This paper has been prepared by the EFRAG Secretariat for discussion at a public meeting of EFRAG TEG. The paper forms part of an early stage of the development of a potential EFRAG position. Consequently, the paper does not represent the official views of EFRAG or any individual member of the EFRAG Board or EFRAG TEG. The paper is made available to enable the public to follow the discussions in the meeting. Tentative decisions are made in public and reported in the EFRAG Update. EFRAG positions, as approved by the EFRAG Board, are published as comment letters, discussion or position papers, or in any other form considered appropriate in the circumstances.

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

## Introduction

1 This paper presents the preliminary assessment of the EFRAG Secretariat of IFRS 17 *Insurance Contracts* against the endorsement criteria relevance, reliability, understandability, comparability and prudence.

## Relevance

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

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

(a) Level of aggregation;

(b) Measurement of insurance contracts;

(c) Performance of the insurance business;

(d) Presentation in the statement of comprehensive income;

(e) Contracts with direct participation features;

(f) Sharing of risks; and

(g) Disclosures

*Level of aggregation*

*Group of contracts versus individual contracts*

4 IFRS 17 requires an entity to divide a portfolio of contracts, at inception, into groups of insurance contracts rather than individual contracts.

5 EFRAG considers that, if the level of aggregation would have been the individual contract instead of a group of contracts, the information would be more relevant to users of financial statements in order to perform their evaluations. This is because an entity's rights and obligations arise from individual contracts with policyholders. In addition, the individual contract level would ensure (i) timely recognition of losses when they arise and (ii) relevant and timely allocation of profit (contractual service margin), including the development of the profitability over time and (iii) gains and losses between individual contracts would not be set off against each other.

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6 However, EFRAG acknowledges that many (but not all) insurance entities do not manage and/or price their contracts on an individual level. Instead, the insurance contracts are generally priced and managed on a higher level of aggregation than at contract level. This is done because insurers issue a large number of insurance contracts knowing that some will result in claims and others will not.

7 Consequently, EFRAG acknowledges that for those insurers that manage their insurance contracts at a higher level of aggregation, there would be an operational burden to collect information at individual contract level. On the other hand, EFRAG is aware that local requirements in some Member States exist whereby the liability provision for particular contract types is to be calculated at individual contract level. In one Member State, some casualty-type insurance contracts are priced at a very granular and almost individual level. For the insurers applying these local requirements, the aggregation as proposed by IFRS 17 will reduce the operational burden in collecting data. Therefore, EFRAG considers that the IFRS 17 requirements on the level of aggregation provide a balance in reflecting the insurance business among insurers.

*Types of groups of contracts*

8 Portfolios of insurance contracts are divided into a minimum of, where applicable, separate groups of (i) contracts that are onerous at inception; (ii) contracts that have no significant possibility of becoming onerous subsequently; and (iii) all remaining contracts.

9 In EFRAG's view, the separate group of onerous contracts provides relevant information to users of financial statements about an entity's decisions on pricing contracts and about future cash flows. Further, it will allow users to assess profitability of insurers at business line level or at geographical level depending on the segmentation used by the insurer. Grouping of onerous contracts also ensures that losses are recognised in a timely manner and would provide useful and relevant information because the users can incorporate this information when assessing stewardship of an entity.

10 EFRAG is of the view that having separate groups relating to (i) contracts that have no significant possibility of becoming onerous subsequently and (ii) remaining contracts instead of having them in a single group provides relevant information to users of financial statements. The contracts that have no significant possibility of becoming onerous are likely to have a smaller margin than other contracts, consequently a higher than expected variability in the cash flows may cause them to become onerous subsequently.

*Impact of regulation*

11 Situations occur when law or regulation constrains the entity's practical ability to set a different price or level of benefits for contracts or policyholders with different characteristics. For example, pricing contracts for male and female policyholders. In grouping insurance contracts, IFRS 17 permits an exception to the overall grouping requirements, that in such cases insurance entities are allowed to include such contracts in the same group.

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

*Qualitative assessment of onerous contracts*

13 It is argued by some that the grouping requirements should be qualitative instead of quantitative. EFRAG currently lacks sufficient understanding of the pricing practices of insurers to conclude on the topic. Consequently, EFRAG will conclude on whether this is compatible with the endorsement criteria after analysis of the pricing practices for insurance contracts.

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*One year issuing period*

14 IFRS 17 requires a group of contracts to be divided into contracts issued within one year. EFRAG assesses that this requirement provides relevant information as it would enable the users of financial statements to assess and evaluate the profitability of contracts over time because:

(a) the requirement ensures that profit (i.e. the contractual service margin) is appropriately recognised in profit or loss in the relevant reporting period and on a timely basis;

(b) the remaining profit would reflect the contracts that are in-force within a group; and

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

*A longer issuing period*

15 Some have suggested that the issuing period should be longer than one year. If the issuing period of a group of insurance contracts is longer (e.g. three years), EFRAG currently lacks sufficient understanding how a longer issuing period can, at inception, affect whether a group of contracts is profitable or onerous.

