance component of the insurance contract. EFRAG assesses this leads to comparable information.

298 EFRAG also assesses that the accounting policy choice for contracts that meet the definition of insurance contract but have as primary purpose the provision of services for a fixed fee aims to improve comparability by allowing for these to be treated under IFRS 15. However, as the same contracts (in the same or different entities) may be treated differently, it may in fact impair comparability. Nonetheless, EFRAG notes that most of these contracts are likely to fall in the scope of the PAA and this result would be similar to the result arising from IFRS 15. For further analysis related to IFRS 15, refer to Appendix III.

Insurance components

299 Being a principles-based standard, IFRS 17 does not provide application guidance about when the separation of insurance components may be required or not;

[25] This refers to the requirement to separate promises to transfer distinct goods or non-insurance services by applying IFRS 15.

therefore, entities will apply judgement and are expected to define the accounting in a way that reflects the economic substance.

300 EFRAG understands that an agreed implementation practice is emerging to cope with this specific aspect of the Standard[26]. EFRAG considers that reflecting the substance of the contracts, which usually are the same as the legal form, would add to comparability among entities.

Overall – separating components

301 EFRAG considers that separating these components provides information that allows users to better compare entities providing similar services albeit in different businesses or industries.

Transition requirements

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

303 EFRAG acknowledges that the possible use of three different transition methods may affect comparability among entities and, in the case of very long-term contracts, over a considerable period. Furthermore, the comparability between contracts measured at fair value on transition and similar contracts issued after transition will be impaired.

304 Alternative approaches (modified retrospective or fair value) have been developed in the Standard to support the first-time application when the full retrospective application is impracticable, owing to, for example, the absence of the necessary granular information from past periods. EFRAG notes that judgement is required in all the transition methods, including with reference to the general requirements of IAS 8 (paragraph 51): there is a need for estimates in retrospective application and this is relevant to entities applying IFRS 17 for the first time, just as it is to entities applying other IFRS Standards for the first time. EFRAG concurs with the IASB in expecting that entities will often need to make estimates when applying a specified modification in the modified retrospective approach, not only in the application of the full retrospective method. EFRAG assesses that the use of judgement in this context supports the achievement of reliable information and, as such, a possible loss of comparability is acceptable if not unavoidable.

305 When considering the existence of three different approaches to the transition as described in paragraphs 230 to 236 and its possible impact on comparability, EFRAG notes that the benefits in terms of practicability may justify the reduced comparability. In addition, in order to help with or mitigate the reduced comparability, separate disclosures are required for each transition approach that an entity applies. The separate disclosures are provided in all subsequent reporting periods post transition until all respective contracts are derecognised. An example is that reconciliations are required for the CSM and insurance revenue of insurance

[26] The IASB Transaction Resource Group (TRG), created to support consistent implementation, observed that the lowest unit of account that is used in IFRS 17 is the contract that includes all insurance components and that entities would usually design contracts in a way that reflects their substance. Therefore, a contract with the legal form of a single contract would generally be considered on its own to be a single contract in substance. However, the TRG also observed that there might be circumstances where the legal form of a single contract would not reflect the substance of its contractual rights and obligations, therefore overriding the contract unit of account presumption would involve significant judgement and careful consideration of all relevant facts and circumstances.

contracts groups, separately for each of the transition methods used. EFRAG also notes that the use of simplified options at transition has been applied in other standards.

Business combinations

Contracts acquired in their settlement period

306 Some have argued that including incurred claims in the liability for remaining coverage after the business combination date is likely to impair comparability with the treatment of other portfolios and by other entities. This is because the treatment leads to two differences in treatment of these insurance contracts in the financial statements of the acquirer compared to the financial statements of the acquiree. Firstly, at acquisition date in the consolidated financial statements of the acquirer as a result of IFRS 3, and secondly when comparing the subsequent treatment by the acquiree and the consolidated group.

307 The difference at the acquisition date is justified by the fact that the acquirer measures the liability at fair value as a proxy of the amount that it should have received from the seller if the liability were acquired separately from the business.

308 The remaining difference refers to an allocation of CSM on consolidation relating to these contracts which would not occur in the accounts of the acquiree. It is noted that this is a consequence of the first difference explained above. As explained above, IFRS 3 often leads to such differences[27] that otherwise would not be allowed. Therefore, it is accepted under IFRS that after the recognition of a liability in business combination, the originator and the acquirer may recognise different values. However, this is true of all assets, liabilities and contingent liabilities acquired in a business combination.

