

**Solicitor's Office**  
4<sup>th</sup> Floor, Ralli Quays West  
3 Stanley Street  
Salford  
M60 9LB

Michelle Sansom  
The Accounting Standards Board  
5<sup>th</sup> Floor, Aldwych House  
71-91 Aldwych  
London  
WC2B 4HN

**Tel** 0870 785 8517

**Fax** 0870 785 8528

**Email** Matt.Blake@hmrc.gsi.gov.uk

Date 3 May 2012

Dear Ms Sansom

### **ASB Staff Discussion Paper on Insurance Accounting in the UK**

Thank you for the opportunity to comment on the insurance discussion paper. We would be happy to discuss any of the points raised in this letter if you so wish.

#### **Our perspective**

1. HM Revenue & Customs (HMRC) administers and collects tax in the United Kingdom. In doing so, we use the financial statements of most businesses in the UK, and a number of overseas businesses. The managers and owners of those businesses directly use the numbers reported in financial statements as the basis of their corporate or personal tax liabilities. We check those numbers and the tax liabilities based on them, and we use many of the disclosures in financial statements to help us to check those and other tax liabilities.
2. In the UK, it has long been the case that the starting point for most businesses for calculating a business's corporate or income tax liability is its commercial profit. It is now enshrined in UK tax law that the starting point for taxable business profits is the "profit prepared in accordance with Generally Accepted Accounting Practice" (GAAP).

#### **Background to HMRC's particular interest in the issue**

3. While the taxation of general insurance business has for some time been based primarily on a company's financial statements, the taxation of long-term insurance business ("life insurance") has relied on the annual regulatory returns to the Financial Services Authority. However, if the proposals in the Finance Bill 2012 become law in their

currently proposed form, with effect from 1 January 2013 the taxation of life insurance will be based much more closely on the financial statements. This change was initially driven by the fact that, under Solvency II, the current regulatory returns will cease to exist. However, the opportunity has been taken to streamline and modernise the tax regime for life insurers, using financial statements to align the tax result more closely with economic profits.

#### **General points/Overarching considerations**

4. We have set out in an Appendix our comments on each of the specific options presented in the Staff Paper. In forming our views on the options we have been guided by certain general, overarching considerations which we cover in the following paragraphs.

#### *Timing*

5. Our expectation is that the 'gap in GAAP' will arise from the point at which Solvency II is implemented in the UK. Current expectations are that this will be from 1 January 2014. Companies will therefore need to be able to prepare financial statements under whichever short-term option is chosen for 2014, including, presumably, comparatives for 2013 and an opening balance sheet at 1 January 2013.
6. It is therefore very important that the short-term solution is selected as soon as possible and that it is one for which companies can prepare in detail during the rest of 2012. A lack of time to prepare thoroughly increases the risk of error and inappropriate treatments.
7. This is particularly important for HMRC given the necessary long lead time for changes to tax policy and in tax legislation. In order to protect government revenues and for us to deliver a policy result that makes it less burdensome for our customers to calculate their tax liabilities, we need to research the possible consequences of any change. This may involve, to a greater or lesser extent, consultation with customers and other stakeholders before Ministers are able to make a judgement and we are able to go about amending legislation. In considering the various options we have therefore attached considerable importance to the likelihood of the chosen basis being fully available in time. This points towards options 1 and 2 rather than options 3 and 4.

#### *One step or two step change to get to end goal*

8. The new insurance contracts standard (IFRS4 Phase II) seems to us to provide a robust and practical basis. We agree that the right long-term solution is to incorporate IFRS 4 Phase II into UK GAAP once it has been issued by the IASB and adopted for use in the EU. We consider it preferable to get to that long-term goal if possible in one step rather than two, in order to minimise disruption and change for both preparers and users including, of course, companies calculating tax liabilities on an accounting basis.
9. Comparability and consistency between companies and between periods is important to HMRC; stability helps ensure equal and consistent treatment between companies and reduces the risk of inappropriate tax treatments. In particular, transitions between different bases or policies are a source of considerable additional risk to the UK Exchequer.
10. We have therefore considered the potential short-term solutions in that light and this consideration has been a significant factor in determining our preferred solution. In this context we do not consider current UK GAAP to be so 'broken' that it has to be fixed as a matter of urgency, and for that reason we would not see a delay in moving to a new basis as a major drawback of any potential short-term solution.

