The role of Internal Audit in IFRS 17

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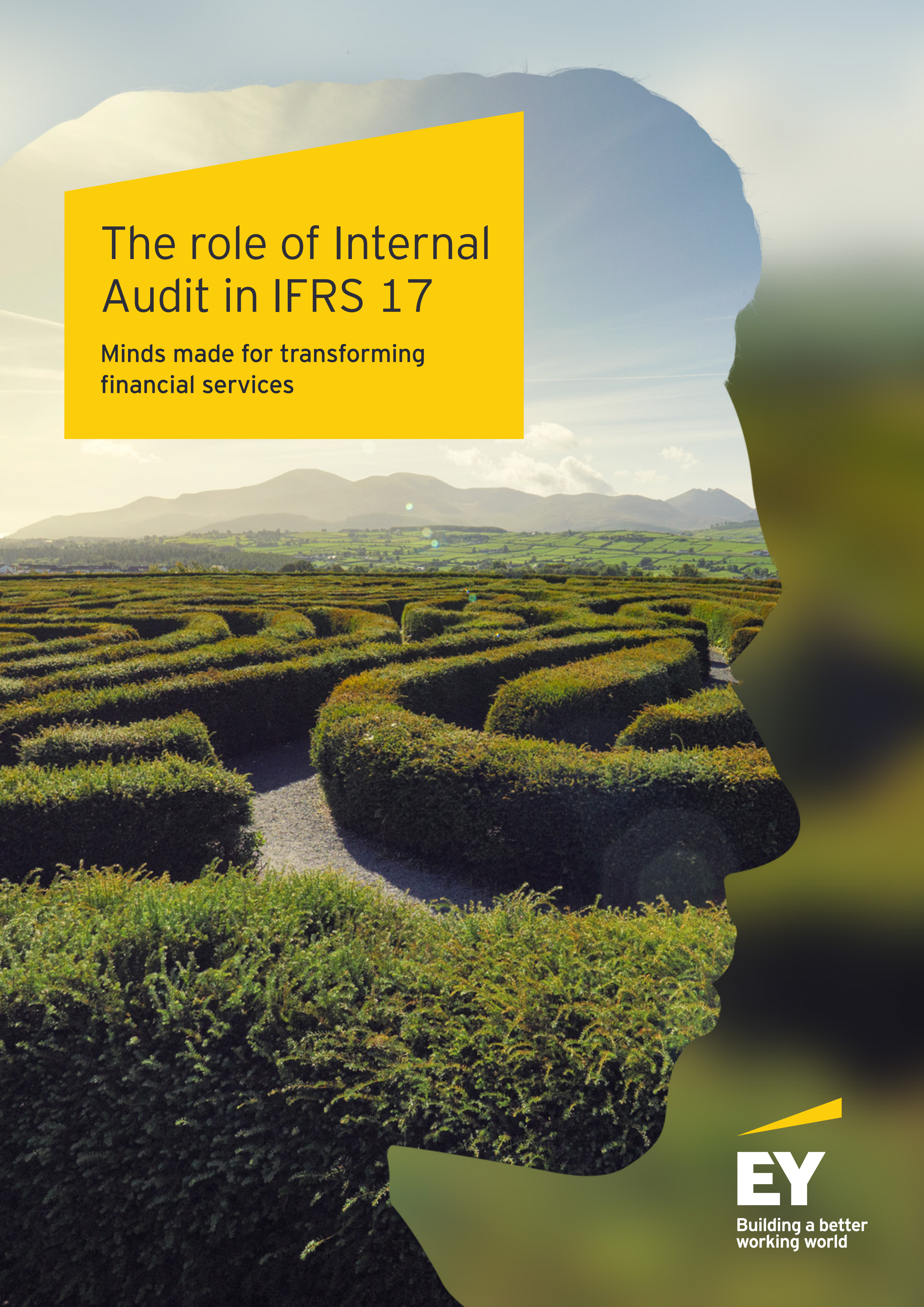

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Minds made for transforming financial services

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Content

In May 2017, the International Accounting Standards Board (IASB) issued IFRS 17 *insurance contracts* (IFRS 17 or the standard) - the most significant change to insurance accounting requirements in over 20 years. The standard is expected to be first applied for reporting periods starting on or after 1 January 2022.

IFRS 17 will have wide-ranging impacts on businesses, including, but not limited to, the financial accounting and actuarial systems, performance measurement, and operating models for financial reporting.