309 Furthermore, some have argued that removing the exception in IFRS 3 to classify contracts at inception date may not be consistent with the approach specified in IFRS 17 with regard to contracts that the entity has issued which does not permit an entity to reassess the features of insurance contracts after their issuance.

310 As explained in the Relevance section, these contracts may have a remaining insured event and are reflected as such. Furthermore, if preparers deem that users require additional information on these contracts, they can provide those. EFRAG notes that IFRS 3 includes the requirement to reclassify the financial instruments of the acquiree on acquisition. Some of these differences would not be allowed if not for IFRS 3 and therefore, EFRAG considers that IFRS 17 makes the accounting for acquisitions of insurance contracts consistent with the accounting for acquisitions of other contracts acquired in a business combination. However, EFRAG acknowledges that this is not required with respect to leasing contracts where the impact on the statement of financial position may not be significant but could lead to a difference in profit or loss.

311 Therefore, on balance, EFRAG is of the view that accounting treatment for contracts acquired in their settlement period would not impair comparability.

[27] For example, IAS 37 requires provisions to be recognised as the best estimate of the expenditure to settle the obligation or by the amount required to fulfil the obligation or the amount to be paid to a third party to transfer the obligation.

Accounting policy options

Finance income or expense presentation

312 Refer to paragraphs 292 to 294 above. EFRAG assesses that the additional disclosures are helpful to overcome concerns about comparability.

Own debt or equity instruments as underlying items

313 IFRS 17 amends IAS 32 *Financial Instruments: Presentation* to allow an accounting policy choice: under certain circumstances an entity may elect to continue to account for treasury shares as issued equity and the reacquired instruments as a financial asset and measure such instruments at fair value through profit or loss in accordance with IFRS 9 rather than applying the usual treatment under IAS 32. Such policy choice is made on an instrument-by-instrument basis and is irrevocable.

314 A similar accounting policy choice is available for debt instruments issued by the entity in IFRS 9.

315 EFRAG assesses that such accounting policy choices for both own debt and equity instruments as underlying items may reduce the comparability of information between entities. However, any loss in comparability is balanced by the relevance of reflecting an 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.

Presentation of changes in risk adjustment for non-financial risk

316 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, the full amount is included in the insurance service result.

317 EFRAG considers that although such a choice may reduce the comparability of the insurance service result between entities, it avoids the complexity of requiring that entities 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 in comparability is mitigated by the requirement to disclose the confidence level to which the risk adjustment for non-financial risk corresponds as this allows users to assess the difference in compensation required for the bearing of non-financial risk among insurers.

Interim reporting

318 An entity has an accounting policy choice, at entity level, to change the treatment of accounting estimates made in previous interim financial statements when applying IFRS 17, in subsequent interim financial statements or in the annual reporting period.

319 EFRAG assesses that this accounting policy choice may impact comparability between entities as an entity may decide which option to use for different reasons, e.g. depending on its reporting frequency, which option is less burdensome practically or a combination of both factors. However, EFRAG also assesses that since the choice is at entity level, there would be consistent accounting of all insurance contracts issued and reinsurance contracts held within the entity. In addition, EFRAG has heard from European preparers that this option is beneficial in reducing the operational burden of changing the current market practice and has heard from both European users and preparers that, in allowing continuity for those entities that apply a "year-to-date" approach, this option supports the relevance of the resulting information.

Conclusion about the comparability of the information resulting from IFRS 17

320 For credit cards (and similar payment instruments), there would be comparability amongst different sectors and the accounting would reflect the economics of the transactions. For loans, the accounting policy option to apply either IFRS 17 or IFRS 9 reduces comparability between the two sectors although it allows the reflection of the relevant business model.

321 On measurement, a number of areas require judgement during application. Judgement is inevitable in principles-based standards however, this is balanced by the relevance of the resulting information which reflects the entity's view. Disclosures for the risk adjustment can mitigate some of the reduction in comparability. EFRAG notes that this disclosure may create issues around comparability but was determined to be the simplest to implement, explain and understand.

322 In addition, for discount rates, EFRAG considers that combined with the relevant disclosures on the topic, on balance, the dual approach does not impair comparability. Furthermore, the IASB created the top-down approach due to feedback that it may be difficult to determine the liquidity premium for insurance contracts. However, EFRAG notes that for the bottom-up approach the estimation of the liquidity premium may require judgement and so impair comparability, which is overall justified.

