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Dear Seema

Insurance accounting – mind the UK GAAP

ICAEW welcomes the opportunity to comment on the staff paper *Insurance Accounting - mind the UK GAAP* published by the Accounting Standards Board (ASB).

ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter, working in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 138,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.

ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.

The Financial Services Faculty was established in 2007 to become a world class centre for thought leadership on issues facing the financial services industry acting free from vested interest. It draws together professionals from across the financial services sector and from the 25,000 ICAEW members specialising in the sector and provides a range of services and provides a monthly magazine *FS Focus*.

Major comments

1. ICAEW identified some time ago the problem addressed in the staff paper, and has actively engaged with both the Association of British Insurers (ABI) and the ASB to explore possible solutions. We welcome the ASB's staff paper as part of the continuing effort to find a workable approach to accounting by UK insurers who do not currently account under International Financial Reporting Standards.

2. This letter should be read in the context of our response to the ASB's exposure draft, *The Future of Financial Reporting in the UK and Republic of Ireland*, Rep 64/12.

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Long-term solution

7.4 Do you agree that the long-term solution for accounting for insurance by reporting entities in the UK (listed and unlisted) is to incorporate IFRS Phase II into UK GAAP, when issued by the IASB and adopted for use in the EU?

Yes, we agree that in the long term the best way forward for UK insurance accounting is likely to be the adoption of IFRS Phase II. As the final standard has not yet been published, our view here is subject to the content of the forthcoming insurance IFRS being broadly consistent with the work done to date.

Short-term solution

7.5 When providing comments on the short-term solutions please comment on:

(a) whether you agree that all aspects of the problem have been identified? If not, what is missing and how do you see it impacting the accounting for insurance contracts?

3. Company law is mentioned in the paper at paragraphs 4.7 through to 4.9 but it is not clear to us how the implications of the current legal requirements have been factored into the proposed solutions. Specifically, our understanding is that option III, Update FRS 27 and the ABI Statement of Recommended Practice (SORP) and option IV, Incorporate IFRS 4 Phase II into UK GAAP, would not be allowed without changes to company law. For example, discounting of general reserves is not allowed under company law unless specific criteria are met, but would be needed under the each of these two options even where the criteria are not met. The paper does not indicate a possible timetable for any necessary legal changes and we consider they could take some time to achieve. Accordingly, we are not convinced that these two approaches are genuine options at the current time.

4. A further legal consideration concerns presentation. The formats required for insurers under Companies Act, such as the three-part profit and loss, would not be consistent with the presentation needed under International Accounting Standard 1. Depending on which route is taken, it may be necessary to consider whether the accounting requirements for UK insurers need to specifically allow them to comply with Companies Act requirements as far as presentation is concerned.

5. In relation to equalisation reserves, there is an issue that arises from the risk that Solvency II could be delayed. In this case, the Solvency I rules will remain in place during at least one accounting period presented under the revised UK GAAP. Where an insurer is required by the Prudential Sourcebook to establish equalisation reserves, Schedule 3 to the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 requires these reserves to be presented as liabilities in the financial statements. Therefore it would be necessary to provide some guidance to general insurers under each of the options on establishing equalisation provisions in accordance with the FSA rules and presenting them as liabilities in accordance with Schedule 3.

6. Assuming III and IV are valid options, we would observe that Solvency II is not yet finalised and so there will be practical problems under option III, with bringing Financial Reporting Standard 27 *Life Assurance* and the ABI SORP into line with it in a detailed manner. That said, it would be possible to use language which required preparers to have regard to the new regulatory requirements in a broader sense. Solvency II is more concerned with capital than with revenue recognition, and further guidance would be needed on the latter under option III. In particular, as you explain at paragraph 6.16, Solvency II would allow a day 1 profit and an income recognition policy might be needed to address this and other matters. It is unclear from the staff paper whether under option III Solvency II would apply to general insurers or just to life insurers; this would need to be clarified. It may not be worthwhile to require general insurers to move to Solvencv II for accounting in this gap period, given that subsequent adoption of IFRS 4 Phase II would require them to revert back to a model which is similar to their existing accounting.

7. Similar to Solvency II, a consideration under option IV is that the International Accounting Standards Board's (IASB) work is not yet finalised. The project to replace IFRS 4 with a new standard has been underway for a long time, and it could be risky to assume a final standard would be ready in time. A number of the matters which are still under discussion by the IASB and the Financial Accounting Standards Board are significant ones; using a final review draft or an Exposure Draft without full consultation is not an approach we would support. We would challenge the view that this approach would deliver better quality financial reporting across all insurance companies: this may be true but it would be contingent upon how 'finished' a product the due-process document were to be and whether insurance companies had sufficient time to implement the requirements to an acceptable standard. We share the concerns about option IV that you raise at 6.26 and 6.27. We agree that potentially, insurers preparing financial statements under UK GAAP would be required to apply the new IFRS earlier than insurers preparing financial statements under IFRS, which appears an odd outcome. We also agree that the option III route could result in two sets of changes, and hence entail additional cost.

