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* – DEA – Appendix II – pre-case study results

Draft endorsement advice – Appendix II – pre-case study results

1 In providing its assessment on whether IFRS 17 results in relevant, reliable, understandable and comparable information, EFRAG has considered all the requirements of IFRS 17. EFRAG has, however, focused its assessment on the requirements it considered most significant in relation to each of the criteria. EFRAG has accordingly focused on guidance that:

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

(b) has been subject to substantial debate (evidenced by the comments EFRAG has received from constituents including participants in EFRAG's field-tests);

(c) may be problematic to apply evidenced by the results of EFRAG's field-tests; and

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

2 EFRAG has assessed IFRS 17 requirements against each of the technical criteria for each of the following:

	Topic	Relevance	Reliability	Comparability	Understandability	Prudence
1	Measurement of insurance contracts (including discount rates)	X	X	X	X	X
2	Different insurance accounting models	X		X	X	
3	Level of aggregation (including identification of onerous contracts)	X	X	X	X	X
4	Treatment of investment component	X	X			X
5	Risk mitigation	X				
6	Sharing of risks	X	X			
7	Performance of the insurance business	X	X	X		X
8	Presentation on the statement of comprehensive income	X				
9	Presentation on the statement of financial position	X			X	
10	Contract boundaries	X				X
11	Separating components from an insurance contract	X	X	X		
12	Accounting policy options			X		
13	Recognition of liabilities arising from					X

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	insurance contracts					
14	Disclosures	X			X	
15	Transition requirements	X	X	X	X	
16	Restatement of comparatives			X		

3 Issues that have been submitted to the IASB Transition Resource Group:

	Topic	Relevance	Reliability	Comparability	Understandability	Prudence
A	Separation of insurance components of a single insurance contract	X				
B	Boundary of contracts with annual repricing mechanisms	X topic 10				
C	Boundary of reinsurance contracts held	X topic 10	X – topic 10			
D	Insurance acquisition cash flows paid on an initially written contract	X topic 1			X topic 1	
E	Determining quantity of benefits for identifying coverage units	X topic 3	X topic 7	X topic 7		
F	Insurance acquisition cash flows when using fair value transition	X topic 1				
G	Cash flows within the contract boundary	X topic 10				X topic 10
H	Presentation of groups of insurance contracts in the statement of financial position	X topic 9			X topic 9	

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Questions for EFRAG TEG

4 Does EFRAG TEG have preliminary comments on the draft endorsement advice before relevant parts of the case study results are included?

5 Does EFRAG TEG wants to add/remove assessments on particular issues to/from the draft endorsement advice?

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

(a) Measurement of insurance contracts;

(b) Separation of insurance components

(c) Different insurance accounting models;

(d) Level of aggregation;

(e) Treatment of investment component;

(f) Risk mitigation;

(g) Sharing of risks;

(h) Performance of the insurance business;

(i) Contract boundaries;

(j) Presentation on the statement of comprehensive income;

(k) Presentation on the statement of financial position;

(l) Disclosures; and

(m) Transition requirements.

Measurement of insurance contracts

Measurement components

8 The general measurement model for an insurance contract 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 which represents the unearned profit that the entity will recognise as it provides services in the future.

Future cash flows

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

10 EFRAG considers that estimating only those cash inflows and outflows within the contract boundary (see paragraphs 83 to 89) will provide relevant information because it reflects the rights and obligations that arise from the contract, law or regulation.

Financial options and guarantees

11 Many insurance contracts contain significant embedded options and guarantees. The cash flow estimates will incorporate the intrinsic value of embedded options and guarantees as IFRS 17 requires the entity to look at a full range of possible scenarios in estimating the options and guarantees. In addition, the time value of options and guarantees, which reflects the uncertainty about the amount and timing of the options and guarantees occurring, is considered in the measurement. Therefore, incorporating options and guarantees in the cash flows will provide relevant information about when the options and guarantees will be 'in the money' and their corresponding value.

Treatment of acquisition costs

12 IFRS 17 requires an entity to include in the measurement of insurance contracts any directly attributable acquisition costs. In including the directly attributable acquisition costs in the fulfilment cash flows, any lack of recoverability would be captured by remeasuring the fulfilment cash flows.

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13 EFRAG considers it relevant that the direct acquisition costs are included in the measurement of insurance contracts because it is a cash outflow that is directly linked to the fulfilment of an entity's obligations towards the policyholder. Furthermore, an entity typically prices insurance contracts to recover these direct acquisition costs. Generally, EFRAG considers that including these direct acquisition costs would be relevant in computing the entity's expectation of profit for the contracts (i.e. the contractual service margin). Specific fact patterns are assessed separately in paragraphs 14 and 106 to 108 below.

14 EFRAG has considered the situation where direct acquisition costs such as commissions are not refundable even if a contract is not renewed. This means that these cannot be allocated to a future group and thus belong to the measurement of the group to which the initially issued contract belongs. EFRAG is of the view that carrying forward such direct acquisition costs beyond the relevant contract boundary would reduce the relevance of the resulting information.

Updated estimates of future cash flows

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

Discounting

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

17 As insurance contracts can run over many years, 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.

18 EFRAG assesses that the reflection of the time value of money provides relevant information. Incorporating liquidity characteristics is also considered to provide relevant information because an entity generally is unable to sell the contract liability quickly. In addition, EFRAG considers that the discount rate chosen by entities will provide useful information on the characteristics of the cash flows because it will be focussed on the nature of the liability, for example, cash flows that vary based on returns from underlying items would use rates that reflect that variability.

Risk adjustment

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

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

21 Furthermore, the risk adjustment is estimated at current value. Some have argued that a small change in interest rates can affect the amount of risk adjustment that would be recognised in profit or loss and therefore, the statement of comprehensive

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income would not provide relevant information on performance of the entity. EFRAG assesses that because of the long duration[1] of many insurance contracts, there would be some uncertainty about both the timing and cash flows to and from policyholders. Therefore, the time value of money aspect of the risk adjustment would be relevant information because it reflects the present value of the risks associated with that uncertainty, which would assist a user in assessing the overall obligation of the entity.

<u>Contractual service margin</u>

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

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

24 In addition, the contractual service margin provides relevant information because it enables users to consider the allocation of the unearned profit over the reporting periods included in the coverage period.

Separation of insurance components

25 Insurance contracts may combine different types of insurance coverage, thereby grouping different insurance risks into one legal insurance contract. It is argued by some that the Standard should permit the separation of different insurance risks contained in a single insurance contract.

26 EFRAG disagrees with this view, except in cases where two or more insurance contracts are combined for administrative convenience, as the cost and complexity of the separation of a single insurance contract into its component is expected to outweigh any resulting increase of relevance of the information.

Different insurance accounting models

27 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

<u>Distinction between contracts with and without direct participation features</u>

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

29 For contracts without direct participation features, EFRAG considers that the net gains the entity makes from invested premiums reflects the entity's ability to make decisions on how to invest those premiums. Consequently, the net gains from the investment portfolio are similar to returns from a standalone investment and should

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

be recognised in a similar way i.e., recognised in the statement of comprehensive income.

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

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

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

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

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

32 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.

<u>Scope of the approach for contracts with direct participation features</u>

33 EFRAG assesses the relevance of the conditions that determine the scope of the approach available to contracts with direct participation features in the following paragraphs. EFRAG considers whether contracts that contain a constructive instead of a contractual obligation should be accounted for in accordance with the approach applicable to contracts with direct participation features in paragraphs 202 to 203 below (comparability section).

