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EFRAG IAWG Report to EFRAG TEG – January 2019

Agenda for the 24 January 2019 EFRAG IAWG meeting

1 EFRAG IAWG discussed the IASB's tentative decisions made at its meeting in December 2018 on the following topics:

(a) Presentation of insurance contracts on the statement of financial position;

(b) Discount rates, risk adjustment and other comprehensive income ('OCI') option;

(c) Variable fee approach;

(d) Business combinations;

(e) Future cash flows in the measurement of reinsurance contracts held; and

(f) The treatment of accounting estimates in interim financial statements.

2 For each of the issues considered by the IASB based on IASB staff papers and any potential solutions to the issues, EFRAG IAWG was asked for their views, and the reasons for those views, quantified where relevant, on:

(a) Whether the EFRAG IAWG agree with or disagree with the IASB staff's reasons for the position that they recommend to the IASB;

(b) Where the IASB has tentatively decided to make amendments to the Standard, how should the IASB's proposed changes be considered in developing the comment letter on the forthcoming Exposure Draft; and

(c) Where the IASB has tentatively decided *not* to make amendments to the Standard, the impact of the IASB's tentative decisions on the technical endorsement criteria of relevance, reliability, comparability, understandability and prudence as well as other criteria considered in developing an endorsement advice such as the impact on the cost-benefit relationship.

Presentation of insurance contracts on the statement of financial position

3 EFRAG IAWG members discussed the following:

(a) Issue 1: Separate presentation of groups of insurance contracts that are in an asset position and liability position (the IASB tentatively decided to amend IFRS 17 for separate presentation at portfolio level rather than group level); and

(b) Issue 2: Separate presentation and measurement of premiums receivable and claims payable (IASB tentatively decided not to amend IFRS 17).

Issue 1: Separate presentation of groups of insurance contracts that are in an asset position and liability position

Discussion

4 Some EFRAG IAWG members stated that the proposed amendments were feasible by using simplifications. However, they did not see any added value and they questioned the usefulness for users for presentation at portfolio level.

5 It was noted that groups of insurance contracts are static as they are created from inception, however portfolios can change over time.

Input into draft comment letter on the forthcoming ED - main takeaway

6 Notwithstanding the above comments, on balance the EFRAG IAWG members supported the IASB's tentative decisions.

Issue 2: Separate presentation and measurement of premiums receivable and claims payable

Discussion

7 A number of EFRAG IAWG members considered that the two issues were linked.

8 Regarding premiums receivable and claims payable, EFRAG IAWG members raised the following points:

(a) Current accounting practices of presenting separately the premiums receivable and claims payable are preferred. It was acknowledged that the terminology 'premium receivable' and 'claim payable' were not used consistently in current accounting. In addition, under current practices 'premium receivable' and 'claim payable' are units of account in their own right, contrary to the IFRS 17 principle that the insurance liability incorporates all expected cash inflows and outflows. As a result, the operational issues do not seem to be limited to presentation only but also may affect the measurement of the insurance liability.

(b) Including premiums receivables and claims payable within the insurance asset/liability would reduce the relevance the insurance asset/liability as different components of these amounts are subject to different levels of uncertainty.

(c) Specifically for reinsurance business (but not limited to this business) including separately premiums receivable and claims payable in the insurance liability for presentation purposes would be very difficult as an arbitrary allocation would need to be made for these components.

(d) The cost of combining premiums receivable and claims payable with the insurance liability was greater than the benefits as systems changes would be needed to connect the accounting and actuarial systems. One EFRAG IAWG member mentioned that there would also be an issue regarding providing roll-forwards in the disclosures because of the need to disclose amount of premiums received, amount of claims paid, etc. This member estimated that it would cost 20 million euros only for these disclosures.

(e) The challenge of providing these disclosures was the granularity of the premiums receivable and claims payable as the mapping will have to be done at group level for measurement. One EFRAG IAWG member believes that the separate presentation of premiums receivable would also require the implementation of an impairment model as for all other financial assets scoped in IFRS 9.

(f) Although IAS 1 *Presentation of Financial Statements* allows disaggregation of line items as long as this provides relevant information, it was noted that analysts want a harmonised approach to disaggregation (which would require standard-setting).

Technical endorsement criteria - main takeaway

9 Regarding Issue 2, the main concern related to cost being greater than the benefits because of development of systems.

Discount rates, risk adjustment and OCI option

10 EFRAG IAWG members discussed the following tentative decisions of the IASB not to amend the requirements of IFRS 17 in respect of:

(a) Issue 1: The use of a locked-in discount rate to adjust the contractual service margin ('CSM') under the general model ('GM');

(b) Issue 2: The adjustment for non-financial risk in a group of entities based on the compensation that the entity issuing the insurance contract requires for measuring that risk;

(c) Issue 3: The perceived subjectivity in the determination of discount rates and risk adjustment; and

(d) Issue 4: The accounting policy option to disaggregate insurance finance income or expenses between profit or loss and OCI.