Compounding the scale and complexity of the change is the fact that the standard is still evolving, and the knowledge and understanding of what "right answers" should look like is only beginning to develop. The IASB has considered the concerns and implementation challenges raised by stakeholders. In June 2019 it issued an Exposure Draft proposing a number of limited amendments to IFRS 17. The comment period closed in September 2019.

Due to the complexity involved in an IFRS 17 implementation project, it is important that Internal Audit has a "seat at the table", providing comfort the program is running effectively and risks are identified and addressed as and when they arise.

From an Internal Audit perspective, involvement should span across the whole IFRS 17 lifecycle. The scope of Internal Audit's activities will vary by organization, but will include:

- The governance of the IFRS 17 project
- The core system changes
- Training of people
- Process design and operation

Summary of IFRS 17

Historically, insurers have not been subject to a globally harmonized set of principles for recognizing the profit and loss arising from insurance contracts. IFRS 17 seeks to increase the transparency of insurers' financial positions and performance, and is intended to make their financial statements more comparable with those of both other insurers and other industries.

The key changes introduced by IFRS 17 are:

- Insurance contract revenue is reported on an earned basis and will exclude the receipt and payment of investment components.
- Revenue and expenses are recognized as earned or incurred over the coverage period of contracts.
- Insurance finance expense is excluded from insurance service result and is presented (i) fully in profit or loss or (ii) in profit or loss and Other Comprehensive Income (OCI), depending on accounting policy.
- Insurance liabilities are measured on a probability weighted best estimate basis plus an allowance for risk, and a Contractual Service Margin (CSM) which spreads the profit on the contract over the coverage period.
- Written premiums are disclosed in the notes.

IFRS 17 requires insurers to distinguish at initial recognition between groups of contracts that are expected to be profitable and those that are expected to be loss-making with losses recognized up front in profit or loss.

For this to happen, insurers will need to identify portfolios of insurance contracts subject to similar risks and managed together. Insurers will need to further divide these portfolios for recognition and measurement purposes into groups of contracts which are expected to be loss-making, those (profitable contracts) with no significant risk of becoming loss making in the future, and all other profitable contracts. Contracts issued more than a year apart cannot be included in the same group.

The Standard allows for three different approaches to measuring the liability to policyholders arising from insurance contracts:

1. The General Model (formerly The Building Block Approach)

- This is the default valuation approach.
- Insurance contract valued using fulfilment cash flows – the present value of expected weighted average future cash flows, plus a risk adjustment.
- Insurance contract liability will include the CSM, which represents unearned profit the insurer recognizes as it provides services under the contract.

2. The Premium Allocation Approach (PAA)

- An optional simplified approach for contracts with a coverage duration of one year or less, or where it is a reasonable approximation to the General Model.
- Many non-life, and some life, insurance contracts will meet these criteria.
- Insurance contract valued as a pre-claims coverage liability and an incurred claims liability.
- Similar approach to existing non-life insurance contract accounting models.
- The PAA does not require an explicit CSM measurement and contains certain other practical expedients.

3. The Variable Fee Approach (VFA)

- Applies to certain participating contracts, as defined by three criteria, but based on policyholders sharing in the profit from a clearly identified pool of underlying items. This approach is based on the general model with some modifications for these direct participating contracts.
- Insurance contract liability based on the obligation for the entity to pay the policyholder an amount equal to the fair value of the underlying items, net of a consideration charged for the contract – a "variable fee" for the service it provides reflecting the entity's share of the fair value of the underlying items.