<u>Participation in a clearly identified pool of assets</u>

34 The requirement that contracts with direct participation features relates to a clearly identified pool of underlying items ensures that the nexus between the insurance contract liability and the associated assets is contractually determined. This provides relevant information as economic mismatches should not arise where the entity elects to hold those underlying items.

<u>Payment to the policyholder a substantial share of the fair value returns from the underlying items</u>

35 EFRAG assesses that this criterion leads to relevant information because it distinguishes situations in which the investment returns are viewed as belonging

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substantially to the policyholders rather than the entity. In other situations, the investment returns belong to the entity and are allocated by the entity to the policyholder. Therefore, since the entity can be viewed as managing the underlying items on behalf of the policyholder, and receiving a fee in exchange for that service, EFRAG considers that this modification to the general measurement requirements portrays this special relationship by requiring that the policyholder receives a substantial part of the fair value returns on the underlying items.

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

36 This criterion ensures that the return provided to the policyholder encompasses not only interest or dividends accrued but also (un)realised value increases on the principal amounts invested. This provides relevant information as it fully reflects the entity's provision of investment services.

Reinsurance contracts held

General assessment

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

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

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

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

41 In EFRAG's view, the following mismatches may arise, and these mismatches reflect the economic mismatches between the underlying insurance contracts and the reinsurance contract:

(a) Reinsurance contracts come in many forms. For example, proportional contracts (which reinsure a proportion of the underlying risks) can be divided between those providing coverage for a quota share (for example, an entity reinsuring 50% of all underlying risks) or providing coverage up to certain fixed limit (so called surplus treaties). As a result, some of the risk in the underlying contracts is not reinsured;

(b) The terms of the reinsurance contract held and the underlying insurance contracts may differ. For example, the reinsurer may exclude particular risks from coverage such as terrorist attacks or natural disasters or the duration of the reinsurance contract may differ from the underlying insurance contracts; and

(c) Even when the insurance conditions between the two contract types are fully aligned, there may be a timing difference between any changes in contract conditions by the reinsurer and similar changes in the underlying insurance contracts.

42 In contrast, when the contractual characteristics and the timing of the reinsurance contract are fully aligned with the contractual characteristics and timing of the underlying insurance contracts, accounting mismatches may occur in applying IFRS 17. Examples of such accounting mismatches are described in paragraphs 43 to 46 below.

Asymmetrical treatment between reinsurance held and insurance contracts issued

Treatment of the contractual service margin of reinsurance contracts held

43 The contractual service margin of a reinsurance contract held is seen as a net cost or net gain on the purchase of the reinsurance and is spread over the duration of the reinsurance contract. In contrast, when there is a loss at inception on the underlying insurance contracts, that loss is not deferred but accounted for in profit or loss immediately, thereby creating a mismatch.

44 Subject to the conditions described in paragraphs 37 to 42 above, EFRAG acknowledges that this results in an accounting mismatch which impacts the ability of the insurer to demonstrate that it has laid off part of its risk. In those cases EFRAG assesses that the mismatch reduces the relevance of the resulting information.

Reinsurance contracts do not qualify as contracts with direct participation features

45 In accordance with paragraph B109 of IFRS 17, reinsurance contracts issued and held do not qualify as contracts with direct participation features. For reinsurance contracts held this creates a mismatch with the underlying insurance contracts, when these are measured as contracts with direct participation features. EFRAG notes that determination of the nature of the mismatch is more complex for contracts with direct participation features. For example, an economic mismatch may occur when the underlying investment returns are better than initially expected. As reinsurance covers the downside risk, a better than expected investment return of the underlying items would not necessarily result in an increased premium to the reinsurer.

46 Subject to the conditions described in paragraph 42 above, EFRAG acknowledges this mismatch reduces the relevance of the resulting information. However, EFRAG understands that currently very few insurance contracts containing investment risk are reinsured, therefore EFRAG assesses the potential impact of this mismatch to be rare.

Investment contracts with discretionary participation features

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

48 EFRAG assesses that the changes to the general measurement requirements reduce the relevance of the resulting information because the measurement depends on whether the issuer is an entity that also issues insurance contracts. Other entities issuing investment contracts with discretionary participation features apply IFRS 9 *Financial Instruments* in measuring such contracts. This results in entities that issue insurance contracts applying IFRS 17 and entities that do not issue insurance contracts applying IFRS 9, leading to different treatments for economically similar contracts i.

Premium allocation approach

49 The premium allocation approach is a simplification of the IFRS 17 principles and can be applied in circumstances where the entity expects such a simplification would

produce a measurement that is not materially different than a measurement following the general requirements or when the coverage period is one-year or less.

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

Level of aggregation

51 IFRS 17 requires an entity to identify portfolios of insurance contracts and then to divide that portfolio, at inception, into groups of insurance contracts. A group of contracts cannot include contracts issued more than one year apart.

Step 1: Portfolio level

52 IFRS 17 requires an entity to identify portfolios of contracts subject to similar risks and managed together. Contracts within a product line would be expected to have similar risks and hence are expected to be in the same portfolio when they are managed together. Contracts in different product lines are not expected to have similar risks and hence are expected to be in different portfolios.

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

Step 2: One-year issuing period

54 IFRS 17 requires a group of contracts to be divided into contracts issued within one year. EFRAG notes the one-year issuing period is designed to provide information on the development of profitability over time. EFRAG considers that insight into the evolution of profitability over time is essential to users of financial statements and therefore provides relevant information.

55 Concerns have been raised that the one year issuing period is an artificial boundary and would prevent transfers of cash flows between generations of policyholders (i.e. by way of sharing of risks), EFRAG understands that the one-year issuing period does not hinder the recognition of transfers of cash flows between generations of policyholders. This is discussed in paragraphs 69 to 72 below.

56 In addition, it is argued by some that there are alternatives to the one-year issuing period that would be less burdensome. EFRAG has not been provided with examples of these alternatives that achieve the same objective rather than presenting an average result at portfolio level. EFRAG is of the view that the use of averages at portfolio level results in less relevant revenues and expenses because this allows for cross-subsidisation influencing the allocation of the contractual service margin to insurance revenue.

Step 3: Group level

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

Contracts that are onerous at inception

58 Insurance contracts that are onerous at inception are to be identified and grouped separately. The loss related to these contracts is recognised in profit or loss immediately. EFRAG notes that the identification of onerous contracts at an early stage allows users of financial statements to assess the impact and understand why the business model of the entity permits this practice. As a consequence, EFRAG assesses the identification of onerous contracts as providing relevant information.

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<u>Profitable contracts</u>

59 Insurance contracts that are profitable at inception are subdivided into two categories: (i) contracts that have no significant possibility of becoming onerous and (ii) remaining contracts. EFRAG understands this as a limitation to cross-subsidisation between these two types of contracts. EFRAG further understands that, when a contract is derecognised earlier than expected, the related part of the contractual service margin is released through an adjustment of the fulfilment cash flows. That release is done on the basis of an average amount of contractual service margin of the group of contracts at the moment of derecognition of the contract. The average amount is different for each of the two groups.

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

<u>Impact of regulation</u>

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

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

Treatment of investment component

63 IFRS 17 requires any differences between expected and actual amounts of the investment component payable in the period to be recognised in the contractual service margin. A detailed description of this issue is provided in paragraphs 146 to 148 below.