Discussion:

Issue 1: The use of a locked-in discount rate to adjust the CSM under the GM

11 EFRAG IAWG members raised the following points:

(a) Using the locked-in discount rate is not inconsistent with the IFRS 17 principle of treating the rights and obligations arising from a group of insurance contracts as a single asset or liability.

(b) The accounting policy choice on presentation of financial income and expense would not alleviate all the concerns related to the locked-in rate.

(c) Allowing a choice between locked-in rate and current rate would not change revenue or the insurance result if coverage units are discounted. However, the amounts recognised in finance income and expense would differ (in addition to the impact of an accounting policy option on presentation of financial income and expense in OCI).

(d) A change in the requirement to allow CSM to accrete at either locked-in rate or current rate would affect current implementation plans. It would add complexity and would be onerous.

Issue 2: The risk adjustment in a group of entities

12 One EFRAG IAWG member commented that for those that have done certain work on implementation the IASB decision results in easier implementation and supports the decision.

Issue 3: The perceived subjectivity in the determination of discount rates and risk adjustment

13 EFRAG IAWG members raised the following points:

(a) Previous concerns about the subjectivity in the determination of discount rates and the risk adjustment were still relevant.

(b) The principles in IFRS 17 result in relevant information and reflect economic substance. While more detailed guidance may be desirable, the discount rate would depend on asset-liability management techniques and a single rate would not be possible, but sensitivity analysis in this regard is important.

Issue 4: The option to disaggregate insurance finance income or expenses in OCI or not.

14 EFRAG IAWG members raised the following points:

(a) Mixed views were provided, one EFRAG IAWG member not supporting the option as it impairs comparability, while others referred to EFRAG's previous position supporting this option.

(b) The option was intended to avoid volatility in profit or loss and the concerns about comparability were addressed by the increased disclosures.

Technical endorsement criteria

Issue 1: The use of a locked-in discount rate to adjust the CSM under the GM

15 From the discussion it appears that a few EFRAG IAWG members consider the current requirements to impair relevance but this view does not seem to be supported generally. Some argue that the impact on relevance is no greater than the presentation option in respect of finance income and expenses.

Issue 2: The risk adjustment in a group of entities

16 No comments received.

Issue 3: The perceived subjectivity in the determination of discount rates and risk adjustment

17 Most EFRAG IAWG members consider the requirements of IFRS 17 to result in relevant information whilst others consider there to be a trade-off with reliability.

Issue 4: The option to disaggregate insurance finance income or expenses in OCI or not.

18 EFRAG IAWG members consider that this option provides relevant information, with the impairment to comparability being tempered by the additional disclosures.

Variable fee approach

19 EFRAG IAWG members discussed the following tentative decisions of the IASB not to amend the requirements of IFRS 17 in respect of the:

(a) Issue 1: Definition of an insurance contract with direct participation features, where some consider that the definition is too restrictive; and

(b) Issue 2: Limited applicability of the risk mitigation exception.

Issue 1: Definition of an insurance contract with direct participation features

Discussion:

20 EFRAG IAWG members made the following points:

(a) The scope of the variable fee approach (VFA) is too narrow and that the paper written by the IASB staff did not address Belgian contracts.

(b) The scope of the VFA is an implementation issue.

Technical endorsement criteria:

21 EFRAG IAWG did not specifically indicate the impact of the issue on the technical endorsement criteria.

Issue 2: Limited applicability of the risk mitigation exception

Discussion:

22 EFRAG IAWG members discussed the fact that the risk mitigation exception can only be used:

(a) *For insurance contracts with direct participation features* – EFRAG IAWG members indicated that the scope should be extended to include other contracts as they did not see why a different accounting treatment should arise;

(b) *When the hedging instrument is a derivative* – Mixed views were expressed. Some EFRAG IAWG members noted that the scope should be extended to include other instruments used as hedging instruments similar to IFRS 9 *Financial Instruments*. However other EFRAG IAWG members were concerned that by broadening the scope it could have unintended consequences. Some members questioned why the January 2019 IASB tentative decision only extended the scope to reinsurance contracts held and not to other instruments used as hedging instruments; and

(c) *Prospectively although risk mitigation arrangements may have been in place before the date of initial application of IFRS 17* – Although no decision was made by the IASB at the December meeting, EFRAG IAWG members expressed their concern about the requirement. They specifically challenged the argumentation around hedging documentation that should be in place and noted that for Solvency II purposes such documentation is available.

Technical endorsement criteria

23 EFRAG IAWG noted that there will be a trade-off between comparability (as different requirements are applied under the general model and the VFA and whether a derivative or another financial instrument are used as a hedging instrument) and relevance (in cases where instruments other than derivatives are used to mitigate risks).

