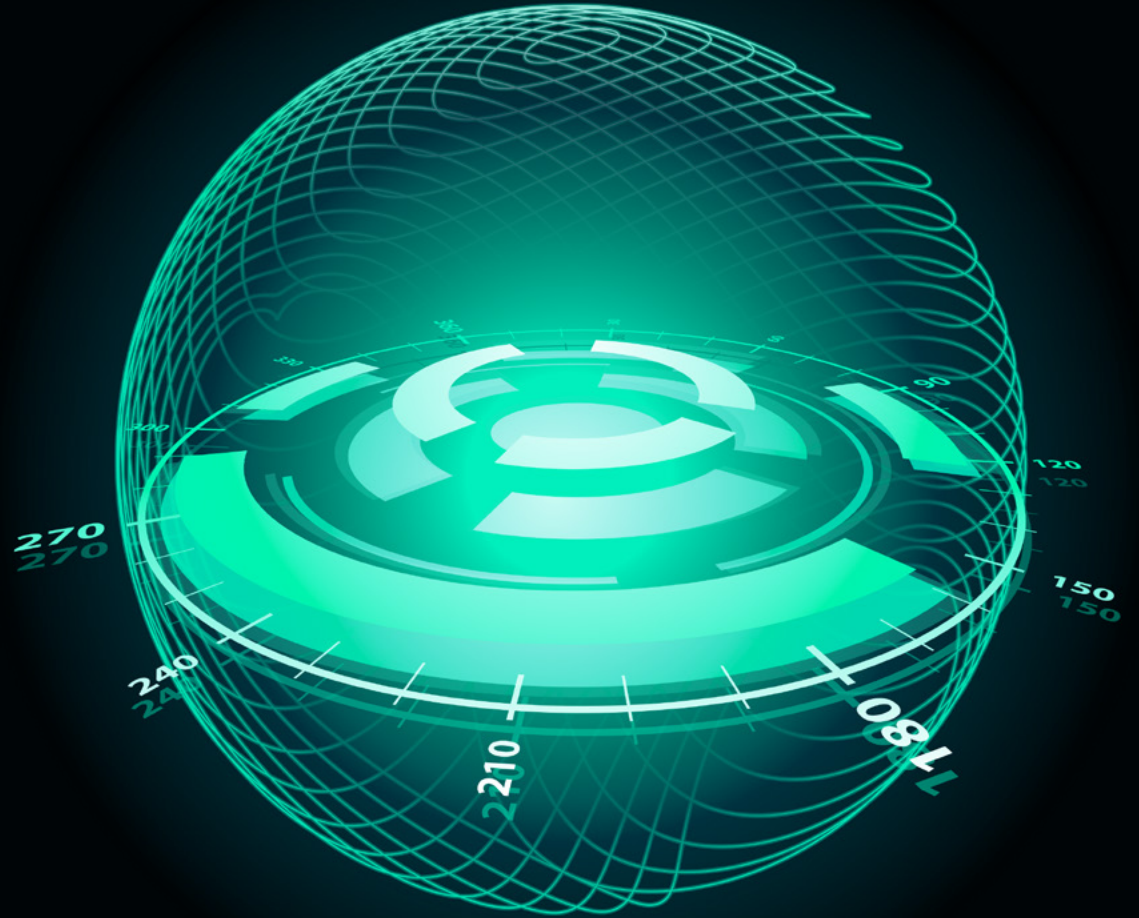




Are you ready  
for an IFRS 17  
external audit?



# Are you ready for an IFRS 17 external audit?



The adoption date of the new financial reporting standard for insurance contracts (IFRS 17) is drawing near. As insurers start entering the home stretch, we expect to see engagement with external audit ramp up significantly. Management need to take steps to ensure that documentation and evidence of implementation and transition activities, as well as new processes and controls to address new risks and changes to financial reporting stand up to external audit scrutiny.

## The external audit process in a nutshell

In determining how insurers can prepare for an external audit under IFRS 17, it is important that those engaging with the auditors understand the context of the external audit approach. During the planning stage of an audit, the auditor performs a risk assessment of the entity, its environment and internal controls. In so doing, the auditor identifies risks that might result in material misstatement to the financial statements and assess to what degree these risks will be significant or not. The higher the level of audit risk identified, the more audit effort that is required to provide the appropriate level of assurance.