64 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 assesses that accounting for the net effect of expected and actual amounts of the investment component in the contractual service margin brings relevant information as it avoids volatility in the profit or loss statement and instead smooths the effect over time. EFRAG concludes that the complexity is balanced by the relevance of the resulting information in line with the insurance business models.

Risk mitigation

65 IFRS 17 provides a risk mitigation approach for contracts with direct participation features. In the absence of this specific risk mitigation, the changes in the effect of financial risk on the entity’s share of the underlying items and on financial guarantees would be recognised in the contractual service margin. However, the derivative used to mitigate this financial risk would be measured at fair value through profit or loss giving rise to an accounting mismatch. Therefore, EFRAG assesses that the risk mitigation approach for contracts with direct participation features addresses a particular set of accounting mismatches.

66 The risk mitigation option is not available to indirect participation contracts (i.e. those that have some characteristics of participation contracts but do not meet the

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definition of contracts with direct participation features). For these (and other contracts under the general measurement model) the entity has the choice to recognise the impact of changes in the effect of financial risk in profit or loss rather than other comprehensive income if it so chooses. Furthermore, hedge accounting under IFRS 9 is available to those who recognise these changes in other comprehensive income or where other risks are hedged.

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

(a) the risk component (hedged item) cannot be separately identified and cannot be reliably measured for those contracts where investment and insurance components are highly interrelated. In addition, policyholder behaviour and other future expectations (for example lapses, surrenders, new business sales, mortality) are correlated with the impact of financial market variables and it is difficult to exclude these from the hedging relationship;

(b) entities hedge their risks on an open portfolio basis, not on a closed portfolio basis, whereas the aggregation requirements of IFRS 17 create closed portfolios; and

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

68 In assessing the absence of a risk mitigation solution for indirect participation contracts, EFRAG notes that when risk components of insurance contracts cannot be separately identified or reliably measured, the creation of a hedge accounting relationship would not lead to relevant information because it would be impossible to assess the effectiveness of the entity's hedging strategy. Hence, EFRAG assesses that the absence of a hedge accounting solution for features of indirect participation contracts does not reduce the relevance of the resulting information.

Sharing of risks

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

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

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

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

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Performance of the insurance business

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

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

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

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

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

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

76 Some argue that insurance contracts without direct participation features should also use current rates to accrete the contractual service margin as this would better reflect the estimate of unearned profit. In addition, some propose that the difference between the current rate and the rate at inception could be recognised in other comprehensive income. EFRAG does not agree with this view as the contractual service margin would no longer present the profit trend expected at the inception of the contract.

Pattern of release of the contractual service margin

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

Coverage units

78 Coverage units of the group are determined as the quantity of benefits provided by the contracts in the group and its expected coverage duration. IFRS 17 does not contain detailed guidance on the identification of coverage units which may create uncertainty. EFRAG does not consider that this requires more judgement that is generally required by principle-based standards. Further, EFRAG assesses such a principles-based approach brings relevant information as it allows each insurer to implement the concept of coverage units in accordance with its own activities. I.e. it allows each insurer to determine the contractual service margin allocation pattern of its groups of insurance contracts in a way that is reflective of how it provides the service to policyholders.

Contracts without direct participation features

79 Some question whether the allocation of the contractual service margin to profit or loss under IFRS 17 provides relevant information about contracts without direct

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participation features. In their view, revenue should increase (via a higher release of the contractual service margin) when claims are paid in order to offset the amount of the claims being paid. This is based on the reasoning that the service provided by the insurer includes the processing and handling of claims as well as the reimbursement of successful claims, i.e. the service provided is more than standing ready for providing insurance service.

80 EFRAG notes that, in accordance with IFRS 17, the service provided under an insurance contracts *is* standing ready to reimburse the policyholder for losses suffered as a result of the insured event. EFRAG notes that the release pattern of the contractual service margin is not affected by the probability of when a claim may occur, instead the contractual service margin release pattern is affected by the quantity of coverage provided in relation to the expected coverage duration. EFRAG assesses this brings relevant information as the contractual service margin release pattern reflects the quantity of insurance coverage provided over time (i.e. the quantity of business being done), and not the likelihood of an insured event occurring.

Contracts with direct participation features

81 Some hold the view that the method to release the contractual service margin is not relevant for contracts with direct participation features which are substantially investment-related contracts because the pattern of release would not lead to an appropriate reflection of the performance of the entity. They argue that the contractual service margin should be released after considering an expected increase in value of the underlying items. The value of the underlying items would increase over time and therefore the shareholder’s share of the underlying items would also increase over time. Under this view, the contractual service margin recognised in profit or loss would increase over time base on the increase in the assets under management.

82 The investment component is accounted for as part of an insurance contract only when it is highly interrelated with the insurance component and other services and hence cannot be accounted for separately. Therefore, EFRAG considers that when the entity provides multiple services, such as insurance coverage and investment services, over the coverage period in return for an expected fee based on the duration of the contracts this should be reflected in the release of the contractual service margin. Consequently, EFRAG assesses that when the fulfilment cash flows of the direct participation contracts reflect an expected increase in value of the underlying assets, the contractual service margin release pattern would show an upward sloping trend based on the services provided.

Contract boundaries

83 Cash flows are within the 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

84 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 that are closely related to the underlying risks, the cash flows resulting from the renewal terms are not part of the boundary of the existing insurance contract but belong to a new insurance contract instead. EFRAG assesses that accounting for this change as a new contract leads to relevant information because it reflects the changed economics of the contracts.

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Contract boundary of reinsurance contracts held

85 IFRS 17 requires insurance and reinsurance contracts held to be treated as separate contracts. This implies that, in contrast to current practices, the contract boundary of reinsurance contracts held is determined independently of the underlying insurance contracts. As a result, the contract boundary of reinsurance contracts held may be shorter or longer than the underlying insurance contracts.

86 EFRAG notes that entities need to use consistent assumptions for measuring reinsurance contracts held and related underlying insurance contracts. Nevertheless, 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 assesses this provides relevant information as it reflects the different conditions of insurance contracts issued and reinsurance contracts held. EFRAG's reasoning on reinsurance contracts held can be found in paragraphs 37 to 45 above.

Cash flows within the contract boundary

87 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. When the contract includes an option to add insurance coverage at a future date, this option is viewed as a substantive right to the policyholder irrespective of whether the option price is fixed or not at inception. As a result, the cash flows arising from the option are within the contract boundary.

88 EFRAG notes that including an option in an insurance contract to add insurance coverage at a future date has consequences for both the insurer and the policyholder (i.e. the option represents economic substance). EFRAG disagrees with the view that such an option would only represent economic substance in case it is priced at inception for the following reason. When the policyholder exercises the option, the insurer's assessment of the risk will not be different than its' assessment of similar policyholder risks. Hence, inclusion of the option is a commercial gesture, not a deterrent subject to determination of a very high future premium. The potential future cash outflows that relate to the exercise of such an option thus belong in EFRAG's view to the contract boundary at inception (on a probability-weighted average basis). The situation where the insurer has chosen not (fully) pricing for that risk at inception does not change that view.

89 For the above reason, EFRAG assesses that including the cash flows in the contract boundary that relate to an option adding insurance coverage at a future date does result in relevant information.

Presentation on the statement of comprehensive income

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

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

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

91 EFRAG is of the view that the insurance service result will provide useful information for users. This is because it will reflect insurance services that have already been provided and therefore will reflect profit on an earned basis for each reporting period. The insurance revenue and incurred claims excludes any deposit component because this represents amounts payable to the policyholder regardless of an

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insured event occurring. EFRAG considers that, since the insurance revenue and incurred claims relates to insurance services, presenting the deposit component separately provides relevant information.