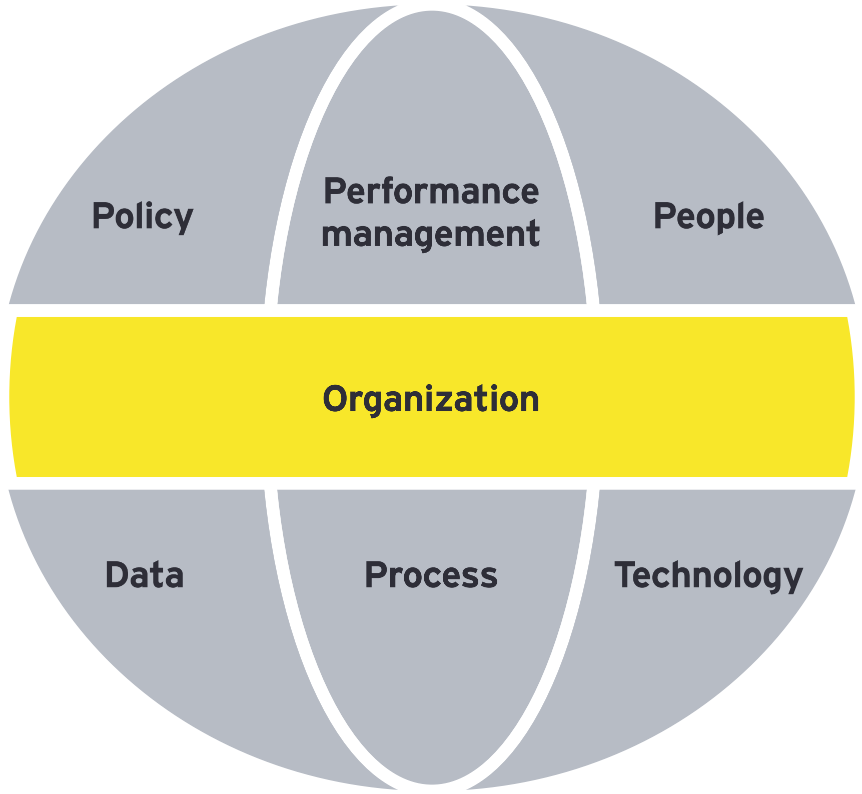
Impact on the business

Correctly implemented, IFRS 17 will provide better information about the current and future profitability of insurance contracts.

This information will improve the transparency of reporting for insurance contracts and provide additional and more comparable information for investors and other users of financial statements for their decision-making.

It represents a significant change for insurance finance functions, which will require system and process changes, and training. Insurers applying full IFRS are expected to have no option but to comply with the new standard by 2022, and getting this right will be a critical goal. This requires firms to consider the treatment of long-term contracts from inception, with associated data changes, process changes, and staff training to deliver on the changes.

The impact of this change across the business is represented in the below diagram:



Policy

- New accounting policies and procedures and control documentation
- IFRS 17 methodology guidance and reporting instructions
- General ledger chart of accounts changes and account mappings
- Assumptions setting (for modeling)
- Accounting policies for financial investments (*Financial Instruments* IFRS 9)

Performance management

- Changes in Management Information reports and KPIs
- Planning, budgeting and forecasting proceses need to be adjusted
- Value-based management, scorecards and incentive schemes

People

- Training
- Cross functional collaboration (especially for finance and risk)
- Project resourcing and budget
- Managing change fatigue

Organization

- Clear roles and responsibilities between actuarial and finance departments
- Technical provisions assumptions and expert judgement committee
- Impact on outsourcing contacts