Based on the risk assessment, auditors will design and perform audit procedures to address these risks. These procedures could include substantive tests alone (test of detail, such as sample testing, and predictive analytical procedures) or a combined approach of substantive tests and controls testing, which include testing the design and implementation and operating effectiveness of the entity's system of internal control. Where the internal controls

are weak, the emphasis of the audit will be on performing substantive tests which require significant additional effort and are more costly.

In certain instances, auditors will have to take a combined audit approach. Such circumstances are where substantive procedures alone may not provide sufficient and appropriate audit evidence<sup>1</sup> e.g., environments where there are high volumes of data or transactions, complex calculations, several systems with many handoffs and interfaces of data between the systems. Given these circumstances are expected to be prevalent in adopting IFRS 17, as well as the heightened risk of material risk of misstatement in an IFRS 17 set of financial statements, auditors will likely have to test the operating effectiveness of controls in addition to performing substantive testing<sup>2</sup>.

Given the role of internal audit in providing independent assurance that an organisation's internal controls are operating effectively, external audit may seek to rely on the work performed by internal audit in this regard.

External audit will further consider the work of other risk and compliance functions and their role in identifying and managing the risk within the entity.

How management engage with these stakeholders and respond to risk in their IFRS 17 programmes will influence the approach adopted by external audit and the nature, extent and timing of audit work to be done.

<sup>1</sup>ISA 330 *The Auditor's Responses to Assessed Risks* paragraph 8: "The auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls when:  
(a) The auditor's assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively, or  
(b) Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level."

<sup>2</sup>ISA 330 *The Auditor's Responses to Assessed Risks* paragraph 18: "Irrespective of the assessed risk of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance, and disclosure."

Which areas are most likely to increase the risk of material misstatement under the application of IFRS 17?



Actuarial models and the assumptions underpinning these models



Data volume and granularity



Information technology changes



Interim transition solutions



Complex and voluminous disclosures prepared within pressurised timelines



### Actuarial models and the assumptions underpinning these models

In line with the International Standards on Auditing, accounting estimates derived from the data, assumption setting process and actuarial models are susceptible to an inherent lack of precision in their measurement<sup>3</sup>. Further considerations that increase audit risk include:

- **Judgment about the interpretation of the Standard:** IFRS 17 is a principles-based standard, and this results in key drivers of the balance sheet and revenue being open to interpretation and involve judgement which may be subject to management bias.
- **Judgement applied in determining assumptions:** Although insurers are experienced in having to apply judgement in determining subjective assumptions, the requirements of IFRS 17 takes the risk in these estimation processes to new levels.
- **Accuracy of complex models:** IFRS 17 requires models to be calibrated to the requirements of the standard and to solve for complex concepts such as non-distinct investment components, loss components and loss recovery components. This requires changes to existing models and may necessitate the development of new models that are able to produce accurate results.

Significant judgement and estimation uncertainty will be ubiquitous in determining the inputs, assumptions and techniques used to develop accounting estimates, increasing the risk of material misstatement.



### Data volume and granularity

Complete and accurate data is the foundation to the production of relevant and reliable financial reporting and should not be underestimated. All insurers have grappled with the demand of IFRS 17 in this space. Not only has the volume and granularity of data requirements increased, but this data needs to be sourced, interpreted, grouped and used based on the complex technical requirements set out by IFRS 17.

Key drivers impacting data requirements include the level of aggregation on insurance contracts, explicit measurement of the individual components of both insurance and reinsurance contracts held, more detailed disclosures, and the restatement of prior period results on transition. These factors, along with the requirement to source both historical and current data sets, possibly from areas outside current financial reporting systems or from outsourced providers, increase the risk of material misstatement of the financial results.

<sup>3</sup>ISA 540 (Revised) Auditing Accounting Estimates and Related Disclosures, defines an accounting estimate as "a monetary amount for which the measurement, in accordance with the requirements of the applicable financial reporting framework, is subject to estimation uncertainty." Estimation uncertainty is further defined as "Susceptibility to an inherent lack of precision in measurement."