92 EFRAG considers that the financial result will provide useful information because it depicts the effects of investments and of market interest rates.

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

94 EFRAG expects that entities will choose the presentation that better reflects the economics of their business. This choice provides relevant information because entities can align the accounting treatment of insurance contract liabilities with that of assets, thereby aligning investment income and investment finance expense.

95 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.

96 As described in paragraph 93, IFRS 17 permits that entities can recognise the effect of changes in financial assumptions either in profit or loss or disaggregated between profit or loss and other comprehensive income. Some reject this and propose that the entire release of the contractual service margin should be recognised in profit or loss to avoid the complexities of permitting the option to recognise the release of the contractual service margin in other comprehensive income as permitted in IFRS 17.

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

Presentation on the statement of financial position

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

99 Some consider that this separate presentation does not result in relevant information because the timing of the cash flows could make the insurance contracts move between a liability and an asset position.

100 The requirements in IFRS 17 are in line with IAS 1 which generally prohibits the offsetting of assets and liabilities. Insurance contracts could be in an asset position if, for example, claims are already paid out by the entity but premiums have not yet been received or the remaining fulfilment cash flows are positive. Therefore, separate presentation of contracts in an asset position and those in a liability position would provide relevant information because users would be able to understand the status of different groups of contracts.

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

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Disclosures

102 The objective of the disclosure requirements is to provide a basis for the users of financial statements to assess the effect of applying IFRS 17 on the entity's financial position, financial performance and cash flows. To meet this objective, IFRS 17 contains a range of qualitative and quantitative disclosure requirements. The relevance of the disclosures will be assessed after the user outreach. Disclosures have been assessed under the Understandability section as from paragraph 255 onwards.

Transition requirements

103 At transition, entities are required to apply IFRS 17 retrospectively unless impracticable. The full retrospective approach recognises and measures insurance contracts as if IFRS 17 had always been applied. When impracticable, entities can choose between applying either the modified retrospective approach or the fair value approach using IFRS 13 *Fair Value Measurement*.

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

105 EFRAG has been made aware of the concern that the data available on past cash flows may not be sufficient to ensure an estimate of the contractual service margin at transition under the modified retrospective approach that reflects the insurer's view on profitability of these cash flows. EFRAG notes that in absence of sufficient data any retrospective approach would not result in relevant information, and IFRS 17 addresses this concern by providing the fair value approach.

Insurance acquisition cash flows when using fair value transition

106 EFRAG has also considered the treatment of insurance acquisition cash flows when using fair value measurement on transition. Insurance acquisition cash flows that occurred prior to the transition date are not included in the measurement of the contractual service margin at the transition date and are not included in presentation of insurance revenue and expenses for reporting periods subsequent to the transition date.

107 The fair value approach at transition may be applied when it is impracticable for the entity to apply the full retrospective approach and must be applied when the entity has insufficient reasonable and supportable information to apply the modified retrospective approach. The fair value approach provides a fresh start that does not depend on previous recognition and measurement.

108 EFRAG assesses that not considering acquisition cash flows that occurred prior to transition leads to relevant information. This because the selective use of any past cash flows in the estimation of the fulfilment cash flows is inconsistent with the principle underlying the use of fair value.

Conclusion about the relevance of information resulting from IFRS 17

109 The general measurement requirements are assessed to lead to relevant information as the rights and obligations that arise from insurance contracts are considered. Also, the measurement captures a full range of foreseeable outcomes

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and their probabilities. Finally, time value of money is being considered through the use of discounting.

110 The general measurement requirements are modified or simplified for:

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

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

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

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

111 The level of aggregation requirements are assessed to result in a profitability distribution which forms the basis for building a meaningful and thus relevant contractual service margin. EFRAG assesses the level of aggregation requirements as a trade-off between requiring individual contract tracking and reducing cross-subsidisation between insurance contracts with different profitability.

112 The risk mitigation approach of IFRS 17 addresses adequately particular accounting mismatches for contract with direct participation features. The fact that the approach is not available for indirect participation contracts is seen as justified where the risk components of insurance contracts cannot be separately identified or reliably measured.

113 The fact that risk sharing in accordance with IFRS 17 follows the contractual terms of the insurance contracts is assessed to lead to relevant information as risk sharing based on discretion are not enforceable and may be subject to changes that are independent from the insurance contract between the insurer and the policyholder.

114 On measuring the performance of an insurance entity, the contractual service margin is treated as a residual. For contracts without direct participation features accreting this residual at a locked in rate provides relevant information about the pricing power and cost control of an entity for a group of insurance contrast. In contrast, contracts with direct participation features essentially act as a 'pass-through' of all the benefits (minus a fee for the insurer) to the policyholder. For such more investment-like contracts, a treatment similar to the use of current discount rates is assessed to be appropriate.

115 The release pattern of the contractual service margin for contracts without direct participation features is assessed as leading to relevant information as it reflects the quantity of insurance coverage over time. In addition, when an insurer provides both insurance coverage and investment services for direct participation contracts, EFRAG assesses the release of the contractual service margin would reflect this.

116 The absence of detailed guidance on how to identify coverage units is not seen as problematic as it allows each individual insurer to determine the CSM contractual service margin allocation pattern of its groups of insurance contracts in a way that is reflective of how it provides the service to policyholders.

117 The issues that EFRAG is aware of in relation to the contract boundary do not limit the relevance of the resulting information.

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118 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.

119 The requirement for separate presentation of contracts in an asset position and contracts in a liability position on the statement of financial position is assessed to be relevant as it is consistent with the requirements in IAS 1 that apply to all entities.

120 The transition requirements consider the situation where an insurer has all, partly or an insufficient amount of information available to apply the Standard retrospectively. In addressing each of these situations, the transition requirements are assessed to lead to relevant information, considering the extent of the information available for each particular group of insurance contracts at transition.

121 EFRAG's overall assessment is to be finalised.

Reliability

122 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.

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

124 In its assessment of reliability, many of the aspects addressed in the relevance section also affect reliability. These issues are not repeated. As a result, EFRAG has identified the following topics as being the most significant to the assessment of reliability:

(a) Measurement of insurance contracts;

(b) Level of aggregation;

(c) Separating components from an insurance contract;

(d) Treatment of investment component;

(e) Sharing of risks;

(f) Performance of the insurance business; and

(g) Transition requirements.

Measurement of insurance contracts

125 Measurement of insurance liabilities in IFRS 17 requires judgement in estimating the fulfilment value of an insurance contract. EFRAG acknowledges that judgement is inherent in the insurance business and it follows that it is inherent in the measurement of insurance contracts. Therefore, EFRAG considers that estimating future cash flows and the use of discount rates would not lead to reduced reliability but reliability would be enhanced when combined with disclosures.

126 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.

Discount rates

127 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.

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128 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.

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

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

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

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

Contract boundary of reinsurance contracts held

131 EFRAG understands that the cash flows within the boundary of the reinsurance contract held arise from the substantive rights and obligations of the primary insurer. The substantive right is to receive services from the reinsurer. The substantive obligation is to pay amounts to the reinsurer. Therefore, a substantive right to receive services from the reinsurer 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.

132 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 of a primary insurer are measured separately.

133 EFRAG considers that there may be a reduction in reliability in estimating contracts expected to be written in the future. However, EFRAG:

(a) expects that the reinsurer would consider these future contracts when pricing the treaty;

(b) expects entities to have a budget or forecast which includes expected new business and to have past information on new business acquired; and

(c) notes that the estimation of these contracts would follow the same measurement principles as IFRS 17, i.e., probability-weighted estimate of the present value of cash flows.

