



Article from  
**Financial Reporter**  
September 2017  
Issue 110

# Challenges to Consider Upon IFRS 17 Adoption

By Michael Beck, Laura Gray and Gavin Stewart

In the 1990s the International Accounting Standards Board (IASB) put in place International Financial Reporting Standards 4 (IFRS 4) to provide guidance for the accounting of insurance contracts. This measure was implemented as a stop gap while awaiting the development of a permanent standard. Twenty years later IFRS 17 (the Standard) was issued by the IASB on May 18, 2017 and provides the principles that will govern insurance contracts in many countries around the world, effective Jan. 1, 2021. This article provides an overview of IFRS 17 followed by a discussion of some of the intricacies related to IFRS 17 and how companies can consider addressing these in their upcoming implementations.

## IFRS 17 OVERVIEW

IFRS 17 is a principle-based approach to accounting for insurance contracts. The standard brings with it some new concepts, as well as incorporating concepts that exist under other measures but were not previously included in IFRS 4. This standard introduces the general measurement model (GMM) which is constructed by four separate building blocks: (1) cash flows, (2) risk adjustment, (3) discount rates and (4) contractual service margin.

Under IFRS 17, cash inflows and outflows are explicitly projected as a part of the valuation. The cash flows should include all cash flows that relate to the fulfillment of a “group” of contracts on a best estimate basis without an allowance for adverse deviation. Certain expenses, such as product development, are therefore not included as these cannot be tied to a specific contract.

The cash flows are discounted back to the valuation date using the current rates. In addition to the basic cash flows, a risk adjustment (RA) for non-financial risks is included in the liability. This RA represents an amount that makes the entity indifferent between providing a known set of cash flows and one with uncertainties in terms of amount and timing.

At the inception (or point-of-sale) of the contracts, a contractual service margin (CSM) is established to eliminate any initial profit recognition. Over the duration of the contract life, the CSM

is released as the risk to which the company is exposed runs off. The release of the CSM represents profit from the product which can be recognized in the profit and loss statement. The pattern of the release of the CSM is based on the principle of “coverage units” which represents the amount of service provided during the period. Although the production of the financial statements is not covered in this article, it is worth noting that disclosures will require considerable effort and should be proactively developed early in the adoption process.

## CSM AND LOSS COMPONENT

Paragraph 38 of IFRS 17 defines the CSM as “the unearned profit the entity will recognize as it provides services in the future.” There are a number of adjustments to the CSM that must occur each reporting period including accretion of interest, changes in the cash flows due to certain assumption updates, and calculation of the run-off. If the CSM is eliminated prior to the end of the life of the contracts, a separate “loss component” must be tracked and monitored in case the CSM needs to be re-established at a future point in time. As the inclusion of the CSM and/or loss component is one of the biggest methodology changes from IFRS 4 to IFRS 17, it represents one of the most crucial and challenging implementation aspects for companies adopting the new standard. To be able to calculate and understand the CSM and loss component, companies will need to focus attention on data, analysis of change and coverage units, as discussed below.

## CSM Data Challenges

The ongoing data needs associated with the CSM are substantial, and will require a holistic approach to capturing data so that it can be appropriately allocated to a “group” of insurance contracts. Appendix A of IFRS 17 defines a group of insurance contracts as a set of contracts which, at initial recognition, are:

- Subject to similar risks and managed together (i.e., are part of a portfolio)
- Written within a period of no more than one year (see transition section for treatment of business written prior to transition)
- All categorized as being either (a) onerous at inception, (b) not onerous at inception with no significant risk of subsequently becoming onerous, or (c) not onerous at inception with risk of subsequently becoming onerous

For many insurers, this grouping is more granular than current levels at which products are managed. While most insurers are already managing products with similar risk profiles together, current portfolios may not be limited to a 12-month period. Additionally, as the sub-division of onerous and non-onerous

contracts is new to IFRS 17, it is doubtful that many insurers currently manage to this level of granularity.