### Information technology changes

For many insurers, IFRS 17 has required significant investments in systems. Even outside the changes to the modelling systems we have seen enhancements to data storage and processing capabilities, and significant changes to the financial ledger systems. Whether an insurer has taken the decision to purchase, enhance existing or develop new systems, it would have required a review of their technology landscape and resulted in system and operating model changes. Management needs to consider what impact their system implementation approach has had on the financial reporting process holistically and the degree to which additional risks have arisen because of this approach. Examples of factors that may increase the risk of material misstatement in financial reporting include:

- **Increased organisation and transfer of data:** this may result in lesser degrees of automation and more manual activities, which have increased susceptibility to human error.
- **The use of service organisations:** In implementing new technologies insurers may have taken the decision to use a service organisation e.g. for cloud-based solutions. Where insurers have elected this option, management and Boards cannot abdicate from their responsibilities for the oversight and governance of information generated for use in the preparation of IFRS 17 financial statements. Outsourcing will therefore introduce new types of risks or increase existing risks for insurers.



### Interim transition solutions

While some insurers may perform transition calculations using their “business as usual” IFRS 17 systems and models, others may adopt more “tactical solutions” outside of their core architecture. The latter may result in increased levels of risk depending on how well governed these proxy models are. For example, in those entities that are running transition calculations in Excel spreadsheets, the risk of misstatement may increase due to the manual nature of the process, with data and calculations not likely to be maintained in a secured controlled environment.



### Complex and voluminous disclosures prepared within pressurised timelines

Relevant and reliable disclosures are fundamental to communicating deeper insights about an entity’s financial position and financial performance. IFRS 17 requires an insurer to prepare more extensive qualitative and quantitative disclosures that provides users insight into highly subjective matters such as alternative measurement bases, assumptions, models, and sources of estimation uncertainty. Under IFRS 17, insurers will experience increased time and resource pressure on their financial reporting working day timetable and financial close processes. These factors increase the susceptibility of the financial statements to error.

Key questions that management need to address in assessing whether the disclosures are subject to increased risk of material misstatement include:

- Have accounting policies and significant areas of judgement and estimation uncertainty been adequately disclosed?
- Have the IFRS 17 note disclosures been correctly calculated, aggregated and presented in the financial statements in accordance with the IFRS 17 requirements?
- Is the information in the financial statements relevant, reliable, comparable, and understandable?
- Do the financial statements achieve fair presentation of the entity’s performance and financial position?

All these questions will be areas of focus for external audit, who need to provide assurance to the Board, investors and other key stakeholders that the financial reports fairly present the financial performance, cash flow and financial position of the entity.



## What can management do to prepare for an IFRS 17 external audit?



**Engage early with external audit to enable progressive and continuous assurance**



**Apply an “if it’s not documented, it’s not done” rule**



**Prioritise the enhancement, design, and implementation of manual and automated internal controls**



**Bed down management’s view of materiality**



**Optimise IFRS 17 implementation testing strategies**



**Engage early with external audit to enable progressive and continuous assurance**

If you have not already started, now would be the time to engage with external audit. Akin with the challenges faced by management in adopting the standard, external audit will be required to re-design their external audit approach to provide assurance on the IFRS 17 results. This will require external auditors to develop an accelerated understanding of the key changes to, and impact of, IFRS 17 on the entity. To facilitate this understanding management should encourage participation of external audit in internal forums such as IFRS 17 Steering Committees. In order for external audit to appropriately plan the nature, timing and extent of their audit procedures, management must provide external audit with a view of project milestones and timelines and schedule frequent touch points to discuss project developments as they arise. This will not only facilitate a more streamlined audit process but provide management the benefit of obtaining progressive assurance, allowing sufficient time to resolve any differences in opinion and implement remediation plans, where necessary.



**Apply an “if it’s not documented, it’s not done” rule**

In general, the starting point for external audit will be to review policy and methodology papers prepared by the entity. These papers are critical for the auditor to obtain an understanding of the key judgements, accounting policy choices, methodologies and interpretations taken

by management and approved by those charged with governance. External audit will use these papers to test management’s interpretation of the standard, and the practical application of their policies between reporting entities (in a group set of financial statements) and from reporting period to reporting period.