Premium allocation approach

134 EFRAG considers that the measurement under the premium allocation approach provides information that is reliable because the information is expected to provide a reasonable approximation of the general requirements.

135 Under IFRS 17, the liability in the premium allocation approach includes premiums received in the period, if any. However, IFRS 17 does not mention whether premiums due or premiums expected in the future should also be included in the liability measurement. EFRAG considers that the premium allocation approach was created to balance operational complexity and cost with information that users can

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faithfully use for their analysis. Therefore, EFRAG considers that since the premium allocation approach is a simplification, only including premiums received only in the liability calculation provides complete information within the bounds of materiality and cost.

Level of aggregation

Step 1: Portfolio level

136 The starting point being the portfolio level as the unit of account provides a reliable basis for the release of the contractual service margin, which is recognised based on services provided. This is because the contracts within the portfolio will have similar risks and will be managed together, therefore the resulting contractual service margin faithfully represents the risks undertaken.

Step 2: One-year issuing period

137 The one-year groups allow an average of the contractual service margin to be released to profit or loss over time. EFRAG considers that this degree of averaging provides a balance between information which faithfully represents the insurance revenue of an entity and loss of information, compared to measuring individual contracts. Furthermore, the one-year groups ensure that all the contractual service margin is recognised in profit or loss once all the contracts in any group have terminated. Therefore, EFRAG considers that there would be an appropriate release of the contractual service margin to insurance revenue each period and over time and providing a faithful representation of the pattern of profit earned.

Step 3: Group level

138 IFRS 17 also requires separate grouping of contracts, if any, into groups of (i) onerous contracts, (ii) contracts that have no significant possibility of becoming onerous subsequently, and (iii) remaining contracts.

139 EFRAG considers that this separate grouping ensures that loss-making contracts are not offset with profitable contracts. In addition, it ensures that profits and losses are reported in appropriate reporting periods. Therefore, EFRAG considers that this grouping provides reliable information for users of financial statements.

Contracts that are onerous at inception

140 An entity is required to determine whether contracts are onerous by looking at a set of contracts. A set of contracts are onerous if, at initial recognition, the fulfilment cash flows allocated to the contracts, including acquisition cash flows, result in a total net outflow. If the entity does not have reasonable and supportable information to make the assessment by looking at a set of contracts, then the individual contracts would be considered.

141 EFRAG considers that since the determination of the fulfilment cash flows, including acquisition cash flows, can be performed at a level higher than the group level, there will be judgement involved in allocating these to the various groups. This allocation may be one of the factors that could cause certain contracts to be onerous or not, possibly due to the acquisition costs.

142 However, EFRAG considers that the identification of onerous contracts at inception would lead to reliable information because it will provide information about an entity's decisions on pricing contracts and about future cash flows. In addition, loss-making contracts would not be offset with profitable ones. Further, it will provide reliable information about the nature of an entity's financial performance.

Separating components from an insurance contract

143 The lowest level of the unit of account used in IFRS 17 is a contract, or a host insurance contract after separating non-insurance components.

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144 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, an entity selling one legal contract which has several insurance components only for the convenience of the policyholder 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 represents the economics of the transactions.

145 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.

Treatment of investment component

146 IFRS 17 requires any differences between expected and actual amounts of the investment component payable in the period to be recognised in the contractual service margin.

147 EFRAG considers that there are cases where an investment component that becomes payable in a period may directly cause changes in estimates of the present value of other future cash flows. For example, an acceleration in the repayment of an investment component because of more deaths than expected causes a reduction in the investment component to be paid in the future.

148 The difference between the expected and actual cash flows of the investment component are recognised in the contractual service margin instead of profit or loss. Also, the changes in estimates relating to the future would adjust the contractual service margin. EFRAG considers that the combined effect of such events adjusting the contractual service margin provides a faithful representation of information because it avoids the recognition of a loss or gain in the current period and a consequential gain or loss in future periods. As a result, the net effect on the contractual service margin would be the effect of the change in timing of the payment of the investment component.

Sharing of risks

149 Cash flows from sharing of risks as defined under IFRS 17 form part of the fulfilment cash flows which can be determined at a higher level of aggregation than the groups. These sharing of risks cash flows are then allocated on a systematic and rational basis to the groups.

150 As the sharing of risks is based on the contractual terms of the contracts, EFRAG is of the view that judgement will be required in allocating this amount to the groups. However, EFRAG considers that this allocation follows the same principle of measuring the fulfilment cash flows which can also be determined at a higher level of aggregation than a group and then allocated to the various groups. Therefore, EFRAG considers that allocating the impact of sharing of risks to groups would not lead to reduced reliability.

Performance of the insurance business

Use of coverage units for the contractual service margin

151 EFRAG acknowledges that the determination of the profit allocated in profit or loss based on the actual service provided over the expected duration and quantity of benefits of the contracts within a portfolio represents the use of significant estimates

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

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

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

Use of locked-in rate for the contractual service margin

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

154 Some argue that using current rates to accrete the contractual service margin would better reflect the best estimate of unearned profit. EFRAG has assessed the relevance of the use of the locked-in rate from paragraphs 73 to 76 above. The arguments used in that assessment are equally valid when assessing reliability.

155 In addition, for contracts without direct participation features, there is no direct connection between the liability and the underlying items. Therefore, the argument that the use of a current rate is necessary to avoid accounting mismatches with the assets is not supported by EFRAG. Specifically, EFRAG notes that the relationship between the insurance liability and the assets held by the entity is not static. The variability arises from asset liability management techniques such as the following.

(a) An insurance contract may promise a share of some of the returns on particular assets, but the entity decides not to hold these assets. When the returns from the assets held do not move in line with the promised returns, the resulting economic mismatch will have an impact on the statement of comprehensive income.

(b) Entities hold different types of asset portfolios: (i) dedicated asset portfolios that support specific liability portfolios; (ii) a general fund, the assets of which support different insurance contract liabilities and (iii) surplus assets, which represent the overall excess of assets in relation to insurance liabilities. Individual assets can move between these asset portfolios at the discretion of the entity.

(c) An entity may want to achieve a targeted return on particular assets. When the assets in one of the portfolios described in (b) above do not achieve that return, assets from another portfolio described in (b) above with better prospects can be re-allocated to take their place without derecognition of the original assets.

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

Transition requirements

Transition approaches

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

158 EFRAG assesses that the fully retrospective approach and the modified retrospective approach would result in the provision of reliable information based on the reasons explained in paragraphs 103 to 105. It is likely that retrospective application will be practicable for short-term contracts and recently issued long-term contracts. The comments below relate to long-term contracts that have been issued some time before the transition to IFRS 17.

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

160 In applying IFRS 13, entities will have to consider assumptions from a market participant perspective, together with 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.

161 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 under the modified retrospective approach or the profit for future services reported under the entity's previous accounting policies.

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

163 In addition, when applying the fair value approach, IFRS 17 excludes insurance acquisition cash flows that occurred prior to the transition date from the measurement of the contractual service margin at the transition date. EFRAG does not consider that this reduces the reliability of information because fair value reflects future cash flow expectations and does not reflect past cash flows.

164 Finally, some have argued that when applying the fair value approach, the contractual service margin on transition does not appropriately represent the profit for future services to be provided and therefore does not provide relevant information. Refer to paragraphs 159 to 162 for EFRAG's analysis on this point.