323 Allocation of insurance acquisition cash flows being mandatory would mitigate the potential comparability issue relating to internal estimates. Comparability could be impaired under the PAA because of the accounting policy choice but this would be limited due to the short duration of the contracts and acceptable on the ground of operation simplification.

324 IFRS 17 includes requirements for the separation of non-insurance components from the insurance components of a contract. Separating these components provides information that allows users to better compare entities providing similar services albeit in different businesses or industries.

325 EFRAG notes that the general measurement model under IFRS 17 is modified under four different scenarios. EFRAG considers that, as there are different categories of contracts corresponding to different definitions, the existence of different models does not hinder comparability.

326 Some argue that certain contracts with indirect participation features are economically similar in nature to insurance contracts with direct participation features and should therefore apply the VFA. EFRAG considers that the coverage units for these contracts with indirect participation features take into consideration investment-return service which addresses the similarity to a large extent with contracts with direct participation features. The remaining differences are assessed not to impact comparability in the context of the difference in contractual arrangements.

327 EFRAG assesses that the PAA does not affect comparability of contracts as it is applied when the coverage period is a year or less or where the results under the PAA would be similar to that under the general model.

328 Some argue that the restriction on VFA application to reinsurance contracts held and issued would reduce comparable information between insurance contracts that are eligible for the VFA and reinsurance contracts that theoretically could be eligible for the VFA. EFRAG considers that this is balanced against the relevance of information.

329 On contracts that change nature over time, EFRAG notes that the economic characteristics of contracts must differ significantly to qualify for different models and that previously unbundling of interrelated components was said to be complex and arbitrary. Therefore, EFRAG assesses the accounting outcome as appropriate and notes that additional disclosures may be required to help users understand the financial results.

330 On mutual entities, EFRAG considers that in those cases where a mutual entity does not recognise a CSM, this reflects the different contractual relationship between the policyholder and the mutual entity when compared to contracts where the insurer earns a variable fee. That is, when a mutual entity is contractually required to distribute profits to current and/or future policyholders, this results in no CSM whereas for contracts under the VFA, the insurer has a CSM as the entity receives a fee for services provided

331 EFRAG acknowledges the complexity of the requirements of adjusting CSM for changes in investment components payable but notes that accelerations or delays in payment of investment components are inherent to insurance business models. EFRAG also acknowledges that the judgement that may be involved that may impact the comparability of the numbers presented but concludes that the complexity is balanced by the importance of this information as well as the applicability to all relevant insurers. Furthermore, even when the equity position differs from previous results or expectations, adequate disclosures and explanations may be required to support comparability.

332 Contracts under the general model cannot apply the risk mitigation option. EFRAG acknowledges the grey area for some contracts accounted for under the general model but that have strong similarities to contracts under the VFA. Nevertheless, EFRAG considers that for these contracts under the general model, there is no conceptual barrier against the application of hedge accounting. EFRAG acknowledges that hedge accounting may only be suitable for some, but not all, cases. However, adding yet another risk mitigation approach for these cases would have resulted in additional complexity and been detrimental to the overall quality of the Standard.

333 On the contractual service margin, judgement would be involved when determining coverage units which may impact comparability between entities. However, EFRAG considers that this is balanced by the relevance of the resulting information.

334 On presentation in the statement of comprehensive income, there are accounting policy options which may impact comparability between entities. However, this is balanced by the relevance of the information to reduce or eliminate accounting mismatches. In addition, separating embedded derivatives that are not closely related to the host contract leads to comparable information due to the similar treatment. Furthermore, the requirement under IFRS 17 to exclude investment components from revenue is assessed by EFRAG to increase comparability of financial performance between insurance entities and other industries. Also, separating service components leads to comparable information as it reflects the economics of the contract. Finally, on separation or not of insurance components, EFRAG considers that reflecting the substance of the contracts, which usually is the same as the legal form, would improve comparability among entities.

335 EFRAG acknowledges that the possible use of three different transition methods may affect comparability among entities and, for long-term contracts, over time. However, the practical benefits may justify the reduced comparability.

336 With regards to contracts that are acquired in their settlement period, some have argued that the accounting treatment is likely to impair comparability with other

portfolios and other entities. EFRAG considers that these contracts may have significant insurance risk and as such should reflect such ongoing risk exposure. Furthermore, removing the exception under IFRS 3[28], IFRS 17 makes the accounting for acquisitions of insurance contracts consistent with the accounting for other contracts acquired in a business combination. Therefore, on balance, EFRAG is of the view that the accounting treatment would not impair comparability.

