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Our ref

For the attention of Seema Jamil-O'Neill

Contact

30 April 2012

Dear Sirs

Insurance Accounting – Mind the UK GAAP

We welcome the opportunity to respond to the questions raised in the staff's paper 'Insurance Accounting - Mind the UK GAAP'.

Our responses to the specific questions raised are set out in the Appendix to this letter.

If you wish to discuss any of the points raised, please contact Danny Clark on 0207 311 5684 or David Holliday on 0207 311 5663.

Yours faithfully

KPMG LLP

Enclosures:

Appendix: Responses to questions raised in the ASB's paper 'Insurance Accounting – Mind the UK GAAP'

Appendix

Responses to questions raised in the ASB's paper 'Insurance Accounting - Mind the UK GAAP'

Long-term solution

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 4 Phase II into UK GAAP, when issued by the IASB and adopted for use in the EU?
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We agree that the best long-term solution would be to incorporate accounting requirements based on IFRS 4 Phase II into FRS 102, when it is issued by the IASB and adopted for use in the EU.

We have considered the possibility of adopting an accounting basis for insurance contracts in FRS 102 that is more closely aligned to the requirements of Solvency II (similar to Option 3 of the short-term solutions) but do not believe that this would be a viable long-term solution for the following reasons:

- It would not be helpful for users of insurer's financial statements if there were two different bases for insurance contract accounting in UK general purpose financial statements depending on whether the accounts are prepared using the recognition and measurement requirements of EU-adopted IFRS (IAS accounts, or accounts prepared under FRS 101); or are prepared under FRS 102.
- We are not convinced that an accounting methodology based on Solvency II would be suitable for general purpose financial statements without significant modification and development. The process of determining the necessary modifications and developments would not be straightforward and would most likely result in a set of requirements that are not significantly different from IFRS 4 phase II.

It is conceivable that there might be some aspects of the final IFRS 4 phase II standard that would be unnecessarily onerous for unlisted companies. We consider that the ASB should avoid making an unequivocal decision to require companies preparing accounts under FRS 102 to apply IFRS 4 Phase II in full at this stage (for instance it might be appropriate to reduce some of the disclosure requirements), and that it should review the appropriateness of adopting the full requirements of IFRS 4 Phase II when the final standard has been issued by the IASB.

Short-term solution

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?
- b) What is your preferred solution (whether one of those set out in section 6 above or not) for insurance accounting in the UK during the gap period?
- c) What is your rationale for proposing that solution, including the balance of cost and benefits?
- d) What is the likely impact of any changes in accounting for insurance contracts under UK GAAP on the entity that 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).

We do not believe that options 3 and 4 would provide viable short-term solutions.

Both options would require extensive new requirements to be developed. As described above, we do not consider that Solvency II would be suitable for general purpose financial statements without significant modification and development, and like Solvency II, IFRS 4 Phase II has not yet been finalised and it is a distinct possibility that a fully developed version of the standard might not be available when FRS 102 is finalised. The development of new requirements would not be straightforward and would require significant effort by the ASB (including further detailed consultation) and by the preparers of general purpose financial statements that choose to adopt FRS 102.

Option 3 might provide an appropriate short-term solution if it were also to be adopted as the long-term solution. However, as described above, we do not believe that an approach based on Solvency II requirements would provide the best long-term solution.

Although option 3 might enable companies that choose to prepare their general purpose financial statements under FRS 102 to ‘switch off’ their Solvency I systems when FRS 102 becomes effective, this approach would require companies to make two significant and fundamental changes to (and restatements of) their general purpose financial statements over a relatively short period of time. We do not believe that this would be beneficial either to those companies or to users of their financial statements.

Option 4 would only require a single stage transition to IFRS 4 Phase II (if it is assumed that the EU endorsed version of IFRS 4 Phase II is not significantly different from the IASB's latest proposals at the time that the requirements to be included in FRS 102 are developed). However, it would effectively require unlisted companies that chose to prepare their financial statements under FRS 102 to adopt IFRS 4 Phase II ahead of IFRS reporters (or companies preparing their financial statements under FRS 101). We believe that as a consequence many insurers that do not currently adopt EU-adopted IFRS either in their consolidated group financial statements or in their individual financial statements would choose not to apply FRS 102 because they would not want to have to apply the IFRS 4 Phase II requirements in advance of listed insurance companies with more significant resources.