Risk mitigation relating to transition

165 IFRS 17 does not allow retrospective application of the risk mitigation requirements on transition. Some consider that this reduces reliability of the transition numbers as amounts relating to reducing risks before transition are treated differently to those after transition. In assessing this the view, EFRAG notes that:

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

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

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

166 EFRAG assesses that in applying risk mitigation retrospectively an entity could need to use hindsight when allocating the hedging gains or losses to those groups of insurance contracts. The use of hindsight is reinforced because of the absence of detailed historical information and the use of hedging gains or losses at aggregated level. EFRAG assesses that such an approach would not lead to reliable information.

Conclusion about the reliability of the information resulting from IFRS 17

167 EFRAG notes that dealing with estimates and uncertainty is inherent to the insurance business and the use of professional judgement is part of that. Hence, the use of judgement when measuring insurance contracts is assessed not to

reduce reliability. However, combined with disclosures relating to the inputs, assumptions and estimation techniques used, EFRAG considers the resulting information to be reliable. Regarding the contract boundaries, EFRAG considers that overall, the resulting information would be reliable.

168 The level of aggregation requirements are assessed to faithfully represent the profitability of the insurance business along with trend information of the profitability.

169 EFRAG acknowledges that in specific cases, separating insurance components from an insurance contract faithfully represents the economics of the transactions. In addition, the treatment of investment components results in reliable information.

170 The fact that risk mitigation cannot be applied retrospectively is assessed as bringing reliable information as the absence of detailed historical information would require entities to use hindsight when allocating hedging gains or losses to groups of insurance contracts being hedged in the past.

171 Regarding performance, the application of coverage units, in order to determine the release of the contractual service margin, involves professional judgement and therefore enables entities to choose the best way to reflect the release of profit over time based on the services provided. Also, accreting the contractual service margin at a locked-rate for contracts without direct participation features leads to reliable information.

172 Finally, EFRAG acknowledges that when applying the fair value approach at transition date, the contractual service margin on transition does not represent the estimates of the profit for future services calculated under the entity's previous accounting policies. EFRAG points out however that the fair value approach avoids a day 1 impact on equity and it allows an entity to represent the long-term business model (along with the other transition approaches). These effects balance any reduction in reliability.

173 EFRAG's overall assessment is to be finalised.

Comparability

174 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.

175 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.

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

(a) Separating components from an insurance contract;

(b) Measurement of insurance contracts;

(c) Level of aggregation;

(d) Different insurance accounting models;

(e) Accounting policy options;

(f) Performance of the insurance business;

(g) Transition requirements; and

(h) Restatement of comparatives

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Separating components from an insurance contract

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

Embedded derivatives

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

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

Investment components

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

181 As for embedded derivatives, EFRAG assesses that separation of investment components that are distinct from the host insurance contract ensures that contractual rights and obligations that create similar exposures are treated alike whether or not they are part of a host insurance contract. EFRAG assesses this leads to comparable information across industries. Further, EFRAG assesses that the separation of investment components has an additional advantage: the measurement in accordance with IFRS 9 allows the elimination of an accounting mismatch that could arise if the underlying financial assets were also measured in accordance with IFRS 9.

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

Service components

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

Overall

184 EFRAG considers that separating these components provides information that allows users to better compare how entities in different businesses or industries provide similar services.

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Measurement of insurance contracts

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

(a) the fulfilment cash flows; and

(b) the contractual service margin.

186 EFRAG acknowledges that some of the estimates, such as the risk adjustment for non-financial risk, should reflect that perspective of the entity which could reduce the comparability of information through the use of judgement. However, IFRS 17 requires that such information 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.

187 Therefore, EFRAG considers that, although comparability may be impaired for the measurement of the risk adjustment, IFRS 17 requires explicit disclosures to be made which can mitigate to some extent the reduction in comparability of the recognised amounts, for example, entities have to disclose the confidence level used to determine the risk adjustment.

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

Insurance acquisition cash flows paid on initially written contract

189 As explained in paragraph 14, non-refundable acquisition costs paid at inception are allocated to the related group and not to future groups under IFRS 17. EFRAG considers that focussing on the coverage period as evidenced by the contract boundary increases comparability. Comparability would decrease where insurers allocate the acquisition costs to future periods based on internal estimates.

Level of aggregation

190 As explained above, IFRS 17 level of aggregation principles requires an entity at inception of a contract to identify portfolios of insurance contracts, then to divide that portfolio into groups of insurance contracts based on expectations around profitability. Furthermore, a group of contracts cannot include contracts issued more than one year apart.

Step 1: Portfolio level

191 Portfolios of contracts are those subject to similar risks and being managed together. As portfolios are not standardised across the industry, EFRAG considers that this may reduce comparability. However, any lack of comparability is tempered by the principle that the portfolios need to contain contracts with similar risks.

Step 2: One-year issuing period

192 IFRS 17 requires a group of contracts to be divided into contracts issued within one year. EFRAG notes that this requirement enhances comparability across the sector as it reduces different application options.

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Step 3: Group level

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

194 Groups of insurance contracts that are onerous at inception are to be identified and the loss related to these are recognised in profit or loss immediately. This requirement will align the treatment of onerous contracts at inception amongst the industry itself as well as being consistent with other industries where this has been required from the adoption of IFRS Standards. The assessment may differ based on how cash flows estimated on a high level of aggregation is allocated to groups of contracts leading to less comparable information. However, overall, EFRAG assesses the identification of onerous contracts as important for comparability.

195 Insurance contracts that are profitable at inception are subdivided into two categories: (i) contracts that have no significant possibility of becoming onerous and ii) remaining contracts. The attribution of groups of contracts to differing profitability categories will be subject to judgement which means that different entities could conclude differently on similar groups of contracts. This could reduce comparability. However, entities will have to justify the judgement exercised and where relevant they will explain this under the relevant disclosure requirements.

Identification of coverage units

196 Coverage units of the group are determined as the quantity of benefits provided by the contracts in the group and its expected coverage duration. However, the principles-based approach increases the ability of preparers to reflect the economics of the underlying contracts at the cost of strict comparability. EFRAG also acknowledges that disclosures about significant judgement and changes in those judgements may to some extent mitigate the reduction in comparability of the recognised amounts.

Different insurance accounting models

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

(a) contracts with direct participation features;

(b) reinsurance contracts held;

(c) investment contracts with discretionary participation features; and

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

198 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

199 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.

200 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.

201 Furthermore, comparability among contracts with direct participation features would be achieved. One of the characteristics of an insurance contract with direct participation features is that the contractual terms should specify that the policyholder participates in a share of a clearly identified pool of underlying items.

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Therefore, the rights and obligations arising from the discretionary payments could fail the definition of an insurance contract with direct participation features, if they are not considered to form part of the ‘contractual terms’.

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

203 EFRAG assesses that a contract condition can arise because of a constructive obligation but that not all constructive obligations would give rise to contract conditions and, therefore, do not necessarily result in financial liabilities. EFRAG acknowledges that whether an enforceable contractual right or obligation exists is a question to be considered within the context of the relevant legal framework. Consequently, the factors that determine enforceability may differ between jurisdictions. Therefore, in order to demonstrate that discretionary payments made to the policyholder are within the scope of the approach for contracts with direct participation features, EFRAG acknowledges that it should have contractual terms that are enforceable. As a result, EFRAG assesses that, if contractual terms are not enforceable, the fact that the approach for contracts with direct participation features cannot be applied, does not hinder comparability.