337 Accounting policy options for own debt and equity instruments as underlying items may reduce the comparability of information between entities. However, any loss in comparability is balanced by the relevance of reflecting the entity's business model. Presentation of changes in risk adjustment for non-financial risk may reduce the comparability of the insurance service result, but it avoids complexity in the context of differing techniques to calculate the risk adjustment. The disclosures around confidence levels further mitigates the risk of the reduction in comparability.

338 On interim reporting, the accounting policy choice may impact comparability between entities but they are practical and they would be consistent within the entity as the choice is at entity level.

339 **EFRAG provides its observations on how the requirement to apply the annual cohorts requirement to intergenerationally-mutualised contracts and cash flow matched contracts impacts comparability directly in the Cover Letter. For the other requirements in IFRS 17, EFRAG's overall assessment is that they result in the provision of comparable information.**

[28] Paragraph 17(b) of IFRS 3 provided an exception that required an acquirer to classify insurance contracts based on the contractual terms and other factors at the inception of the contract, rather than at the acquisition date. That exception will no longer apply when an entity applies IFRS 17 and entities would have to apply the acquisition date.

Understandability

340 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.

341 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. As a result, EFRAG is of the view that the main additional issue that deserves consideration is assessing whether the information resulting from the application of IFRS 17 is understandable and whether that information is unduly complex.

342 EFRAG considers that while the insurance industry is notoriously complex with complicated and varying contracts, the information provided by IFRS 17 will be understandable. However, a significant investment in time and effort by both preparers and users will be required to achieve the necessary competence. EFRAG considers that the minimum required disclosures will be extremely useful in this area, but also notes that disclosures beyond such minimum is likely to be even more helpful in this task. As mentioned earlier, EFRAG notes that the understanding of significant changes to accounting standards takes time to develop and mature and is not necessarily instantaneous.

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

(a) Different insurance accounting models;

(b) Mutual entities;

(c) Treatment of investment components;

(d) Contractual service margin;

(e) Presentation in the statement of comprehensive income;

(f) Presentation in the statement of financial position;

(g) Disclosures;

(h) Transition requirements; and

(i) Business combinations – contracts acquired in settlement period.

Different insurance accounting models

Distinction between contracts with and without direct participation features

344 EFRAG notes that the measurement of the fulfilment cash flows is the same for both types of contracts, and the differences are limited to the treatment of the CSM. EFRAG also notes that those differences are necessary to provide a faithful representation of and help users understand the different nature of the types of contracts.

345 EFRAG acknowledges that treating insurance contracts with direct participation features differently from insurance contracts without direct participation features may result in complexity for preparers and users of financial statements. This is because preparers would have to classify their insurance contracts and manage two different accounting models and users need to understand the implications of the different accounting requirements.

346 However, EFRAG notes that the different measurement models reflect the characteristics of the different types of contracts. In addition, 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 from the contracts. As such, the distinction between the two different types of contracts does not impair and may also be beneficial to understandability.

Investment contracts with discretionary participation features

347 Investment contracts with discretionary participation features do not meet the definition of insurance contracts but they are measured under IFRS 17 provided the entity also issues insurance contracts.

348 EFRAG assesses that the accounting for investment contracts with discretionary participation features does not result in unduly complex information to understand because:

(a) Investments with discretionary participation features and insurance contracts with direct participation features are often linked to the same underlying pool of assets and frequently share in the performance of such pool; and

(b) Both of these types of contracts often have characteristics, such as long maturities, recurring premiums and high acquisition cash flows, that are more commonly found in insurance contracts than in most other financial instruments.

Contracts where the PAA is applied

349 Under IFRS 17, entities may simplify the measurement of some groups of insurance contracts by applying a premium allocation approach.

350 EFRAG understands that the PAA is similar to the measurement method currently used for short term insurance contracts. Therefore, EFRAG assesses that the simplification would be easily understandable to those analysts already following the industry.

Reinsurance contracts held

351 Reinsurance contracts held are measured using the general measurement principles with some adjustments specified in paragraphs 60 to 70A in IFRS 17. Some stakeholders think the requirements on reinsurance contracts are insufficiently clear and not well-adapted to the specifics of such contracts. Accordingly, they have concerns about the interpretation of those requirements.