Business combinations

24 EFRAG IAWG members discussed the following tentative decisions of the IASB not to amend the requirements of IFRS 17 in respect of the:

(a) Issue 1: Removal of the exception to IFRS 3 *Business Combinations* to classify insurance contracts as such based on the contractual terms at inception rather than on the acquisition date; and

(b) Issue 2: The determination of the insured event for acquired insurance contracts as IFRS 17 requires entities to account for insurance contracts as if they had been entered into on the acquisition date.

Discussion

Issue 1: Removal of the classification exception from IFRS 3

25 EFRAG IAWG members made the following points:

(a) For future acquisitions, the requirement created an operational challenge even while the tentative decisions of the IASB was assessed to be conceptually correct. This included the complexity of changing the nature of the liability upon acquisition such as from the premium allocation approach to the general model.

(b) The requirement to apply the normal IFRS 3 principle does not add value and is costly to implement. While costs could not be quantified during the meeting, it was noted the size of the costs were specific to each acquisition.

(c) It was hard to justify not accounting for business combinations in accordance with IFRS 3, even while recognising the cost issue.

(d) Information from historical acquisitions is not available especially in the long-term business (more than 20 years).

Issue 2: Determination of the insured event for acquired insurance contracts

26 EFRAG IAWG members made the following points:

(a) The relevance of the resulting information was questioned, especially how revenue was being created.

(b) Recognition of a liability for remaining coverage and recognising revenue based upon claims management services was not conceptually correct (e.g. acquiring a portfolio with no remaining insurance risk).

(c) Presenting the liability for remaining coverage as a liability in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, did not lead to relevant information as it creates revenue where it should not and leads to undue complexity.

(d) There would be always insurance risk as in this case it was the uncertainty about how claims would evolve (both in amount and over time). This requirement is very costly to implement but no quantification was provided.

(e) In terms of implementation, the requirement may take more than one year (accounting architecture) or five to ten years (contract administration architecture) to switch from the systems of the acquiree to the systems of the acquirer (on the assumption there is a switch from a premium allocation approach to a general model approach).

Technical endorsement criteria

27 Most EFRAG IAWG members argued that applying the normal IFRS 3 principle did not lead to relevant information in the case of acquired insurance contracts in the settlement period. However, some EFRAG IAWG noted that there will be a trade-off between comparability (as IFRS 3 requirements would not be applied to all transactions) and relevance. EFRAG IAWG members noted that the main concern related to costs because the requirement is very costly to implement.

Future cash flows in the measurement of reinsurance contracts held

28 EFRAG IAWG members discussed the tentative decisions made by the IASB not to amend the requirements of IFRS 17 in respect of the inclusion of future cash flows relating to insurance contracts not yet issued in the measurement of reinsurance contracts held.

Discussion

29 EFRAG IAWG members made the following points:

(a) The example provided by IASB staff was simplistic. With more complex reinsurance contracts there was a lack of matching between the reinsurance contract and the underlying insurance contracts. Examples of mismatches were differences in discount rates (and so changes to these would lead to differences in the measurement) and the risk adjustment. Another example was that the underlying insurance contract would be accounted for in accordance with the premium allocation approach while the reinsurance was measured in accordance with the general model. It resulted in non-meaningful information on the balance sheet.

(b) The various arguments provided by the IASB staff in their paper were questionable. EFRAG IAWG noted there was a huge difference between estimating the outcome of an insurance contract and estimating the volume, mix and size of future insurance contracts to be sold. It was also commercially sensitive. Also, the approach taken by the IASB is inconsistent with risk mitigation with derivatives (where matching is allowed even if the derivative is an independent contract to the insurance contract).

Technical endorsement criteria

30 EFRAG IAWG argued that the requirements did not lead to reliable and relevant information.

The treatment of accounting estimates in interim financial statements

31 EFRAG IAWG members discussed the tentative decision of the IASB not to amend the requirement of IFRS 17 B137 whereby entities should not adjust accounting estimates made in previous interim financial statements when applying IFRS 17 in subsequent interim financial statements or in the annual financial statements.

32 EFRAG IAWG members made the following points:

(a) the “discrete period approach” of IAS 34 *Interim Financial Statements* has not been changed for IFRS 17.

(b) There could be ‘dual-reporting’ for reporting by any subsidiaries and for reporting by the group. Also, intra-group charges and other factors will necessitate two calculations (i.e. one at group level and one for subsidiaries reporting under IFRS Standards.

(c) There were concerns that the current process for half yearly reporting uses simplifications and approximations which then impacts the annual reporting.

(d) Mixed views were provided. On the one hand, IFRS 17 paragraph B137 should be amended to include a wider range of interim reports such as monthly internal reports. On the other hand, support was expressed for paragraph B137 as written.

Technical endorsement criteria

33 Points made on the technical endorsement criteria were:

(a) Comparability is impaired as the results in the annual financial statements could differ between groups, depending on frequency of reporting under IAS 34.

(b) Cost concerns were raised about ‘dual-reporting’ of IFRS 17 numbers (however no estimates of costs could be or were provided).