16 Potential reasons for keeping a group open for a longer time could be the following:

(a) An entity that issues a participating insurance contract at inception with a long duration promises a pay-out of an average expected return of the underlying assets over the first (say) three-year period. Subsequently, the entity promises a pay-out over the subsequent three-year periods;

(b) Insurers price their contracts on an (almost) individual basis and ignore the provision in IFRS 17 that permits the grouping of contracts with different pricing; or

(c) The costs that relate to future contracts (thus outside the contract boundary) are included in the calculation of the fulfilment cash flows and as a result, the contractual service margin from inception. EFRAG understands that some insurers price their insurance contracts based on the assumption of selling a minimum quantity of contracts. That is, the group of contracts will only become profitable if at least a minimum number of them has been sold, allowing to recover a fixed amount of costs. Assuming that fixed costs are allocated on a systematic basis, it is not clear why this should be the case.

17 EFRAG currently lacks sufficient understanding of the pricing practices of insurers to conclude on the topic. EFRAG will conclude on this topic after analysis of the pricing practices for insurance contracts.

*Measurement of insurance contracts*

*Insurance contracts with and without direct participation features*

18 IFRS 17 distinguishes between two types of insurance contracts: those without direct participation features which apply the general measurement requirements and those with direct participation features for which these general requirements are modified.

19 For contracts with direct participation features, the returns to the entity from a pool of underlying items can be viewed as the compensation that the entity charges the policyholder for the investment service provided under the insurance contract. Therefore, changes in the estimate of the entity's share of returns are regarded as a change in the entity's compensation for the contract and would be recognised over the period of the contract via the contractual service margin.

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20 However, for contracts without direct participation features, the returns to the entity from the underlying items could be viewed as a share of returns from an investment rather than compensation for providing an investment service to the policyholder and as a result this amount is recognised in the statement of comprehensive income.

21 Therefore, EFRAG considers that the different measurement requirements provide relevant information about the differences in the nature of the fees in the contracts.

*Current updated estimates*

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

23 Because insurance contracts can run over many years, amounts payable in the short-term would not have the same value as the same amount payable after a few years. Therefore, EFRAG considers that discounting the future cash flows provides relevant information for users of financial statements.

*Risk mitigation*

24 IFRS 17 provides a particular risk mitigation approach for contracts with direct participation features but not for other contracts. In the absence of a specific risk mitigation approach, accounting mismatches would occur between the adjustments to the contractual service margin and the change in value of the derivatives which would be recognised in profit or loss. Therefore, this risk mitigation provides relevant information for users to make their evaluations.

25 EFRAG assesses that the risk mitigation approach for contracts with direct participation features addresses a particular set of accounting mismatches. EFRAG notes that for contracts accounted for in accordance with the general requirements of IFRS 17, the hedge accounting requirements of IFRS 9 can be relied upon to address potential accounting mismatches.

*Performance of the insurance business*

26 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. Some argue that using current rates to accrete the CSM would reflect the best estimate of unearned profit and the difference between the current rate and the rate at inception could be recognised in other comprehensive income.

27 EFRAG does not agree with this view because:

(a) the CSM is not a cash flow but it represents the unearned profit in the contract, measured at initial recognition and adjusted only for specified amounts that relate to the future;

(b) accreting CSM at a current rate implies incorporating financial risk into revenue as CSM is subsequently allocated to the underwriting result. EFRAG considers that using current rates would not provide more relevant information for users because changes in discount rates would cause changes in the CSM and underwriting result from period to period even if there was no change in expected cash flows; and

(c) EFRAG assesses that recognising the difference between the current rate and the locked-in rate in other comprehensive income would increase complexity

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without increasing the relevance of the financial statements because the CSM in total represents unearned profit.

*Presentation in the statement of comprehensive income*

28 IFRS 17 requires that an entity presents separately the carrying amount of groups of insurance contracts issued that are assets and insurance contracts issued that are liabilities. EFRAG assesses this requirement as leading to relevant information as it ensures that users can distinguish between the profitability of different business lines.

29 In contrast to this separate presentation in the statement of comprehensive income, entities are required to present reconciliations of the net carrying amounts at the beginning and at the end of the period, disaggregated into a total for groups that are assets and a total for groups of contracts that are liabilities. EFRAG would have preferred that the presentation and disclosure requirements should be better aligned. However, EFRAG notes that entities can voluntarily provide presentation on a more granular basis than required by IFRS 17, thereby aligning the presentation requirements with the disclosure requirements.