We believe that options 1 and 2 would both be viable short-term solutions, although our preferred solution would be option 1. While there is a small risk that financial information presented by those companies that choose to adopt FRS 102 might not be as easy to compare as information presented under option 2, this would only be for the short-term. Option 1 would be more straightforward for the ASB to develop, and would have the added benefit of aligning the insurance contract accounting requirements of UK GAAP reporters with IFRS reporters when FRS 102 becomes effective rather than waiting until IFRS 4 Phase II is issued by the IASB and adopted for use in the EU.

We are not overly concerned that option 1 might lead to more diversity in the valuation bases adopted by UK insurers in the short term. In practice, UK insurance companies and groups that currently prepare general purpose financial statements in accordance with EU-adopted IFRS, made very few modifications to their accounting policies when adopting IFRS 4 Phase I. We acknowledge, however, that there was little incentive for them to make a change because the accounting and regulatory reporting bases for insurance contracts were closely aligned at the time.

Although, if option 1 were adopted, it is conceivable that some insurers might choose to align their accounting policies more closely with Solvency II requirements, this could also be achieved by choosing to prepare accounts that comply with EU-adopted IFRS. However, as stated above, we do not consider that it would be in the best interests of preparers and users of financial statements to make two significant and fundamental changes to (and restatements of) their general purpose financial statements over a relatively short period of time.

If option 1 were adopted as the short-term solution, we consider that capital disclosures should be included in FRS 102 as a requirement. As a minimum, these should be based on the requirements currently included in Appendix E of FRS 29, although for life insurers, we consider that additional disclosures based on the requirements in FRS 27 should also be included. Since these disclosures were developed over eight years ago and were based on the capital requirements under the FSA's Solvency I and realistic capital regimes, the requirements would require updating to be made compatible with the capital requirements in Solvency II.

Although we are hopeful that the IASB's IFRS 4 Phase II standard will be issued and endorsed for use in the EU without significant further delay, there is nevertheless a risk that the short-term solution could be in place for several years. If option 2 were adopted, we consider that the ASB should take the opportunity to address some current inconsistencies in insurers' general purpose financial reporting when developing new requirements based on the existing requirements in FRS 27 and the ABI SORP.

We consider that any new requirements based on FRS 27 and the ABI SORP should include the definition of an insurance contract currently contained in IFRS 4 Phase I (and FRS 26) so that in their general purpose financial statements all UK life insurers would be required to account for contracts that do not transfer significant insurance risk as financial instruments and not insurance contracts. We also believe that the new requirements should include disclosure requirements for insurance contracts based on the requirements contained in IFRS 4 Phase I (although these would not necessarily have to be the full disclosure requirements). These disclosure requirements would apply to all insurers preparing accounts under FRS 102 and not only to life insurers.

Other comments

General purpose financial statements prepared under FRS 101 and FRS 102 would be required to comply with the provisions of the Large and Medium-size Companies and Groups (Accounts and Reports) Regulations 2008. The ASB's paper acknowledges that certain of the current requirements contained in these regulations, including the requirements that:

- Long-term business provisions must be determined with due regard to the actuarial principles laid down in Directive 2002/83/EC (Solvency I basis); and
- General insurance claim liabilities cannot be discounted unless the period between claim and settlement is greater than four years

would not be compatible without amendment with options 3 or 4. These requirements are also likely to be inconsistent with the measurement basis in the IFRS 4 Phase II standard so this is not only a short-term issue. This does not appear to have been identified in the ASB's paper.

The ASB's paper does not address how insurance entities that currently report under UK GAAP might report their insurance contracts in the period (if any) between the implementation date for the new Solvency II regime (currently expected to be 1 January 2014) and the effective date of the new UK GAAP requirements (currently 1 January 2015).

Although (as stated above), if adopted, option 3 might enable companies to 'switch off' their Solvency I systems when FRS 102 becomes effective, this option would not be available to companies that prepare their general purpose financial statements under the current UK GAAP requirements in the year that the Solvency II regime becomes effective. Conversely, companies preparing financial statements in compliance with IFRS 4 Phase I would have scope to amend their accounting policies to bring them more into line with Solvency II valuation requirements.

If option 1 were adopted as the short-term solution, companies would of course be able to early adopt FRS 102 when Solvency II is implemented so that they would have the same options available to them as companies that prepare accounts in compliance with IFRS 4 Phase 1 (if it assumed that changes described above are made to the provisions of the Large and Medium-size Companies and Groups (Accounts and Reports) Regulations 2008). However, it is not clear if there would be other options available to a company that did not want to early adopt FRS 102.

As described in our comment letter on the Revised Financial Reporting Exposure Drafts: *The Future of Financial Reporting in the UK and Republic of Ireland* we consider that it would be appropriate to permit early adoption of FRS 102 for accounting periods ending (rather than beginning) on or after the date of issue of the final standards.