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IFRS 17 – Don’t trip up in the last stretch

With just less than four months remaining until the go-live date of 1 January 2023 for *IFRS 17 Insurance Contracts* (IFRS 17) (for insurers with a December year-end), the insurance industry has reached the last stretch of the implementation journey. Progress has been made and lessons have been learnt, and although it feels like it has often been two steps forward and one step back, the industry is slowly but surely moving closer to the finish line. In this article we consider some of the current challenges experienced within the industry, as a guide to assist you in overcoming the last hurdles.

Impracticability

IFRS 17 requires an entity to apply the standard fully retrospectively, unless it is impracticable to do so (par C3). The standard however does not define “impracticable”. Entities must consider their interpretation of what they define as “impracticable”. This consideration has been top of mind for the insurance industry as it directly impacts the adoption of the standard and involves significant management judgement, and it remains a key hurdle to overcome. Not only does the entity’s implementation team have to be comfortable with the decision, but various stakeholders also need to be satisfied. Although insurers may have had an initial “gut feel” for where fully retrospective application would be impracticable, this assessment may have been further refined as insurers enhanced their understanding of the standard, particularly the detail required relative to the information available to the entity. Included below are the common areas of consideration which insurers have been grappling with in respect of the impracticability assessment:

- Data requirements – IFRS 17 requires a significant amount of data at a more granular level than what was required under *IFRS 4 Insurance Contracts* (IFRS 4). A comprehensive understanding of current data flows (and how these have changed over the years) is key in determining what data is available for IFRS 17 calculations. The data requirements and data availability may differ between products and may differ where intermediaries have been or are involved. As data from previous financial reporting years will be used in the adoption of IFRS 17, entities should also consider how confident they are with the quality of historical data, and what controls are in place to ensure that this data has not been inappropriately altered over the years.

- Systems – legacy systems are prevalent in the insurance industry. Understanding the capabilities and limitations of these legacy systems is key in determining impracticability. Information may not have been stored in a sufficient level of detail, or may be irretrievable or unreadable from older systems. Entities with multiple legacy systems may also struggle to collate historical data due to differences in previous data formatting and capturing. A complete understanding of how these systems interlink, the data available from these systems and how to retrieve this data is key in an entity’s impracticability assessment. It is also important for an insurer to understand how systems have evolved over the years, including migration of data between systems and adequacy of embedded controls.

- Modelling – an understanding of the modelling of technical provisions undertaken in prior years is necessary in understanding where there may be limitations and where fully retrospective adoption may not be possible, particularly where significant modelling changes were made. Models under IFRS 4 are not always IFRS 17 compliant and may need to be updated. Insurers need to determine whether the older models can be updated and whether the time and effort needed to do so is worth it. Insurers need to consider whether the changes required to IFRS 4 models are material, or whether these can be accepted under IFRS 17 based on materiality. If models cannot be updated or the difference in the insurance result using an older model cannot be quantified, this may impact the impracticability consideration.

Once the impracticability decision has been made, documentation of the factors and thought process is imperative to ensure that the decision can stand up to interrogation – both now as we enter IFRS 17 go-live, and also in the upcoming years when the arguments supporting impracticability drivers are no longer at the forefront of everyone's minds.

Where business is written prior to the impracticability date, the insurer has a choice of applying the fair value or the modified retrospective approach. This requirement is in line with IFRS 17.C5 which states that if, and only if, it is impracticable for an entity to apply paragraph C3 for a group of insurance contracts, an entity shall apply the modified retrospective approach, or the fair value approach. There is no hierarchy in the choice between modified retrospective or fair value approach, except that if the modified retrospective approach is not feasible given the lack of reasonable and supportable information, then the fair value approach must be adopted. This gives the entity some flexibility to select an approach that best reflects their desired outcome in terms of the contractual service margin (CSM) at transition which determines the opening balance of the comparative period on adoption of the standard, and future earnings from those opening CSM balances.

Fair value

Within the South African market, a significant number of insurers initially opted for the fair value approach rather than the modified retrospective approach, where a fully retrospective approach was deemed impracticable. However, determining fair value for these groups brings its own complications as IFRS 17 does not prescribe the calculation to be followed in determining a fair value. What may have previously been seen as an easier alternative to fully retrospective adoption has become an area of equal debate as IFRS 17 implementation has progressed. *IFRS 13 Fair Value Measurement* contains guidance which insurers must apply when determining the fair value of a group of insurance contracts at the transition date, in order to ultimately calculate the CSM, or loss component of the liability for remaining coverage at that date.

Areas of judgement in the fair value calculation include the buyer's required return on the transaction, the level and diversification of capital and how to allow for cross subsidies between products and anticipated business synergies as a result of the transaction. All of these are assessed from the willing buyer's perspective but the absence of an active market and the limited availability of comparable transactions to inform reasonable ranges makes this option challenging.

As projects have matured, we have seen more insurers electing the modified retrospective approach instead of the fair value approach, where the fully retrospective approach is impracticable.