The increased granularity required by IFRS 17 has two implications for data needs relative to the CSM:

1. Since IFRS 17 requires best-estimate cash flows to be recast at each valuation date, projection models must be run for each group of insurance contracts, with changes in certain estimates relating to future service flowing through the CSM. Changes related to financial assumptions do not flow through the CSM, nor do changes related to incurred claim liabilities, so tracking the nature of the changes is also critical. Depending on the methods in place for making and reviewing assumption updates across product groupings, this may put strain on both the assumption review process as well as any controls that are in place to ensure assumption updates are made as expected.
2. As the current period CSM is calculated using the prior period CSM as a starting point, the retention of historical CSM information is critical. Ultimately, this requirement forces companies to maintain a greater amount of data than current requirements. For those contracts that are either considered onerous at inception or become onerous in subsequent valuation periods, companies will need to track a loss component rather than a CSM. While the loss component is recognized immediately in profit and loss, the accumulated balance must be disclosed in a company's financial statements and tracked on a recurring basis to monitor if the product becomes profitable.

To begin preparing for these increased data needs, companies would be well-advised to begin conducting gap assessments on current valuation systems and data management capabilities sooner rather than later. In addition, companies will want to begin conversations with assumption committees and with their auditor over the increased population of product groupings requiring assumption updates and controls. For those companies that have a simplified or siloed approach to assumption updates, now may be a good time to invest in enhancing these processes and positioning them to be successful under IFRS 17. Finally, actuarial departments will benefit from close coordination with IT and data groups to manage the flow of information necessary to track the period-over-period CSM and/or loss component for each group of insurance contracts.

### Analysis of Change

The disclosure requirements defined within paragraphs 101 and 104 of IFRS 17 require that companies reconcile the opening and closing balances of the CSM, separating out:

- Changes related to future service (such as assumption updates or contracts initially recognized in the period)
- Changes related to current service (such as experience adjustments and the amount of CSM recognized in current profit and loss)
- Changes related to past service (such as changes related to incurred claims)

The practical implication of these disclosure requirements is that companies will need a stepwise set of cash flow projections that show the impact of experience updates, assumption changes, and the subsequent release of the CSM (as paragraph 44(e) of IFRS 17 prescribes that the release of CSM should be based on the end-of-period balance, accounting for experience updates and assumption changes). These stepwise projections can then be used to construct an analysis of change that fulfills the disclosure requirements.

Many companies already produce waterfall-type analyses showing such breakdowns under current IFRS 4 reporting. However, the updated contract grouping requirements and increased complexity of the CSM under IFRS 17 introduce additional challenges to these analyses, and companies should consider including the disclosure requirements of IFRS 17 in their initial gap assessments.

### Coverage Units

In each reporting period, a portion of the CSM for a group of insurance contracts is released to reflect the transfer of services for that period, as described by paragraph B119. This release of CSM represents a company's expected profit for the period. The amount to be released is determined by reference to "coverage units" within the group, such as face amount, policy count, or annualized premium, which are not specifically defined in the standard. The choice of different coverage units may lead to varying patterns of profit emergence, depending on the nature of the product. For some products, such as term life insurance, the choice of coverage units may be less influential, as the coverage units maintain fairly stable proportions over the product life irrespective of how the company defines them. For other products, such as universal life insurance, the choice of coverage units is much more consequential.

As the choice of coverage units has a direct impact on a company's income statements under IFRS 17, companies should begin thinking through what coverage units best reflect the nature of each grouping of insurance contracts. Analysis of the impact of different choices for coverage units can also be included in financial impact assessments as companies seek to understand the impact of IFRS 17 on their business. Additionally, as the standard does not specify a level at which coverage units should

be consistent between product groupings, companies will likely want to discuss the consistency of chosen coverage units with their auditors.

## TRANSITION

Unlike some valuation bases, such as U.S. principle-based reserving (PBR), IFRS 17 is a fully retrospective standard which means that all policies must be reported on this new basis. Once a company has developed their methodologies and tools, it then has a very large exercise to go back and determine what all of its old business would have looked like on an IFRS 17 basis. This section discusses some of the apparent challenges and possible solutions to transition.

### Transition Approaches

To address the complexities of transition, an entire appendix within the standard (Appendix C) is included to discuss the effective date and transition. The details provided in this appendix cover the whole process of transition, and the decision that companies have to make boils down to choosing what methods should be used for old business.

The standard prescribes that the full retrospective approach (FRA) should be used (paragraph C3) unless it is “impracticable” to do so. Under the FRA a company would be required to calculate the IFRS 17 balances from inception to the transition date in order to determine the CSM at the date of the opening balance sheet. For most companies this may be exceedingly difficult if not impossible for much of their business, especially the older contracts. In recognition of this, the IASB included provisions for simplified methods in the standard. Where the full retrospective approach is impracticable, companies can choose either the modified retrospective approach (MRA) or the fair value approach (FVA).