Data

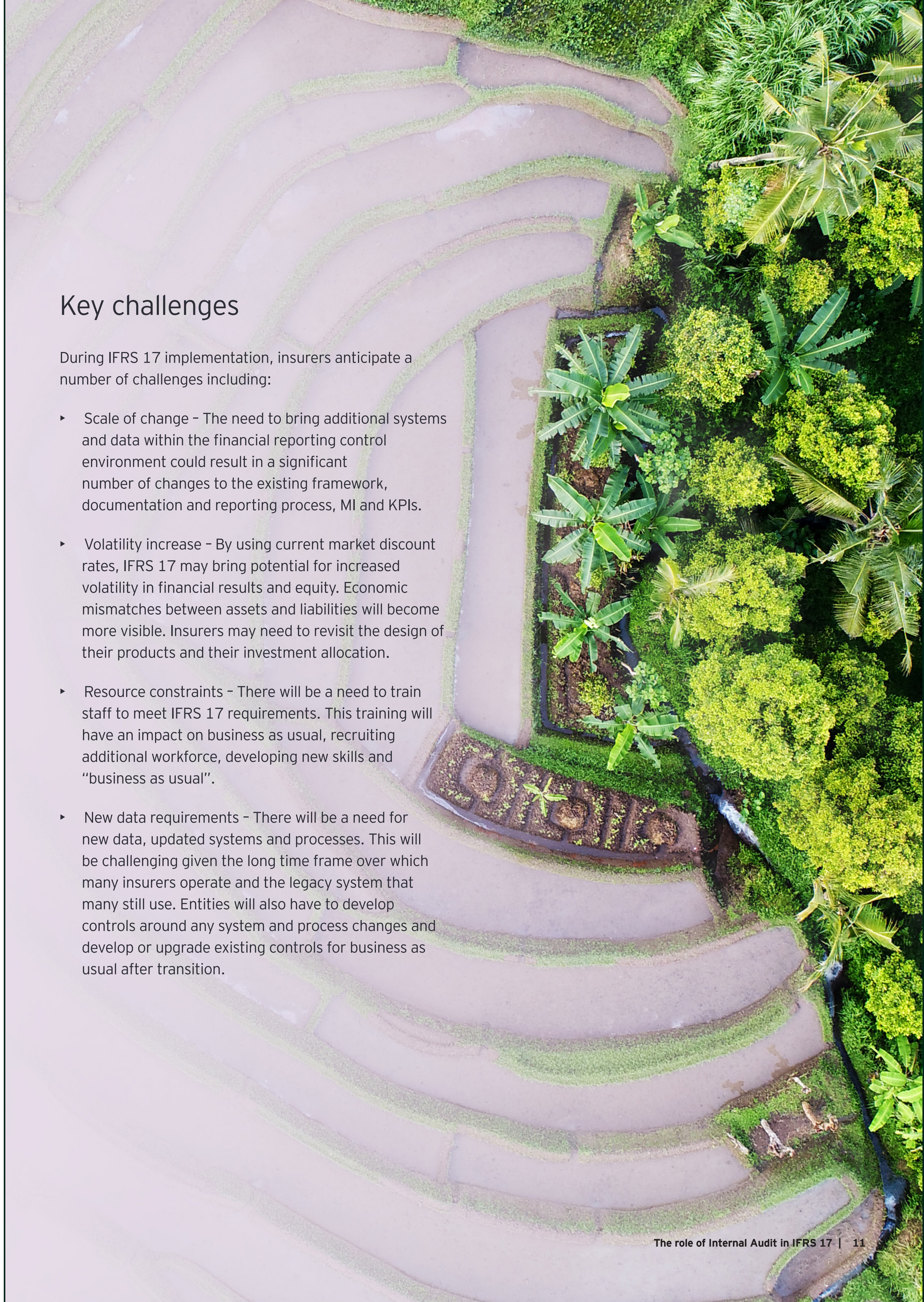
- Refinement, upgrading, conversion and migration of (complex) actuarial valuation models
- New financial reporting data requirements (input/output)
- Data reconciliations at different levels
- Data quality, security and controls
- Data governance and master data management

Processes

- Materiality concepts guidelines
- Updating closing and reporting procedures, planning processes, actuarial processes and risk management
- Internal and external reporting templates including group reporting packages
- Internal controls and audit trail

Technology

- Core system, investment system, actuarial systems, pricing systems
- Accounting posting logic or engine
- General ledger, consolidation package and reporting systems
- System interfaces
- Current system capacities and capabilities (agile technology)
- New functionalities and features



Key challenges

During IFRS 17 implementation, insurers anticipate a number of challenges including:

- Scale of change – The need to bring additional systems and data within the financial reporting control environment could result in a significant number of changes to the existing framework, documentation and reporting process, MI and KPIs.
- Volatility increase – By using current market discount rates, IFRS 17 may bring potential for increased volatility in financial results and equity. Economic mismatches between assets and liabilities will become more visible. Insurers may need to revisit the design of their products and their investment allocation.
- Resource constraints – There will be a need to train staff to meet IFRS 17 requirements. This training will have an impact on business as usual, recruiting additional workforce, developing new skills and "business as usual".
- New data requirements – There will be a need for new data, updated systems and processes. This will be challenging given the long time frame over which many insurers operate and the legacy system that many still use. Entities will also have to develop controls around any system and process changes and develop or upgrade existing controls for business as usual after transition.

The role of Internal Audit in IFRS 17

Given the size of the change and risk that an ineffective implementation would present to the business, IFRS 17 programs will likely form part of any Internal Audit risk assessment in upcoming years.

Internal Audit's activities should follow the diagram opposite to better understand the IFRS 17 implementation and how Internal Audit can best assess the risks the business faces:

1. Secure early involvement with first and second Lines of Defense to understand the opportunities and risks IFRS 17 poses across the business.
2. Undertake a health check on how the organization is setting up for IFRS 17 implementation success.
3. Develop an ongoing program of assurance work, focusing on whether the IFRS 17 program is likely to deliver intended outcomes in line with regulatory expectations.
4. Align planned activity to fit pragmatically within an overall organizational "assurance map".
5. Assess required skills so Internal Audit will be able to provide the necessary assurance at the right time.

What would an Internal Audit scope include?

IFRS 17 will represent a major change program and will extend beyond finance and actuarial teams. It will impact insurers' processes, people and technology. The diagram below summarizes the typical workstreams and responsibilities involved in an IFRS 17 implementation.