352 IFRS 17 requires measuring reinsurance contracts based on their own merits, without mirroring[29] the measurement of the underlying contracts. The fact that reinsurance and related direct contracts are measured independently from each other does not mean that where possible the same assumptions and inputs cannot be used to the extent they reflect the respective contracts. Some have observed that this treatment does not fully reflect the fact that rights and obligations from a reinsurance contracts are contingent to the underlying reinsured contracts. In particular, some have observed that this would be evident when considering that pecuniary rights under the reinsurance agreement are tied to the underlying insurance obligations. They note that the determination of the contract boundary under a reinsurance contract held ignores the fact that the ceding company has no actual rights against the reinsurer until it writes an underlying contract that is reinsured. Also, the calculation of the loss recovery component upon the initial recognition of a reinsurance contract held that covers onerous reinsured contracts

[29] Current practice is to deem the accounting impact of reinsurance contracts held equal to but offsetting the accounting impact of the underlying direct contracts.

only takes into account the reinsurer's share in the claims and disregards the reinsurance premium and commissions.

353 EFRAG notes these concerns, however, is supportive of measuring reinsurance contracts held on their own merits, as this is consistent with the need to reflect the substantial specific rights and obligation of each contract. EFRAG also notes that the concerns raised in paragraph 351 do not conflict with EFRAG's view that reinsurance contract being a separate contract is to be supported. The first concern highlights that there is no substantive right for a ceding company to receive reinsurance coverage unless it has underwritten contracts to be reinsured. The second concern stresses that the calculation of the loss recovery component should be consistent with the terms of the reinsurance contract. EFRAG acknowledges that the proposed calculation of the loss recovery component only takes into account the reinsurer's share in the claims and disregards the reinsurance premium and commissions.

354 Measuring reinsurance contracts on their own merits is also consistent with the requirements of many other standards that assume the contract as unit of account and with the *Conceptual Framework* as the accounting reflect the rights and obligations of the specific contract.

355 EFRAG acknowledges that the accounting for reinsurance contracts would require careful explanation of the numbers and may impair understanding in particular circumstances. These circumstances could be for example: reinsurance contracts may not be accounted for under the VFA; one reinsurance contract may cover various contracts under differing measurement models; the reinsurance contracts held are in a net cost position etc. In the context of preparers indicating that separating different cash flows from the same contract as being too complex, EFRAG considers that this is an appropriate compromise. EFRAG also concludes that the understandability or not of the accounting would depend on the quality of the disclosures and explanations provided by the insurer.

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

356 As discussed in paragraph 32 and further above, under the general model, the CSM is accreted at the rate at inception. Some argue that the resulting numbers would not be understandable to users of financial statements.

357 EFRAG disagrees as the CSM and its allocation are not cash flows and this treatment is aligned with the rest of IFRS where unearned profit is accrued at the rate at inception. EFRAG assesses that this requirement does not impair understandability.

Contracts that change nature over time

358 As discussed in paragraphs 54 to 57, some preparers have indicated that certain products change significantly in nature during their life. The concern is that users will not understand when similar products fall under different models or when participation features are supported by items that do not qualify as underlying items. EFRAG notes that appropriate education about the different models would be required for users to understand the reasons and impact of the different accounting models on the financial result. Furthermore, as explained above in paragraph 58, stakeholders considered that the unbundling of components would be inappropriate, thus giving rise to the current prescribed accounting. EFRAG acknowledges that this may be complex to explain and to understand, but not overly so in the context of the complexity of the products and the business. EFRAG considers that as for reinsurance contracts held, that the extent of understandability would depend on the quality of disclosures and explanations provided by the entity.

Mutual entities

359 Some are concerned that the results under IFRS 17 for some mutual entities (refer to paragraph 82 above) would not be understandable to users or regulators. EFRAG acknowledges that the change will require education and clear communication as well as time to be embedded. However, as discussed in paragraphs 84 to 86, there are several required disclosures that would assist in this regard. Overall, EFRAG considers that the information under IFRS 17 will be understandable.

Treatment of investment components

360 EFRAG assesses that the requirement to remove and separately present investment components from insurance revenue and insurance service expenses will result in understandable information, because this investment component does not represent the consideration the entity expects to receive in exchange for providing services. Also, it increases consistency with IFRS 15 thereby reducing complexity to understand the financial statements. The presentation of such components is discussed in paragraph 363.

Contractual service margin

361 EFRAG acknowledges that the recognition of the CSM as profit over the coverage period, rather than as a gain immediately on initial recognition of the group of insurance contracts (except for onerous groups of insurance contracts), may result in operational complexity for preparers, because they will need to track and allocate the CSM. This method of recognising the CSM also may add complexity for users of financial statements, at least in the first periods after the first-time adoption, because of the need to understand the amounts recognised in the statement of financial position and in the statement of comprehensive income. However, EFRAG considers that recognition of the profit in the group of insurance contracts over the coverage period is necessary to represent faithfully an entity's financial performance over the coverage period and represents the entity's performance obligations satisfied over a period of time, which is consistent with IFRS 15 and also supports understandability of the profit realised through provision of services.