11. These considerations point towards options 2 and 4, although even Option 4 might involve two steps to some extent if the final version of IFRS 4 Phase II is not available in time and new UK GAAP for insurance contracts is based on the most recent available ED.

*Accounting for General Insurance ("GI") business*

12. The 'gap in GAAP' is actually quite a narrow gap in that it applies only to the valuation of life insurance technical provisions. Most other aspects of insurance accounting will remain unaffected. In particular, accounting for GI business will be directly impacted to a much lesser extent than accounting for life business by the coming accounting and regulatory changes. Whereas current GAAP makes specific reference to Solvency I regulatory measurement for life business, this does not apply to GI business; GI provisions do not follow the regulatory measurement, rather the accounting measurement drives the regulatory reporting.
13. There is of course an issue about whether and to what extent insurers might amend their accounting for GI business in the light of Solvency II, but if they did this would be a matter of choice rather than due to any requirement: there would be no need to change and the SORP would continue to be valid.
14. We think the consideration of the issues and the merits of the potential solutions should be judged in this light. This is reflected in our conclusions about the options. We do not favour an option which involves getting rid of the SORP, as so far as GI is concerned that would be unnecessary: it would create a void in accounting guidance for no real reason. From HMRC's perspective as a user, the lack of consistency that could arise from a solution which removed detailed standards and guidance with nothing specific to replace them might be problematical.
15. Clearly accounting for GI business will be affected to some degree. For example, we understand that claims equalisation reserves are likely to disappear as a regulatory requirement under Solvency II and hence also from financial statements. However, that might be considered a relatively straight-forward change to be dealt with as an amendment to the SORP and then presumably by way of a prior period adjustment in the financial statements.
16. Similarly, if the Companies Act<sup>1</sup> restrictions on discounting GI provisions are removed as a result of Solvency II, then that again could be dealt with as a specific amendment to the SORP. But the fundamental valuation basis would not need to change.

**Overall conclusions**

17. As already noted, on the basis that IFRS4 Phase II will be a high quality and comprehensive standard, we agree that the right long-term solution is to incorporate IFRS 4 Phase II into UK GAAP once it has been issued by the IASB and adopted for use in the EU. We believe that this would have a number of significant benefits and we do not believe that the development of a UK alternative to IFRS 4 Phase II would be desirable or cost-effective.
18. Of the options presented for the short-term solution, the primary factors we have considered point towards option 2. The principal reasons for this are that Option 2:
  - Would entail only one change in accounting – the move to IFRS 4 Phase II – thereby at least maintaining existing levels of consistency and comparability

---

<sup>1</sup> SI2008/410 Schedule 3 s53 – s54

- Does not add to the changes which insurers are going to have to handle over the next 3 years in any event (Solvency II, new UK GAAP, IFRS 9)
- Appears to be practicable within the time constraints
- Allows companies to plan for 2014 and subsequent years knowing exactly what the requirements will be, even before the technical work is complete
- Does not unnecessarily disturb G.I accounting

Please contact me or Peter Drummond on 020 7438 7300 should you wish to discuss any of the points raised in this response.

Yours faithfully



**Matt Blake, FCA**  
Commissioners' Advisory Accountant

## **Appendix**

### **Long-term solution**

- We agree that the right long-term solution for accounting for insurance by entities in the UK is to incorporate IFRS 4 Phase II into UK GAAP. Presumably this would be achieved by way of cross reference.
- In our view this solution would have a number of significant benefits:
  - High quality and comprehensive accounting standard addressing all of recognition, measurement, presentation and disclosure
  - Consistency with IFRS – and hence enhanced comparability across the sector internationally
  - Supported by a considerable amount of detailed explanatory material – so both widely and thoroughly understood, and as a result of the extensive consultation, generally endorsed by industry and the accounting profession
  - Part of and hence consistent with an integrated conceptual framework and common IFRS principles
- We believe this long-term solution should be applied to all entities which issue insurance contracts, including non-insurance entities. This would be important for consistency and the integrity of financial reporting. Concessions could be made in respect of disclosures for non-insurers.
- We agree that this long-term solution should be implemented as soon as IFRS 4 Phase II has been both approved by the IASB and endorsed by the EU. We note that technically, if incorporated into UK GAAP, UK entities could apply the requirements of IFRS 4 Phase II whether or not it has been endorsed by the EU. However, we do not consider this would be the most appropriate approach since that would permit inconsistencies between the accounts of entities applying UK GAAP and those applying IFRS.
- We do not believe that the development of a UK alternative to IFRS 4 Phase II would be desirable or cost-effective. However, in the process of incorporating IFRS 4 Phase II into UK GAAP, the consultation should be open to identifying any potential aspects of the Phase II standard which are not possible under the Companies Act or otherwise not appropriate.