*Contracts with direct participation features*

30 For contracts with direct participation features, IFRS 17 modifies the general measurement requirements for insurance contracts. Insurance contracts with direct participation features are insurance contracts for which, on inception, among other conditions, the contractual terms specify that the policyholder participates in a share of a clearly identified pool of underlying items.

31 It is argued by some that this scope is too restrictive and should include contracts that do not meet the above criteria but have some participation features. It is argued that this exclusion results in less relevant information.

*Participation in a clearly identified pool of assets*

32 The aim of this modification to the general requirements is to allow insurers to reduce or, when holding the underlying assets, entirely eliminate accounting mismatches between the insurance liability and the underlying assets. EFRAG assesses that in order to address accounting mismatches, the underlying assets need to be clearly and contractually identified to ensure that the potential accounting mismatches are precisely targeted. If the entity's interest in the underlying assets is not the equivalent of a direct holding in assets, accounting mismatches could arise as changes arise in holdings of assets backing the insurance liability. This does not imply that one needs to rely on a ring-fenced portfolio of assets. It is also possible to refer to the net assets of the entity or a subsidiary within the group that is the reporting entity.

*Sharing of risks*

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

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

35 In determining the fulfilment cash flows of a group of insurance contracts, payments arising from the terms of existing contract to policyholders of contracts in other



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groups are considered, regardless of whether those payments are expected to be made to current or future policyholders. This effectively allows a transfer of cash flows between generations of policyholders (even when relying on closed groups of contracts). EFRAG acknowledges that such a transfer would have to follow from the contractual terms of the affected insurance contracts. EFRAG assesses this as leading to relevant information as amounts based on discretion are, by definition, not enforceable and their allocation may be subject to changes arising from internal and external factors. Further, the basis for any allocation may not be known to the affected policyholders and hence not available to users.

*Disclosures*

36 The objective of the disclosure requirements is to give 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 which EFRAG assesses as sufficient to provide relevant information.

*Conclusion about the relevance of information resulting from IFRS 17*

37 To be developed.

**Reliability**

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

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

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

(a) Measurement of insurance contracts;

(b) Transition requirements; and

(c) Performance of the insurance business.

*Measurement of insurance contracts*

41 Measurement of insurance liabilities in IFRS 17 requires judgement in estimating the fulfilment value of an insurance contract. EFRAG acknowledges that the judgement required in estimating future cash flows and in the use of discount rates could lead to reduced reliability but notes that entities users have already experience in applying judgement through previous measurement of insurance contract liabilities and in applying other IFRS Standards.

42 To address the judgement used in applying IFRS 17, the Standard requires disclosures on significant judgements and changes in judgements specifically relating to the inputs, assumptions and estimation techniques used.

*Transition requirements*

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

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

45 In applying IFRS 13 Fair Value Measurement, entities will have to consider not only assumptions from a market participant perspective, but also the compensation that a market participant would require for taking on the obligation. This compensation will be part of the contractual service margin on transition and will be allocated to profit or loss consistently with IFRS 17.

46 It is argued by some that such an approach will not result in reliable information as the compensation that a market participant will require will differ in almost all cases from the contractual service margin that an entity would calculate otherwise. Thus, when applying the fair value approach, the contractual service margin on transition does not represent, entirely, the profit for future services to be provided.

47 EFRAG acknowledges this comment but notes that transitioning to a new standard changes previous recognition and measurement. Applying a fair value approach allows entities to recognise the transition effect over the remaining duration of the contract portfolio. That is, the fair value approach embraces the idea of the long-term business model.

*Performance of the insurance business*

48 IFRS 17 requires a company to recognise the contractual service margin in profit or loss over the coverage period based on the coverage units, reflecting the expected duration and size of the contracts in the group.

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

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

51 The contractual service margin allocation based on coverage units implies the estimation of the number of contracts in force in each reporting period because the contractual service margin at the end of each reporting period should represent the amount to which the entity expects to be entitled in exchange for the services in the future.

52 EFRAG considers that this estimation is included in the estimation of future cash flows. The estimation of future cash flows is not possible without the consideration of the number of contracts in each reporting period, so the uncertainty that could arise, in this regard, is similar to the uncertainty implicit in the assumptions and judgements made in measuring the insurance liability.

*Conclusion about the reliability of the information resulting from IFRS 17*

53 To be developed.

**Comparability**

54 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.

55 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.

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

(a) Different insurance accounting models;

(b) Performance of the insurance business;

(c) Transition requirements;

(d) Restatement of comparatives for 2020 for IFRS 17; and

(e) Accounting policy options on discounting.

*Different insurance accounting models*

57 IFRS 17 defines the principles for the measurement of insurance contracts. Those principles are modified in the four following cases: (i) for contracts with direct participation features, (ii) for reinsurance contracts held, (iii) for investment contracts with discretionary participation features and (iv) for contracts where the Premium Allocation Approach applies. As discussed below, these differences do not create a material reduction in comparability, but rather reflect the characteristics of different types of insurance contracts.