A large determinant of the choice between FRA, MRA and FVA will be the availability of data, and the approach which is adopted may vary by block of business and age. A possible approach when performing initial impact assessments might be to assume a FRA for business back “x” years where data is more readily available, and then the FVA or MRA approach is used for older business as appropriate. Such an approach would be subject to refinement as a company determines what level of data is truly attainable. Engaging early with auditors and, where applicable, regulators will smooth the process a company experiences.

### Data Needs

As mentioned above, availability and granularity of data are key factors in deciding which approach a company can adopt. To be able to perform the FRA all of the following data would be required for the whole history of the product:

The exercise of transitioning from IFRS 4 to IFRS 17 for in-force business is a very significant undertaking. ...

- Assumptions (economic and insurance)
- In force policy data
- Experience cash flows
- Reinsurance treaties

Given that some policies were issued many decades ago, the likelihood that companies have these data elements readily available is slim. Where this information is not “available without due cost or effort” (paragraph C6), then either the MRA or the FVA will be used. In deciding between the MRA and the FVA, companies will need to consider that the MRA still requires “reasonable and supportable” data as well as considerable estimation effort, while the FVA is still subject to uncertainty regarding application as the IASB has not provided significant additional guidance. It is worth noting that paragraph B37 states that “Information available from an entity’s own information systems is considered to be available without undue cost or effort.”

To assess the availability of data, companies need to undertake significant data mapping exercises. This allows companies to understand what data is available and where there are gaps, providing evidence to demonstrate impracticability where the FRA is not adopted. As the transition process will come only after a company’s methodologies and tools have been developed, this allows time to consider the various approaches. Where companies perform the data analysis earlier they will have more time to discuss with their management and auditors.

### Practicalities

The exercise of transitioning from IFRS 4 to IFRS 17 for in-force business is a very significant undertaking even when all of the technical issues have been reasonably considered. That said, companies can consider a few things to help them speed up their transition initiatives.

The grouping of new policies for the CSM calculation is at an annual level for new business. However, this requirement doesn’t exist for existing business (paragraph C10 and C23). Grouping policies into larger groups may have a number of benefits: potential mitigation of volatility in the CSM, more policies in a group when considering if a block is onerous, fewer groups to run through models, and fewer groups for which to determine



the CSM. These benefits have to be weighed against computing requirements from having very large in force policy data files. Depending on the products, companies may consider splitting the business into 5-year blocks as a suitable compromise. When determining such groupings, an important consideration is that the discount rate curve for each block needs to be determined. Companies are able to use a weighted average approach, but may also want to consider changes in interest rate environments when determining the grouping.

The introduction of new regulations and financial reporting requirements provides an opportunity for companies to reassess their actuarial, data infrastructure, and processes. The introduction of PBR for life products in the United States led to a number of companies shifting modeling platforms. Depending on the priorities and structure of the company, technology solutions will range in effort and cost.

## CONCLUSION

IFRS 17 brings with it many new challenges which companies need to start considering. Many of these revolve around data either for calculation of the CSM or for the transition, but challenges also exist for other building blocks. In the next is-

sue, we will continue to investigate these challenges and how companies may begin to think about the solutions specific to their business. ■



Michael Beck, FSA, FIA, is a manager at KPMG. He can be reached at [michaelbeck1@kpmg.com](mailto:michaelbeck1@kpmg.com).



Laura Gray, FSA, MAAA, is a principal at KPMG. She can be reached at [lgray@kpmg.com](mailto:lgray@kpmg.com).



Gavin Stewart, FSA, MAAA, is a manager at KPMG. He can be reached at [gtstewart@kpmg.com](mailto:gtstewart@kpmg.com).

**LIVING to 100**  
SOCIETY OF ACTUARIES  
INTERNATIONAL SYMPOSIUM

**SOCIETY OF ACTUARIES**

## Human Longevity Around The World

During the sixth Living to 100 Symposium, leaders from around the world shared ideas and knowledge on aging, rising survival rates and implications caused by increases in aging populations. The monograph is now available and captures the conversations on living longer, its impact on social support systems and the practical needs of advanced-age populations. Discover featured sessions and material from the Living to 100 Symposium.

[livingto100.soa.org](http://livingto100.soa.org)