(b) what is your preferred solution (whether one of those set out in section 6 or not) for insurance accounting in the UK during the gap period? And (c) what is your rationale for proposing that solution, including the balance of costs and benefits?

8. Between options I, Incorporate the current version of IFRS 4 into UK GAAP and II, Embed the relevant rules of FSA's realistic capital regime into UK GAAP, our preferred solution is option I. We recognise that it would not produce information which would be as readily comparable as that produced under option II. That said, option I would align requirements for UK GAAP reporters with listed company and other IFRS reporters. This would help to deliver consistency because, whilst IFRS 4 is permissive, in practice many UK insurers tend to adopt similar accounting policies to their peers. The information produced under option I would be much more relevant than information produced with reference to obsolete regulatory requirements. A further reason for preferring option I is that it would allow improvements to accounting policies to be made, whereas option II would prohibit improvements. This will be particularly important should the 'gap period' prove to be prolonged.

9. Option I currently proposes that the insurance SORP is removed. The SORP contains specific guidance for UK insurers, for example on advertising expenditure and policyholder tax, which could help promote a consistent approach amongst different insurers, including new entrants. We recommend you consider retaining the parts of the SORP that do not relate to the changing regulatory rules until the final Phase II standard is adopted for use in the EU.

10. Under option I insurance contracts such as fixed fee service contracts issued by non-insurance companies would be subject to IFRS 4 requirements. Such contracts may be exempted from the final Phase 11 insurance standard. We recommend that you consider modifying option 1 to only apply to contracts currently accounted for as insurance under UK GAAP. A definition which draws on that used in the Companies Act may be suitable.

11. Were option I to be adopted, you should consider whether a reduced IFRS 4 disclosures regime for subsidiaries should be introduced. This approach would be consistent with the reduced disclosures that the subsidiaries of other companies may be entitled to.

12. The costs of implementing IFRS 4 would be relatively modest for many entities, as it would allow many existing accounting policies being used under UK GAAP to continue to be applied. Unlike options II and IV, the information insurers would need to use is already available. Using option II would require insurers to maintain systems that would allow them to calculate the information required under Solvency I; the current regulatory requirements would mean that Solvency II information would also need to be captured. We do not think that the benefits to users of increased

comparability is proportionate to the costs associated with mandating this information on a continuing basis, given that users would not be looking at relevant regulatory information. As we mentioned above, the use of Solvency I numbers is also likely to cause UK GAAP reporters to diverge from the listed sector. Companies do of course have the option of switching to IFRS which could frustrate an approach which seeks to mandate a single accounting model for the UK.

13. Option II focuses on embedding realistic rules into UK GAAP. However, there are a number of life insurers who do not report using realistic rules but are under the Modified Statutory Solvency Basis (MSSB) today. If option II were to be selected, MSSB may need to be brought into UK GAAP for these companies.

14. The ASB's proposals for UK GAAP generally would take effect for periods starting on or after 1st January 2015, whilst the Solvency II regime is currently planned to apply from 1st January 2014. It will be important that the ASB clarifies ahead of time its expectations for 2014 insurance financial reporting, and avoids creating a vacuum period during which there is no specific guidance on which requirements are applicable. We recommend the ASB considers formally withdrawing FRS 27 on 1 January 2014 as it will refer to a regulatory regime which will no longer exist and provide alternative guidance for life insurers.

(d) what is the likely impact of any changes in accounting for insurance contracts under UK GAAP on the entity you have in mind? It would be helpful if your response clarifies the current position of the reporting entity you have in mind (listed, unlisted, reporting in accordance with IFRS/ grandfathering/own accounting policies/UK GAAP/other)

15. Our response had not been drafted with a specific entity in mind. We are aware that some insurance companies, including some mutual insurers, would strongly prefer a long-term solution based on Solvency II rather than IFRS 4 Phase II. However given that Solvency II does not address the thorny problem of revenue recognition it would provide an incomplete basis for financial reporting information. It would appear to make sense to draw on the IASB's work, which has considered insurers' financial reporting in the round. It would be possible to develop a separate SORP for mutuals and others to use, but this would require significant effort to produce and would make it harder to compare entities using such an approach to other UK and IFRS reporters.

Yours sincerely

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