Modified retrospective approach

When insurers select the modified retrospective approach, the outcome is closer to full retrospective application than that achieved when using the fair value approach.

Where entities have attempted a fully retrospective approach for groups of insurance contracts, but are faced with limitations, the permitted modifications allowed by the standard are limited to the following areas:

a) assessments of insurance contracts or groups of insurance contracts that would have been made at the date of inception or initial recognition;

b) amounts related to the CSM or loss component for insurance contracts without direct participation features;

c) amounts related to the CSM or loss component for insurance contracts with direct participation features; and

d) insurance finance income or expenses.

By applying the modified retrospective approach, an entity maximises the use of information that is available without undue cost or effort that would have been used to apply a full retrospective approach. This approach provides entities with a reasonable "middle ground" in the adoption of IFRS 17, where a fully retrospective approach is impracticable, but where a significant amount of information is available that the entity can utilise in its transition calculations.

When fully retrospective adoption is impracticable, the modified retrospective approach may result in a higher CSM at transition compared to the CSM calculated using the fair value approach. This in turn will translate into higher future earnings as the CSM is released over time. For some risk business, the resulting profile of profit emergence may align more closely with existing profits reported under the current accounting framework.

An entity may also be aiming to be as consistent as possible in their transition approaches. In some jurisdictions (i.e., the European insurance market), the modified retrospective approach is expected to be favoured over the fair value approach – this could be another key driving factor of the transition methodology adopted by South African based subsidiaries or branches of global based (re)insurers.

Once impracticability has been determined, insurers should consider whether the modified retrospective approach is an option for the groups of contracts, and whether opting for the modified retrospective approach or the fair value approach is more appropriate. If, however, reasonable and supportable information is not available to apply the modified retrospective approach, the only remaining option is to apply the fair value approach.

The transition balance sheet

Insurers are working towards the opening transition balance sheet, which includes the calculated CSM and the impact on retained earnings. As a more refined balance sheet is prepared, insurers must consider how and when the adjustments are communicated to various internal and external stakeholders. Stakeholder education is key in ensuring recipients understand the adjustments or changes to retained earnings and the disclosure on the level and extent of judgements and assumptions that resulted in the change to the opening retained earnings balance. Although many insurers may only have an expected range of the equity impact at this point in their implementation projects, it is vital to get the timing of communication with stakeholders right.

Communication that is too early may result in many iterations and changes before a final adjustment is released, whereas delayed communication may result in growing anxiety particularly where peers have communicated their balance sheet impacts. Either way – with go-live day edging closer – time is running out.

Financial statements "pre-IFRS 17"

As we move towards the first set of results under IFRS 17, it is important for insurers to remember the disclosure in current financial statements for standards issued but not yet effective. This is required for reporting leading up to adoption, as specified in paragraph 30 of *IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors* (IAS 8). The disclosure is expected to increase in detail as an insurer moves closer to adopting IFRS 17. Although IAS 8 disclosure has been relatively light across the industry in prior financial reporting periods (something that we have seen across both the South African market and further abroad), insurers will be hard-pressed to provide sufficient disclosure for a user to understand the expected impact of IFRS 17, in the financial statements immediately preceding adoption of the standard. Insurers should also not neglect interim reporting, which may be required during the first year of adoption, and should focus on getting this reporting as accurate as possible to avoid discrepancies between interim reporting, and the first full year reporting under IFRS 17.

Impacts to IFRS 4

The extensive work at a more disaggregated level as required by IFRS 17 has led to some insurers identifying potential issues in their current IFRS 4 reporting. As these concerns may relate to current reporting, this is an area that insurers have had to deal with immediately in financial statements for the years before IFRS 17 is adopted, adding more pressure to the IFRS 17 project. Areas where insurers may encounter issues include misclassification of products, errors within modelling calculations, and data errors/inconsistencies. It is expected that this area will develop further as insurers work through the potential issues, firstly to determine whether these are concerns that impact current IFRS 4 reporting and how they will be dealt with in the current financial statements, and secondly how these will be dealt with for IFRS 17.

Getting to the finish line

Time is no longer on the side of insurers. The effective date for adoption of IFRS 17 has already been extended twice – initially from 2021 to 2022, and then to 2023, but since then insurers have had their hands full with dealing with the impacts of COVID-19 and the resultant shortage of capacity and skills in the industry. This overall lack of resources has pushed many implementation projects into a red status, where timely adoption of the standard is at risk.

For many insurers a parallel run period in the year before adoption is no longer viable; many insurers will be working through teething problems in a live environment. This will place further strain on the current resource base as processes and controls for the business are being established while reporting concurrently on results.

Although the focus is now on finalising the transition balance sheet, this must soon shift to providing restated comparatives and to achieve the end state business as usual processes that insurers had in mind when commencing with their IFRS 17 implementation projects. The go-live date may be edging closer, but the industry still has a way to go before we are truly settled into our new IFRS 17 world.

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