To ensure there is sufficient and appropriate documentation substantiating management’s decisions, they should approach the documentation in a way that someone without knowledge of the entity can logically follow and understand the conclusions reached. Where appropriate, management should ensure that the discipline of documenting new policy and methodologies is embedded in their new business processes and that existing documentation is periodically reviewed and updated and any changes approved by the relevant governance structures.



**Prioritise the enhancement, design, and implementation of manual and automated internal controls**

Internal controls are not only imperative to the safeguarding of your organisation but, as previously discussed, directly impact the quality and efficiency of an external audit process. As with current practice, management need to ensure that any risks that arise from the implementation and application of IFRS 17 are appropriately identified and mitigated by internal controls.



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The type of controls that need to be designed and implemented will vary based on an insurer's specific circumstances; however, new controls implemented for IFRS 17 should link to the additional risks introduced by the new standard:

- **Controls over the models** – such as appropriate access control, change management control, data quality checks, model validations and approvals. Controls over the models need to ensure that the methods, assumptions, and data used are appropriate, judgements made in selecting these are applied consistently and that the calculations are mathematically accurate. An advanced insurer will have a model risk policy, setting out the model governance, model change management control and model validation requirements expected of management. The insurer's Chief Risk Officer and risk team, or sometimes Internal Audit, would then test and assess compliance with the model risk policy, assessing effectiveness of governance and control activities. Management should further consider the regulatory actuary's role in ensuring the models are well controlled and governed.
- **Controls over data** – appropriate data management and governance controls through the journey of data to ensure validity, accuracy and completeness including data quality checks, reconciliations, audit trail logs, data lineage and information security controls.
- **Information technology controls** – Adequate general and application computer controls such as information access controls, IT change management controls, processing controls, software and physical hardware

controls, interface and input controls. Given the changes brought about by IFRS 17 to the technology stack, it will be critical for insurers to harmonise controls across source, actuarial and finance reporting systems.

- **Manual controls** – particularly in addressing proxy transitional solutions, management will need to ensure inputs, calculations and all changes in manual processes are appropriately controlled through robust management review controls before amounts are approved. The adage of "if it is not documented, it is not done" is very pertinent in the auditor's assessment of such management review controls.
- **Monitoring controls** – both entity-level and group-wide controls to ensure that all controls are operating as intended throughout the financial reporting period, including during the transition and determination of opening balances and restated comparative information, and any deviations are identified and rectified.

Management must ensure that end-to-end process and control documentation is updated to reflect changes resulting from transitioning to the new standard, including "business-as-usual" ongoing controls and processes beyond transition.

Management should engage and collaborate with internal audit and other risk functions to perform both inflight-development and post-implementation risk and control reviews. This will significantly aid management in assessing the appropriateness and readiness of the entity's control environment and support increased reliance of external audit on the work performed by internal audit.



### Bed down management's view of materiality

Materiality works as a filter by ensuring that transactions that are sufficiently large and could influence the users of financial statements, are identified and managed. Insurers with a comprehensive log of all materiality judgements made during the implementation activities will allow management to assess the overall aggregate impact of these on the financial statements. This will further facilitate the required ongoing assessment that management will need to perform each financial reporting period to ensure the materiality judgments remain appropriate and do not in the aggregate materially misstate the financial statements when taken as a whole.



### Optimise IFRS 17 implementation testing strategies

In preparation for external audit, management should seek to optimise the insurer's testing strategies to ensure that people, processes, systems, and controls are well rehearsed in preparing IFRS 17 financial information. The benefits will be limiting processing and human errors from occurring and assist in identifying bottle necks in the working day timetable. Any risks identified during testing should be included in the entity's risk register, along with relevant risk mitigations, and addressed by designing and implementing relevant controls or by other appropriate measures.



## ARE YOU READY FOR AN IFRS 17 EXTERNAL AUDIT?

### Conclusion

Preparing for an audit of a standard as complex as IFRS 17 is no simple task. However, the upfront investment required to be audit-ready will have enduring benefits for management. Management's awareness and ownership of key risk factors, with the adoption of robust strategies, to better prepare for the audit process will facilitate a more efficient and effective quality audit, reduce significant audit findings, contain audit fees, and enhance the confidence of the users of the financial statements.

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