362 Furthermore, EFRAG assesses that adjusting the CSM for changes in future service provides relevant information about the unearned profit in the group of insurance contracts and is consistent with the approach in the standard on revenue recognition. Finally, EFRAG assesses that users will benefit from a better understanding of the present and future profitability.

Presentation in the statement of comprehensive income

363 EFRAG considers that presenting insurance revenue and incurred claims excluding investment components provides understandable information because this will only relate to the impact of providing insurance contract services and it increases consistency with other sectors applying IFRS 15, which would help users to better understand the financial statements overall.

Presentation in the statement of financial position

364 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 portfolios of contracts that are assets and those that are liabilities.

365 Disclosures of portfolios of contracts as assets or liabilities are consistent with IAS 1. EFRAG assesses that providing separate information for contracts that are in an asset position from those that are in a liability position would provide useful information to users in understanding the timing of expected cash flows at a point in

time. Nevertheless, EFRAG expects, in general, that reinsurance contracts held to be in an asset position and insurance contracts issued to be in a liability position and acknowledges that it may take time for some users to distinguish between onerous contracts and portfolios in an asset position.

Disclosures

Assumptions and judgements made in measuring the insurance liability

366 EFRAG notes that the use of judgement allows for more relevant entity-specific information. EFRAG also notes that, unless clearly explained, all the assumptions and judgements used during the reporting process may affect the understandability by users of amounts being recognised if not accompanied by an adequate set of disclosures.

367 To compensate, IFRS 17 requires entities to disclose the inputs, assumptions and estimation techniques used in developing their judgements. These disclosures can contribute significantly to a better understandability of the recognised amounts.

368 EFRAG notes the disclosure requirements to provide a reconciliation from the opening to the closing balances for the net liabilities (amongst others). The objective of these reconciliations is to provide different types of information about the insurance service result. EFRAG assesses that this information about the fulfilment cash flows will contribute to providing understandable information about the insurance service result.

369 Furthermore, IFRS 17 requires entities to discount cash flows to reflect the characteristics of the liability. Referring to the judgement required as reflected under paragraphs 192 to 195 of the reliability section, EFRAG assesses that the disclosures related to the determination of the discount rate would help the users to understand the estimation process.

Accounting policy options for presentation of finance income and expense

370 As described in paragraphs 292 and 293 there are accounting policy choices related to the presentation of finance income and expense. The availability of such a choice may reduce the understandability for users of the financial statements in because users often focus more on items recognised in profit or loss than items recognised in other comprehensive income. However, disclosures explaining the relationship between insurance finance income and expenses and the investment return on the assets and the fact that it allows entities to explain their specific business models can contribute significantly to a better understandability of the recognised amounts. Furthermore, the option may make financial statements more understandable overall in reflecting the interplay between IFRS 9 and IFRS 17 for insurers.

Insurance revenue

371 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.

372 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 as well as income and expenses recognised in the statement of financial performance. Users of financial statements would be able to understand why carrying amounts change, not limited to insurance revenue, during a period via the reconciliations. In addition, there are disclosures on the relative weighting of the benefits provided by insurance contracts to enable users to understand the source of insurance revenue.

Aggregation bases for disclosure requirements

373 IFRS 17 provides examples of aggregation bases that might be considered appropriate in disclosing information about insurance contracts. These are:

(a) Type of contract;

(b) Geographical area; or

(c) Reportable segment.

374 EFRAG considers these aggregation bases are familiar to users of financial statements. As a result, EFRAG expects that the information provided on this level of granularity will be understandable for them.

Transition requirements

375 At transition date, EFRAG considers that the disclosures identified in paragraph 305 will mitigate the reduction in understandability due to different transition methods.

376 As explained in paragraph 144 above, in certain cases, an entity can set the accumulated OCI balance as nil. Some argue that this would impact understandability for products without direct participation features but managed under cash flow matching techniques. This could prevent companies from distributing dividends in future where dividend distribution is based on IFRS financial statements.

377 As noted previously, EFRAG understands the wish to match insurance finance income and expenses from assets and liabilities at transition. However, from a conceptual and practical point of view, EFRAG notes there are a number of concerns as explained in paragraph 149 that may affect the relevance and also understandability of the information if other methods are used. Accordingly, EFRAG considers that the accounting for the OCI balances at transition set forth in IFRS 17 does not impair the provision of understandable information.