Benefits Management

- Track program benefits throughout lifecycle
- Track activities for alignment with business case and key stakeholder objectives
- Work with project management to report program performance against business case to program leadership

Finance and Accounting

- Develop implementation roadmap and plan
- Create disclosures and reports
- Create end-to-end reporting processes and target operating model (TOM)
- Transition (first time adoption)
- Assumption management
- Develop and update IFRS policies
- Develop policy guidance
- Implement global policies
- Develop governance and track compliance

Investments valuations

- Define IFRS 9 classifications of financial assets and data sources
- Develop investment models
- Build validation tools
- Test model output
- Map output to reporting templates

Change management

- Monitor and manage change impacts to key stakeholders groups
- Develop and implement a strategy to facilitate change to minimize the impact of the change
- Develop and publish program messaging for consistency

Data, systems and process development

- Develop system requirements and reporting processes
- Develop technical specifications
- Build systems and environment
- Test the build and fix bugs and errors
- Design and document future state processes
- Perform data quality analysis and develop gap closure plan
- Develop guidance
- Build data models and test the output

Internal controls

- Review internal controls over financial reporting plan
- Identify new controls and processes including new in-scope systems over financial reporting
- Test governance over controls
- Develop plan to test controls as they are designed and implemented

Actuarial and risk

- Define CSM and IFRS 17 methodology
- Develop actuarial models
- Build validation tools
- Test model output
- Map model output to reporting templates
- Assumption management

Project management

- Command center and communications hub for all workstreams
- Liaison between all teams and program leadership
- Provides overall program oversight and governance
- Tracks and reports project status to leadership

It's important that core scoping considerations are thought through for each workstream, as illustrated below:

Governance and program, benefits and change management (Governance structure)

- Adequacy of delegation of authorities
- Clarity of responsibilities and accountabilities across the business
- Adequacy and sufficiency of policies in place and how they are embedded at all organizational levels
- Appropriateness of three Lines of Defense model being applied across the business
- Adequacy of the actuarial function in first and second Lines of Defense
- Clarity over remit of the risk management function

Data, systems and processes (DSP)

- Adequacy of data governance operating model and its effectiveness (including awareness of individuals roles and responsibilities)
- Assesment of the systems and technology in place to support the collection, assesment, calculation and reporting of CSM data in a timely manner
- Assesment of the data quality issues management reporting process
- Compliance with defined data governance processes and/or framework

Actuarial & risk

- Adequacy of the system of governance around the internal models
- Sufficiency of the processes and procedures in place to independently review internal model design and operation
- Extent of demonstrable adherence to all internal model policies
- Adequacy of processes to ensure continual compliance and projection of the best estimate liability (BEL)
- Adequacy of contingency plan if the internal model is not approved

Finance & accounting

- Adequacy of the system of governance around the accounting policies
- Sufficiency of the processes and procedures in place to comply with IFRS, Office of the Superintendent of Financial Institutions (OSFI) regulatory requirements, and other reporting requirements
- Compliance with internal control enviroment
- Compliance with accounting policies and reporting requirements

Investments valuations

- Adequacy of the system of governance around investment policies
- Sufficiency of the processes and procedures in place to independently review investment valuations
- Compliance with the defined investment guidelines

Post-project assurance

Once IFRS 17 programs are implemented, Internal Audit should consider conducting post-implementation audits to provide assurance that new policies, processes and controls, and systems are appropriately embedded and comply with the Standard.

This can include:

- Analyzing new closing and reporting processes, including timelines and responsibilities.
- Reviewing the new statement of financial position and profit and loss formats to ensure they meet new presentation requirements.
- Understanding lessons learned from the implementation of this significant change project.
- Reviewing the effectiveness of the second Line of Defense throughout the implementation of the project.
- Reviewing whether benefits identified prior to initiating the project have been tracked and realized now the project is concluded.

Summary

IFRS 17 is more than just changing accounting treatments for financial reporting. Effective implementation programs will need to consider the governance of businesses, their systems and data, the underlying processes and the staff delivering these processes.

Such wide-ranging and deep change represents a significant risk to organizations, both in their ability to meet the requirements of IFRS 17 and in delivering a solution that is sustainable and well controlled. Internal Audit teams are critical to ensuring that IFRS 17 programs enable an effective output that delivers within risk appetite, and without excessive business disruption.

It's vital Internal Audit teams develop a broad program of activity, covering the full scope of the IFRS 17 program, to deliver assurance to the business.

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