*Contracts with direct participation features*

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

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

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

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

*Reinsurance contracts held*

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

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

62 Consequently, EFRAG is of the view that the different measurement for reinsurance contracts held is appropriate.

*Investment contracts with discretionary participation features*

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

64 EFRAG assesses that the changes to the general requirements reflect the fact that such contracts do not transfer significant insurance risk which justify the difference

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from the accounting for insurance contracts without discretionary participation features.

65 EFRAG notes that IFRS 17 applies only to investment contracts with discretionary participation features that are issued by a company that also issues insurance contracts. Other companies apply IFRS 9 to such contracts. The difference in treatment and thus the reduction in comparability between different types of entities, depending on whether the issuer is an insurer or for example a bank, can in EFRAG's view be justified by the difference in business model each type of entity relies upon.

*Premium Allocation Approach*

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

67 EFRAG assesses that this should not lead to a material reduction in comparability and is balanced by the fact that this approach provides a less costly easier way for entities to measure insurance contracts with a shorter duration.

*Performance of the insurance business*

68 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 Revenue from Contracts with Customers. Consistent with that Standard, an entity depicts revenue for the transfer of promised coverage and other services at an amount that reflects the consideration to which the entity expects to be entitled in exchange for the services. This means that the entity:

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

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

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

*Transition requirements*

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

71 EFRAG acknowledges that the use of three different transition methods reduces comparability among entities and, in the case of very long-term contracts, over a considerable period. However, for long-term insurance contracts, it may be difficult to gather the necessary data to apply a retrospective method without undue cost or effort. Hence, EFRAG acknowledges that the reduction in comparability is balanced against the reduction in costs when transitioning to the new Standard. In addition, separate disclosures are required for each transition approach that an entity applies.

*Restatement of comparatives for 2020 of IFRS 17*

72 IFRS 17 requires insurers to present comparative information for at least one reporting period before transition, i.e. 2020. EFRAG notes that this will require insurers to present comparative information during 2020 for insurance liabilities while insurers that have elected to defer IFRS 9 Financial instruments are not required to do so for their financial assets.

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73 EFRAG is of the view that, given the significant changes to insurance accounting introduced by IFRS 17 providing comparative information for 2020 enhances the comparability of the information over time and is justified by the high degree of diversity in current accounting for insurance contracts.

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

*Accounting policy options on discounting*

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

76 EFRAG assesses that this accounting policy option reduces comparability between entities. However, that reduction in comparability is balanced by the relevance of the resulting information because it permits entities to reduce or eliminate accounting mismatches between the insurance liabilities and the investment assets supporting those insurance liabilities.

*Conclusion about the comparability of the information resulting from IFRS 17*

77 To be developed.

**Understandability**

78 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.

79 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.

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

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

(a) Disclosures; and

(b) Remaining accounting mismatches.

*Disclosures*

*Insurance revenue*

82 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.

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



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*Transition requirements*

84 At transition date, reconciliations are required of the contractual service margin and insurance revenue of insurance contracts groups, separately for each of the transition methods used. These disclosures may mitigate the reduction in understandability by applying different transition methods.

*Assumptions and judgements made in measuring the insurance liability*

85 Insurance implies dealing with uncertainty. When concluding an insurance contract, the insurer has no certainty if and at what moment a future claim can occur. As a result, insurers need to rely on assumptions and apply judgements in determining the insurance liabilities. EFRAG notes that such assumptions and judgements may affect the understandability to users of amounts being recognised.

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

*Remaining accounting mismatches*

87 The accounting policy options in IFRS 17 to account for insurance finance income or expenses either in profit or loss or disaggregating it between other comprehensive income and profit or loss allows entities to reduce or fully eliminate accounting mismatches with the assets invested in. Any remaining accounting mismatches reduce the understandability of the resulting information and hinder the understanding of economic mismatches.

*Conclusion about the understandability of the information resulting from IFRS 17*

88 To be developed.

**Prudence**

89 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.

90 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).

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

(a) Recognition of liabilities arising from insurance contracts;

(b) Measurement: Use of present value;

(c) Level of aggregation; and

(d) Performance of the insurance business.

*Recognition of liabilities arising from insurance contracts*

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

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*Measurement: Use of present value*

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

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

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

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

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

(ii) The adjustment for time value of money and financial risk.

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

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

*Level of aggregation*

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

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

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

98 EFRAG considers that these requirements contracts for measuring purposes will avoid understating liabilities and thus lead to prudent accounting.

*Performance of the insurance business*

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

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

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

100 These requirements are assessed to lead to prudent accounting.

*Conclusion about Prudence*

101 To be developed.

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