Reinsurance contracts held

204 EFRAG acknowledges that the treatment of reinsurance contracts held and insurance contracts issued is not identical. However, EFRAG considers that the contractual service margin for a group of reinsurance contracts held is different from that for a group of insurance contracts issued. This is because the contractual service margin for the group of reinsurance contracts held depicts the expense that the entity incurs when purchasing reinsurance coverage rather than the profit it will make by providing services under the insurance contract. EFRAG does not consider that an entity would expect to make a profit on reinsurance contracts held, rather these contracts are purchased in order to share risks or to transfer the risks to the reinsurer. Therefore, the different treatment reflects the different economics of the groups of contracts and is consistent with treatment under other standards of a reduction in costs of services to be received. EFRAG’s full assessment about reinsurance contracts held can be found in paragraphs 37 to 44.

Investment contracts with discretionary participation features

205 EFRAG notes that IFRS 17 applies only to investment contracts with discretionary participation features that are issued by an entity that also issues insurance contracts. Other companies apply IFRS 9 to such contracts. This could create situations where groups with and without insurance contracts apply different standards (IFRS 17 or IFRS 9) for economically similar 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

206 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.

207 EFRAG assesses that this should not lead to a material reduction in comparability because of the eligibility criteria and is balanced by the fact that this approach

provides a simpler way for entities to measure insurance contracts with a shorter duration.

Accounting policy options

Finance income or expense

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

209 For insurance contracts with direct participation features, where the insurer holds the underlying items, it shall make an accounting policy choice between:

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

(b) disaggregating insurance finance income or expenses for the period to include in profit or loss an amount that eliminates accounting mismatches with income or expenses included in profit or loss on the underlying items held.

210 The policy choices on presentation of insurance finance income or expenses is applied to portfolios of insurance contracts and IFRS 17 requires insurers to consider both IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* and for each portfolio the assets that the entity holds and how it accounts for those assets.

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

Own debt or equity instruments as underlying items

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

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

214 EFRAG assesses that such accounting policy choices for both own debt or 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. 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.

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Presentation of changes in risk adjustment for non-financial risk

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

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

Performance of the insurance business

217 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.

218 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.

Transition requirements

219 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.

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

Restatement of comparatives

221 IFRS 17 requires entities to present comparative information for at least one reporting period before transition, i.e. 2020 if an entity applies IFRS 17 at its effective date. EFRAG notes that this will require entities to present comparative information during 2020 for insurance liabilities while entities that have elected to defer IFRS 9 are not required (but are permitted) to do so for their financial assets and financial liabilities. In addition, entities that are SEC-filers have to provide either 2 years or no years of comparative information.

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

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

224 For SEC-filers, EFRAG assesses that the difference in number of comparative years to be produced between IFRS Standards and US GAAP will enhance comparability if the US-filer elects to provide two years of comparatives in its US filings. Comparability is not reduced if the US-filer elects to provide no comparatives in its US filings as the IFRS 17 information will still be available.

Conclusion about the comparability of the information resulting from IFRS 17

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

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

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

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

(b) business model of each type of entity.

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

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

(a) the judgement required in the calculation of the on risk adjustment for non-financial risk (see paragraphs 186 - 188) and when applying the level of aggregation requirements (see paragraphs 190 - 195) as well as for the identification of coverage units (see paragraph 196);

(b) the accounting policy options on discounting (see paragraphs 208 - 211), own debt or equity instruments as underlying items (see paragraphs 212 - 214); as well as presentation of changes in the risk adjustment for non-financial risk (see paragraphs 215 - 216); and

(c) the choice of two transition methods when retrospective application is impracticable under the transition requirements(see paragraphs 219 - 224).

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

231 With regards to the restatement of comparatives for 2020, EFRAG also assesses that comparability is increased over time through the reduction in the diverse treatment of current accounting and the requirement to treat all entities in the same

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manner, irrespective of whether or not they have elected to defer the application of IFRS 9.

232 EFRAG's overall assessment is to be finalised.

Understandability

233 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.

234 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.

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

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

(a) Measurement of insurance contracts

(b) Different insurance accounting models;

(c) Level of aggregation;

(d) Presentation on the statement of financial position;

(e) Disclosures; and

(f) Transition requirements.

Measurement of insurance contracts

Fulfilment cash flows and contractual service margin

237 EFRAG notes the disclosures provide for reconciliations 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. As a result, EFRAG assesses that information about the fulfilment cash flows will contribute in providing understandable information about the insurance service result.

Insurance acquisition cash flows paid on an initially written contract

238 EFRAG considers non-refundable acquisition cash flows to form part of the group of contracts initially written and not to renewed contracts as these acquisition costs are triggered due to the contracts written at that point in time. EFRAG considers this allocation to be less complex as entities will not have to set aside and keep track of acquisition cash flows for expected future contracts that will be entered into. EFRAG acknowledges that the latter method would require a significant amount of judgement which would increase complexity and reduce understandability. EFRAG also assesses that the following disclosure requirements enhance understandability of the IFRS 17 treatment of insurance acquisition cash flows:

(a) the amortisation of insurance acquisition cash flows; and

(b) the allocation of the portion of the premiums included in revenue that relate to the recovery of insurance acquisition cash flows.

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Different insurance accounting models

Distinction between contracts with and without direct participation features

239 EFRAG notes that the measurement of the fulfilment cash flows is the same for both types of contract, and the differences are limited to the treatment of the contractual service margin. EFRAG also notes that those differences are necessary to provide a faithful representation of the different nature of the types of contract.

240 EFRAG assesses that treating insurance contracts with direct participation features differently from insurance contracts without direct participation features adds complexity for preparers and users of financial statements. This is because preparers would have to classify their insurance contracts and users need to understand the implications of the different accounting requirements.

241 However, EFRAG notes that the different measurement models reflect the characteristics of the different types of contracts. As a result, the improved usefulness of the information in reflecting an entity's different product offerings at least partly offsets the loss of understandability arising from the increased complexity.

Reinsurance contracts held

242 IFRS 17 measures reinsurance contracts held on their own merits, i.e. the measurement of reinsurance contracts held does not in all aspects align with the measurement of the underlying insurance contracts. Some have argued that this reduces the understandability of the information as users of financial statements would not be able to see the extent to which insurance risk has been transferred to a reinsurer.

243 EFRAG considers that understandability would be enhanced if the following information was disclosed in the financial statements:

(a) the extent to which existing reinsurance contracts cover risks in contracts already written by primary insurers;

(b) for primary insurance contracts that are partly reinsured, the risks that are not covered by reinsurance (including aspects such as duration of reinsurance, proportion); and

(c) the extent to which existing reinsurance contracts cover insurance contracts that have not yet been written.

Investment contracts with discretionary participation features

244 Investment contracts with discretionary participation features do not meet the definition of insurance contracts. EFRAG assesses that the advantages of treating them the same as insurance contracts rather than as financial instruments when they are issued by entities that issue insurance contracts are that:

(a) Investment contracts with discretionary participation features and insurance contracts that specify a link to returns on underlying items are sometimes linked to the same underlying pool of assets. Sometimes investment contracts with discretionary participation features share in the performance of insurance contracts. Using the same accounting for both types of contracts will produce more useful information for users of financial statements because it enhances comparability within an insurance entity. It simplifies the accounting for those contracts. For example, some cash flow distributions to participating policyholders are made in aggregate both for insurance contracts that specify a link to returns on underlying items and for investment contracts with discretionary participation features. This makes it challenging to apply different accounting models to different parts of that aggregate participation.