Conclusion about the understandability of the information resulting from IFRS 17

378 EFRAG assesses that the various simplifications/modifications introduced by the different insurance accounting models would not result in unduly complex information and would not impair the users' understandability of financial statements.

379 On reinsurance contracts held, EFRAG considers that the extent of the understandability would depend on the quality of disclosures and explanations provided by the entity.

380 For contracts that change nature over time, EFRAG acknowledges that this may be complex to explain and to understand, but not overly so in the context of the complexity of the products and the business. EFRAG considers that as for reinsurance contracts held, that the extent of understandability would depend on the quality of disclosures and explanations provided by the entity.

381 On mutual entities, some are concerned that the resulting information would not be understandable. EFRAG considers that clear communication and education will be needed, and that clear and robust disclosures will help understandability even when the equity position differs from previous results or expectations. Therefore, EFRAG considers that the information will be understandable.

382 Removal on the investment component from insurance revenue results in understandable information because it does not form part of the consideration in exchange for providing services.

383 Recognising the CSM in profit or loss over time and making adjustments to the CSM may add complexity for users of financial statements. However, disclosures and reconciliations required could provide users with more insight.

384 Presentation of insurance revenue and incurred claims provides understandable information as it relates to insurance contract services and is consistent with IFRS 15.

385 Disclosures relating to the presentation in the statement of financial position would provide useful information to users such as reconciliations and explanations of amounts recognised.

386 EFRAG assesses that the requirements, including disclosures, in IFRS 17 result in understandable information even though IFRS 17 requires assumptions and judgements in measuring the insurance liability. Such judgements and assumptions are inherent in the nature of insurance contracts due to the need to predict contractual cash flows and to choose appropriate accounting policies, including policy options and practical expedients upon transition. However, EFRAG has assessed that these assumptions and judgements, options and practical expedients would not significantly impair understandability as they are supported by the disclosure requirements in IFRS 17 which contribute significantly to a better understandability of the recognised amounts.

387 **EFRAG provides its observations on how the requirement to apply the annual cohorts requirement to intergenerationally-mutualised contracts and cash flow matched contracts impacts understandability directly in the Cover Letter. For the other requirements in IFRS 17, EFRAG's overall assessment is that they result in the provision of understandable information.**

Prudence

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

389 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).

390 EFRAG considers that IFRS 17 supports prudence in requiring the recognition and measurement of the complete insurance liability including options and guarantees based on probability weighted estimates of possible future events. The timely recognition of losses also supports prudence and furthermore, while IFRS 17 is based on estimates of the future, insurance is an industry with significant experience in this regard including the need for caution. IFRS 17 also excludes the volatility created by the impact of own credit risk leading to prudent accounting.

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

(a) Measurement of insurance contracts;

(b) Insurance acquisition cash flows;

(c) Contractual service margin;

(d) Reinsurance contracts held in a net cost position;

(e) Transition requirements - Setting accumulated OCI to nil on transition; and

(f) Identification of onerous contracts.

Measurement of insurance contracts

392 EFRAG assesses that the recognition of liabilities arising from all insurance contracts for all expected obligatory and discretionary payments, including options and guarantees on a probability-weighted basis, supports the provision of prudent information.

393 To provide transparent and timely information about the entity's exposure to financial and insurance risks, and changes in those risks, IFRS 17 requires the use of current estimates based on the most up-to-date information available. Similarly, IFRS 17 requires an entity to include the 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.

394 Some have argued that measuring insurance liabilities relying on fulfilment value (i.e. an entity-specific current value) affects the prudence of the measurement. Those stakeholders would prefer a cost approach being applied to insurance liabilities. EFRAG disagrees as the measurement of the liability includes an explicit amount for an adjustment for non-financial risk even though adjustments are made for the time value of money. This risk adjustment as a whole is a measurement of risk and thus contributes to prudence.

Insurance acquisition cash flows

395 Insurance acquisition cash flows are included in the measurement of current and future insurance contracts. EFRAG considers that the allocation of acquisition cash

flows to future groups of insurance contracts based on expected renewals may negatively affect prudence. However, as explained in paragraphs 36 to 38 of the relevance section, it reflects the economic circumstances of the contracts. Furthermore, an impairment test is required which support prudence.

Contractual service margin

396 EFRAG assesses that the recognition of profit only as and when services are provided and as the entity is released from the provision of risk coverage is a prudent approach.

