Financial Reporting Council

9 December 2022

**Insurance audits under IFRS 17**

Dear Sir/Madam

IFRS 17 is effective for annual reporting periods beginning on or after 1 January 2023, replacing the interim standard IFRS 4. Given the significance of the change, the FRC is keen to understand the steps audit firms are taking to prepare for IFRS 17, including the actuarial aspects, so that it can fulfil its regulatory obligations in relation to audit inspections of entities reporting under the new standard.

To that end, in December 2021, the FRC issued an information request letter (IRL) to the largest eight audit firms in the UK. We subsequently discussed responses with representatives of each audit firm and sought further input at a roundtable discussion in November 2022.

The key findings from this exercise are summarised in this letter, which has been sent to the Insurance Business Unit leaders at the largest eight audit firms in the UK.

## Data and Systems

IFRS 17 requires insurance entities to gather a significant amount of new data that is unlikely to be currently gathered under IFRS 4. Some of that data may be difficult to obtain, or may require the quality and reliability to be assessed. Examples include policy clauses for purposes of determining contract boundaries, issue dates for annual cohorts if issued by third parties with binding authorities in place, and data collected by intermediaries.

In the IRL responses, audit firms anticipated that their audit methodology to assess the quality of data would largely follow existing methodology (including for example, walkthroughs, risk assessments, testing of data and IT controls and substantive testing), with the main impact of the increase in data items being a substantial increase in amount of work during the build up to implementing IFRS 17.

Given the level of data complexity associated with IFRS 17, we encourage audit firms to consider the comments made in the FRC's letter of 10 September 2021[1] where we encourage

[1] https://www.frc.org.uk/getattachment/a333f78d-b90b-480d-9b4a-d011d64888c5/Feedback-on-the-actuarial-aspects-of-insurance-entity-audits-10-09-21.pdf

audit teams to clearly set out in their audit files the divisions of responsibility for checking data sets between the core audit team and actuarial specialists; and in the situation that the core audit team is responsible for all data testing, we still consider it important that the actuarial specialists and experts check the data is appropriate for the modelling exercise in question, as per provision 2 of Technical Actuarial Standard (TAS) 100.

## Methodologies and Models

Under IFRS 17 insurance entities will need to determine the appropriate methodology to use to calculate the Liability for Incurred Claims and the Liability for Remaining Coverage. To comply with the requirements for the Contractual Service Margin (CSM) under the General Measurement Model (GMM) and Variable Fee Approach (VFA) models, entities may have developed complex models to allow for the higher level of granularity and larger volumes of historic data. This has necessitated entities undertaking significant systems developments, with models either built internally or purchased from external vendors.

In their IRL responses, audit firms noted that entities are at varying levels of readiness in terms of implementation, testing and dry-running of their models. Audit firms anticipated to continue their approach to auditing models as under IFRS 4, with a greater emphasis on substantive testing for the opening balance sheet. To validate the modelling of the CSM, a new component of balance sheets, some audit firms intend to use their own internally built audit tools.

Where the auditors and/or actuarial specialists are relying on in-house software, we encourage audit firms to consider the comments made in the FRC's letter of 10 September 2021 that it is important that the audit firm is able to demonstrate how they have gained comfort that the software is operating as intended.

## Assumptions and Judgements

The principles-based nature of IFRS 17 leaves entities considerable scope to apply expert judgement when developing methodologies and assumptions. Our interactions with audit firms highlighted many such areas of judgement.

The insurance entity's approach to determine the **risk adjustment for non-financial risk** depends on the entity's appetite for risk and choice of risk measurement metrics. The calibration of the risk distributions involves significant expert judgements. As such, the methodology and calibration to the risk adjustment may vary widely.

IFRS 17 allows a number of approaches to setting **discount rates**, both in the choice of a top-down or bottom-up approach and in the application of the chosen approach.

Audit firms noted the selection of the reference portfolio and the allowance for credit default risk as key judgements when the top-down approach is applied. In the case of the bottom-up approach, audit firms noted the subjectivity of the adjustment for illiquidity.

There are a number of areas within the **contractual service margin** calculation where entities have significant scope for interpretation and judgement. Audit firms highlighted many such areas, for example in the determination of coverage units, the weighting of insurance services and determining which assumptions are locked-in when adjusting the CSM.

With regard to audit approaches, many audit firms emphasised that they would gain assurance from entities' consistent application of methodologies from period to period. While audit firms already have established approaches to auditing expert judgements, for example when reviewing assumptions under IFRS 4, it was clear from the IRL responses received that audit firms considered the risk of management bias to be raised under IFRS 17 and that application of professional scepticism would be crucial.

The actuarial specialists and experts must perform their audit work with professional scepticism, as required by provision 19 of TAS 200, and paragraph 15 of ISA (UK) 200. We encourage audit firms to consider the comments made in the FRC's letter of 18 May 2022[2] in relation to professional scepticism.

## Transition Balance Sheet

Audit firms noted that many insurance entities may be operating under more time pressure than they originally anticipated in the production of the Transition Balance Sheet. Audit firms suggested that many entities may be using different models and systems for the transition balance sheet than for subsequent business-as-usual production. As a consequence, audit firms may place a greater emphasis on substantive testing than controls reliance for the transition balance sheet.

Entities' assessments of the impracticability of the **Full Retrospective Approach** (FRA) presents an inherent risk of management bias, given that the FRA and Fair Value Approach (FVA) may have significantly different financial outcomes and operational complexity. Determination of which factors contribute to impracticability will differ between entities, depending upon availability of models, data, and assumptions, without the benefit of hindsight. In the IRL

[2] https://www.frc.org.uk/getattachment/251a5a08-e73f-4969-8526-bbef850626d6/DAP-Letter_2022.pdf

responses, audit firms noted that they would be employing a heightened level of professional scepticism to challenge entities' impracticability assessments across all products and units of account.

Audit firms did not consider the **Modified Retrospective Approach** (MRA) to be a judgement area, as the circumstances where the approach can be adopted are specified within IFRS 17.

Audit firms indicated that across life insurance entities they would anticipate a significant number of contracts to be measured using the **Fair Value Approach** (FVA) as well as some adoption of the approach amongst non-life entities. The assessment of fair value is a significant judgement due the relatively limited availability of market transaction data. In carrying out their work, audit firms are expecting to challenge whether entities had considered using all available market information, including in similar or adjacent markets, and on the extent of compliance with IFRS 13 Fair Value Measurement.

The audit file should contain sufficient evidence to support the conclusions drawn as required by paragraph 4 of ISA (UK) 500. Given the significance of expert judgement in applying the actuarial aspects of IFRS 17, we encourage audit firms to consider the comments made in the FRC's letter of 18 May 2022 where we encourage actuaries performing audit work to ensure that professional scepticism is clearly evidenced in the actuarial working papers or actuarial reports within the audit file.

If you would like to discuss the contents of this letter, please contact your usual supervisory contact at the FRC.

Yours faithfully

**Mark Babington**
Executive Director, Regulatory Standards