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(b) Both of these types of contract 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. Therefore, a model for insurance contracts were specifically developed under IFRS 17 to generate useful information about contracts containing such features.

(c) If investment contracts with discretionary participation features were not accounted for by applying IFRS 17, some of the discretionary participation features might be separated into an equity component in accordance with other IFRS Standards. This could introduce overly complex accounting.

245 EFRAG considers these advantages to increase understandability.

Contracts where the premium allocation approach is applied

246 Under IFRS 17, entities are allowed to simplify the measurement of some groups of insurance contracts by applying a premium allocation approach.

Liability for remaining coverage

247 EFRAG assesses that the simplification could lead to less operational complexity, which increase understandability as entities:

(a) could assume, without further investigation, that the approach provides a reasonable approximation of the general requirements of IFRS 17 if the coverage period of each contract in the group is one year or less;

(b) should accrete interest on the liability for remaining coverage only for groups of insurance contracts that have a significant financing component (when the period between premiums being due and the provision of coverage is one year or less, the group is deemed not to have a significant financing component);

(c) are permitted to recognise all insurance acquisition cash flows as an expense when incurred for groups of insurance contracts each with a coverage period of one year or less; and

(d) measure the group of insurance contracts using estimates made at initial recognition and does not update those estimates in the measurement of the liability for remaining coverage unless the group is or becomes onerous.

Liability for incurred claims

248 IFRS 17 requires that entities measure the interest expense for the liability for incurred claims using the rate that applied when the liability for incurred claims was initially recognised, rather than when the group of insurance contracts was initially recognised. Some may argue that, for claims that have been incurred but not yet reported, the entity does not know when the claims actually occurred, and it is therefore unclear which discount rates should be applied in determining the amount of the insurance finance income or expenses included in profit or loss.

249 EFRAG considers that although using the discount rate at initial recognition will achieve consistency with the measurement of the liability for remaining coverage, the liability for incurred claims is zero when the group of insurance contracts is initially recognised. EFRAG notes that assessing what the discount rate would have been at the inception of the contract could be costly and operationally complex. Therefore using the discount rate at the date the claim was incurred would be less complex than using the rate at the inception of the contract, and would be more intuitively understandable than using he date at which the contract was written. EFRAG also assesses that permitting entities not to discount claims that are expected to be paid within one year reduces complexity without any loss of understandability. Therefore, EFRAG assesses that these requirements will enhance understandability.

Level of aggregation

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

(a) Type of contract (e.g. major product lines);

(b) Geographical area; or

(c) Reportable segment.

251 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 aggregation will be understandable for them.

252 When onerous contracts are disclosed e.g. by business line, EFRAG expects that this will provide understandable information to users of financial statements about the degree of onerous contracts written in each of the business lines. It will also provide understandable information about the business reasons for writing such contracts.

Presentation on the statement of financial position

253 EFRAG notes that IFRS 17 requires disclosure on the reconciliation of the net carrying amount from the beginning to the end of the period. This reconciliation is to be provided separately for those groups of contracts that are assets and those that are liabilities.

254 As the requirement under IFRS 17 not to offset groups of insurance contracts that are in an asset position with those that are in a liability position is consistent with IAS 1, EFRAG assesses that these disclosures will help users understand to which extent the contracts that the entity is a party to are in an expected cash surplus position or an expected cash deficit position. Moreover, as these disclosures do not introduce new requirements, it does not jeopardise the notion of understandability.

Disclosures

Assumptions and judgements made in measuring the insurance liability

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

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

Accounting policy options on finance income and expense

257 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.

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

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Insurance revenue

259 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.

260 EFRAG notes that the disclosures require an entity to provide reconciliations showing how the net carrying amounts of contracts changed during the period because of cash flows and income and expenses is recognised in the statement of financial performance. In addition, EFRAG notes that disclosures require information about the inputs, assumptions and estimation techniques relating to significant judgements taken in applying IFRS 17.

261 EFRAG will conclude on whether these disclosures provide sufficient information after its outreach with users is completed.

Transition requirements

262 At transition date, the disclosures identified in paragraph 220 will mitigate the reduction in understandability when applying different transition methods.

Conclusion about the understandability of the information resulting from IFRS 17

263 EFRAG considers the level of aggregation criteria for disclosure purposes contribute to understandability as the bases used are already familiar to users of financial statements.

264 EFRAG assesses that the various simplifications introduced by the different insurance accounting models will lead to information that is more understandable to users of financial statements.

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

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

267 EFRAG's overall assessment is to be finalised.

Prudence

268 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.

269 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).

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

(a) Recognition of liabilities arising from insurance contracts;

(b) Measurement of insurance contracts;

(c) Level of aggregation;

(d) Performance of the insurance business;

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(e) Contract boundaries; and

(f) Treatment of investment component.

Recognition of liabilities arising from insurance contracts

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

Measurement of insurance contracts

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

273 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 follow from using such assumptions and estimates:

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

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

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

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

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

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

Level of aggregation

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

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

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

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

Performance of the insurance business

278 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.

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

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

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

Contract boundaries

Inclusion of future premiums in the contract boundary

282 It has been argued that the contractual service margin of a profitable group of insurance contracts could include unearned profit derived from premiums to be received in future periods which could partially be released to profit or loss before the receipt of the premium.

283 This is particularly important for participating insurance contracts where the shareholders' part of future expected asset yield would be included in the contractual service margin at initial recognition. Some are concerned that such frontloading of profit might reduce the prudence of the resulting information.

284 EFRAG has no evidence of such situations occurring. In assessing this issue, EFRAG notes the following:

(a) The contractual service margin represents only a portion of the premiums (expected to be) received;

(b) Such a frontloading of profit would have to be determined:

(i) as a result of a probability-weighted estimate of cash inflows and outflows within the contract boundary of a group of insurance contracts; and

(ii) in accordance with how an entity provides insurance service over the entire duration of the contracts.

(c) The contracts with direct participation features are essentially pass-through contracts, i.e. all expected benefits from the underlying assets are passed through to the policyholder, minus a variable fee for the insurer;

(d) The assumptions made about future asset returns in calculating the shareholders' share need to be aligned with the ones used for calculating the policyholders' share. As a result, over-optimistic expectations of future asset returns would increase the liability to be paid to the policyholders far more they would do to the contractual service margin (as the contractual service margin is a residual of the entire fulfilment cash flows calculation); and

(e) Assumptions are updated on a regular basis in line with market conditions.

285 Based on the above observations, EFRAG is of the view that the inclusion of expected premiums in the contractual service margin issue described above would occur only in rare circumstances. In those rare circumstances where it would occur, EFRAG is of the view it reduces the prudence of the resulting information. However, as the frontloading of future profit would be in line with how the entity provides its insurance service over the entire duration of the contracts, this reduction in prudence is balanced by representation of the long-term nature of the insurance business.

Treatment of investment component

286 IFRS 17 requires any differences between expected and actual amounts of the investment component payable in the period to be recognised in the contractual service margin. A detailed description of this issue is provided in paragraphs 146 to 148 above.

287 EFRAG assesses this as prudent as it avoids a gain being recognised for a delay in repaying an investment component.

Conclusion about prudence

288 EFRAG has concluded that:

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

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

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

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

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

(f) not booking gains when the payment of an investment component is delayed is a prudent approach.

289 EFRAG's overall assessment is to be finalised.

Conclusion – true and fair view

290 To be completed.

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