## Short-term solution – options

### 1 *Incorporate the current version of IFRS 4 into UK GAAP*

- It is not clear to us how this option would be implemented. The implication from the Staff Paper is that this solution would be implemented via FRS 102, but that would not appear to fully solve the 'gap' problem: the gap will exist from 1 January 2014 when Solvency I is switched off but the proposed implementation date of FRS 102 is not until 1 January 2015. We understand that FRS 102 may be applied early<sup>2</sup>, but the implication then is that insurers would be required to early adopt new UK GAAP, which does not seem appropriate. Nor would that solve the issue for non-insurers that issue insurance contracts. It is not clear what alternative mechanism would be used to require IFRS 4 to be applied for all insurance contracts from 1 January 2014.
- Current IFRS 4 permits improvements to be made to accounting policies; so under this option accounting policies for insurance contracts are 'grandfathered' but changes will be possible. As acknowledged in the Staff Paper, this option increases the risk of increasing diversity in practice and lack of comparability. From HMRC's perspective, it is more difficult to ensure that tax legislation continues to operate effectively and fairly in an environment which permits 'ad hoc' change. Such changes could increase tax risk – e.g. a biased selection of 'improvements' to reduce taxable profits or achieve other particular tax results – and could require HMRC to amend legislation, with potentially major resource implications.
- As an example, would changing valuation policies/methods to one which followed Solvency II measurements be a permitted improvement? A company might wish to do that in order to reduce compliance costs (i.e. running two parallel valuation systems). But such a change would introduce changes for a limited period of time – until IFRS 4 Phase II implementation - and which might include features which run specifically counter to some of the decisions in Phase II.
- This option does not make specific allowance for GI business. This option would remove the current basis for GI accounting (the SORP) for no apparent purpose, as the GI insurance contract provisions do not follow Solvency I measurements anyway. So this option would seem to risk allowing GI accounting to diversify without any real justification.
- If FRS 27 and the ABI SORP are dispensed with, it is not clear to us how the ASB could ensure that all current disclosure requirements are maintained; would such disclosures count as grandfathered 'accounting policies'? Based on the definition of 'accounting policies' in FRS 18 it is not clear that they would. This seems to us to be a significant disadvantage of a solution which involves removing all detailed current requirements and guidance.
- In summary:
  - The mechanics for implementation are unclear but implementation through FRS 102 does not seem to address the gap in 2014
  - Would permit increased diversity in accounting which potentially causes resource costs for HMRC and risks to the Exchequer
  - Appears to create rather than solve a GI issue

---

<sup>2</sup> In fact, as the effective date paragraph in FRED 48 says its early application is permitted for periods beginning on or after the date of its issue, even this solution will not be available unless FRS 102 is issued by 31 December 2012.