397 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 (except for onerous contracts whereby losses are recognised immediately). EFRAG assesses that the release of the CSM along the coverage period result in no day one profit recognised on the measurement of groups of insurance contracts and this supports prudence.

Reinsurance contracts in a net cost position

398 Some are concerned that IFRS 17 allows the recognition of a gain upon initial recognition even though the reinsurance agreement is in a net cost position may impair prudence and create structuring opportunities for those who would want to achieve a specific result. The resulting accounting would mean that a net cost position would be recognised in profit or loss over the lifetime of the reinsurance contracts.

399 EFRAG considers that the Standard avoids a mismatch with the loss recognised on the related direct insurance contracts, by the recognition of the corresponding income on the reinsurance contract held. To qualify the reinsurance contract held must be entered into before or at the same time as the underlying contracts.

400 Therefore, EFRAG is of the view that the opportunities are theoretical and hence concludes that this does not affect prudence.

Transition requirements - Setting accumulated OCI to nil on transition

401 Under the general model, an entity that chooses to disaggregate insurance finance income/expenses between profit or loss and other comprehensive income can choose to set the accumulated other comprehensive income to nil.

402 In this case, at transition, the amount that would have been accumulated as an OCI balance is then immediately transferred to retained earnings. However, the OCI balance on the assets may only be transferred to retained earnings over time. As a result, this would affect the financial result in the profit or loss statement in future years subsequent to transition and this is not particularly prudent as insurers would in future recognise in profit and loss the fair value changes from the assets as they are realised (for bonds and dividends), but this would not be offset by the same/similar amounts under finance expenses due to the setting of OCI to nil on transition.

403 Some are concerned of not being able to match the insurance finance income and expenses from assets and liabilities, e.g., setting the OCI-balance to zero for the underlying assets as well as explained in the relevance section. EFRAG understands the wish to match the insurance finance income and expenses from assets and liabilities at transition and beyond and notes this may be helpful for a number of entities as they can match their asset-OCI balance with their liability-OCI balance (avoiding mismatches). However, from a conceptual point of view, EFRAG notes there are a number of concerns as explained in the chapter on applying IFRS 9 and IFRS 17 together (Appendix III) that may affect the usefulness of the

information that results from applying these methods. As a result, EFRAG accepts setting the accumulated OCI to nil.

Identification of onerous contracts

404 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 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 CSM for those groups of contracts is reduced to zero, changes relating to additional expected outflows are recognised in profit or loss.

405 Furthermore, in cases of adverse developments, the CSM can only be restated once losses recognised in profit or loss are reversed.

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

Conclusion about prudence

407 EFRAG has concluded that:

(a) measuring insurance liabilities at a fulfilment value allows to incorporate the value of the embedded options and guarantees granted to policyholders in the liability measurement thereby being prudent. Some have argued that measuring liabilities at fulfilment value affects prudence. However, EFRAG disagrees as the measurement includes a risk adjustment which contributes to prudence as well as considering a range of possible outcomes when considering fulfilment cash flows;

(b) allocation of acquisition cash flows to future groups may negatively impact prudence but it reflects the economics of the contracts. Furthermore, an impairment test is required which supports prudence;

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

(d) for reinsurance contracts in a net cost position, EFRAG considers that the Standard rather allows the reduction of the loss recognised on the related direct insurance contracts, not an upfront recognition of gains. Therefore, EFRAG is of the view that the opportunities are theoretical and hence concludes that this does not affect prudence;

(e) Setting accumulated OCI to nil under the fair value approach would impact the financial result in the profit or loss statement in future years subsequent to transition and this is not particularly prudent; and

(f) Identifying onerous contracts at initial recognition, recognising immediately the losses and subsequently updating the fulfilment cash flows for measurement purposes will avoid understating liabilities.

True and fair view principle

408 Information can be relied on to meet the true and fair view principle when it faithfully represents the financial performance and position of an entity. To do so accounting requirements should help provide information that is relevant, reliable, comparable and understandable and lead to prudent accounting.

409 At the same time, a standard will not impede information from meeting the true and fair view principle when, on a stand-alone basis and in conjunction with other IFRS Standards, it:

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

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

410 **EFRAG presents in the cover letter its observations on the IFRS 17 requirement to apply annual cohorts to intergenerationally-mutualised and cash flow matched contracts. With reference to all the other requirements, EFRAG's assessment on all of the above criteria is positive and therefore concludes that the application of those requirements of IFRS 17 would not be contrary to the true and fair view principle.**