## Short-term solution – options

### 2 *Embed the relevant rules of FSA's Realistic Capital Regime into UK GAAP*

- The Staff Paper refers to the FSA's Realistic Capital regime, but we believe this only applies to large (> £500m) with-profits business. Other life business is subject to the standard Solvency I valuation rules. This means there would be two sets of valuation rules to incorporate – the Realistic Capital rules into FRS 27 and the basic Solvency I rules into the SORP. However, GI should be unaffected.
- From HMRC's perspective this option seems preferable because it preserves the status quo and does not cause more changes or permit more potential changes than are necessary. As explained in the covering letter, consistency in accounting policies between entities and between periods is a major benefit to HMRC and avoids a potential additional risk to the Exchequer. Also, this option does not unnecessarily disturb the basis for GI accounting.
- Consistency of treatment from one period to the next also seems advantageous for preparers: this option would entail only one major change in accounting – the move to IFRS 4 Phase II. As a one step process it seems preferable.
- We acknowledge that it might be burdensome for entities to have to maintain two sets of systems from 2014 – one for Solvency II and one for accounting. On the other hand, this situation could arise under options 1 and 4 as well, and will inevitably arise under the long-term solution. Further, UK GAAP reporters would retain the option of moving to IFRS if the new UK GAAP regime was too onerous. So in our view this may not necessarily be a major factor in the decision, but on this point we defer to preparers for comment.
- The exercise of embedding the existing valuation rules into FRS 27 and the SORP would need to be complete by 1 January 2014. An advantage of this option is that this work could start immediately – there are no other pieces of the jigsaw that would need to be in place before this work could start. Although we do not have full insight into how extensive the work would be, we anticipate that it would be relatively straight-forward to ensure the work was completed in time for 2014. Further, since this option means retaining current practice, companies and users can plan for 2014 and subsequent years knowing exactly what the requirements will be, even before the technical work is complete.

## Short-term solution – options

### 3 *Update FRS 27 and the ABI SORP for Solvency II requirements*

- HMRC does not favour this option for the following principal reasons:
  - Solvency measures are not primarily geared to meeting the requirements of financial reporting (the reason the use of solvency measures is acceptable under Option 2 is because it preserves the status quo). As acknowledged in the Staff Paper, in some respects the Solvency II rules could potentially be an inappropriate basis for financial accounting.
  - There seems little benefit in introducing a sub-optimal regime for only a relatively short period (a few years); due to the likely differences between Solvency II measures and IFRS 4 Phase II there would inevitably be two changes in a few years.
  - The Solvency II rules are not yet widely known and understood by preparers or users, so it is hard to assess what this option would actually mean in practice. Further problems with this option might become apparent further down the line when it was too difficult to change course.
  - Under this option HMRC would probably need to conduct further research and consultation, leading potentially to changes in legislation to ensure the new measurement rules were appropriately addressed by tax legislation. This would be a significant additional demand on resource for both HMRC and the industry, coming soon after the major changes introduced in Finance Bill 2012.
  - For GI business this option creates change where none is needed – it would force a move to a potentially sub-optimal regulatory basis from an acceptable current financial accounting basis.
- This option would also involve a significant amount of work, including consultations, for the ASB and ABI and others. Since the Solvency II rules may not be finalised until the end of 2012, there would be a very short time to complete this work. Although the Staff Paper refers to transition to UK GAAP in 2015 (paragraph 6.17), the solution would ideally be in place for 2014 when the gap first arises.
- Para. 6.20 of the Staff Paper suggests that the option would mean that the quality of financial information would improve: is that necessarily the case? If Solvency II measurement includes elements and features that have been rejected by the IASB for IFRS 4 Phase II, then is it necessarily better than Solvency 1 or the Realistic Basis (the latter is also relatively new and was introduced as an improvement)? Note that under this option differences between financial accounting and regulatory reporting would remain.
- This option would be likely to create additional differences between companies on IFRS and those on UK GAAP. Options 1 and 2 would not seem to create this issue to the same extent.



## Short-term solution – options

### 4 *Incorporate IFRS 4 Phase II into UK GAAP*

- This option would seem to be a good one since it involves only one change and delivers better quality and consistency of financial reporting.
- However, the risk that it is not achievable in time, given the delays in the IASB's work on IFRS 4 Phase II, is considerable. There is significant doubt that this solution could be implemented in time to fill the accounting gap.
- Also, if this solution is implemented by way of FRS 102, then this only works to fill the accounting gap in 2014 if insurers adopt FRS 102 early.
- Another important negative factor from HMRC's perspective is this option would require insurers applying UK GAAP to adopt IFRS 4 Phase II in advance of those applying IFRS, which does not seem appropriate. In addition that would create further differences between IFRS reporters and UK GAAP reporters. Further, if IFRS 4 Phase II were not endorsed by the EU, then such differences would become permanent.
- As for option 3, under this option HMRC would probably need to conduct further research and consultation, leading potentially to changes in legislation to ensure the new measurement rules were appropriately addressed by tax legislation. This would be a significant additional demand on resource for both HMRC and the industry, coming soon after the major changes introduced in Finance Bill 2012.

For the above reasons HMRC does not favour this option.