Deloitte LLP
2 New Street Square
London
EC4A 3BZ

Tel: +44 (0) 20 7936 3000
Fax: +44 (0) 20 7583 1198
www.deloitte.co.uk

Seema Jamil-O'Neill
Accounting Standards Board
5th Floor Aldwych House
71-91 Aldwych
London
United Kingdom
WC2B 4HN

Email: asbcommentletters@frc-asb.org.uk

27 April 2012

Dear Madam

Staff Paper: Insurance Accounting – Mind the UK GAAP

We write in response to your invitation to comment on the Staff Paper: Insurance Accounting – Mind the UK GAAP (the Staff Paper). In summary:

- we agree with the ASB's preferred long-term solution of incorporating IFRS 4 Phase II into UK GAAP;
- in the short term, we support Solution II as being the least disruptive to insurance companies in a time of regulatory change. We agree with the ASB that, if there are continued delays to IFRS 4 Phase II the costs may start to outweigh the benefits; and
- we believe there is a need to provide clarity on an urgent basis if any change is proposed, so that insurance companies and others will be able to change systems and procedures to capture any necessary data to enable them to produce their financial statements. If changes are made, it would be helpful if there were transitional provisions to avoid the need to restate 2013 comparatives.

Our answers to the questions raised in section 7 of the Staff Paper are set out in the appendix to this letter.

If you have any questions concerning our comments, please contact Francesco Nagari at 0207 303 8375 or Amanda Swaffield at 020 7303 5330.

Yours faithfully

Deloitte LLP

Appendix – responses to questions raised in the Staff Paper

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?

We welcome the ASB's preference to consider International Financial Reporting Standard 4 "Insurance Contracts" Phase II as the long term solution for UK GAAP. This would lead to a principles-based approach to accounting for insurance contracts including:

a) the introduction of a consistent measurement basis for insurance contracts as a bundle of rights and obligations;
b) the use of a current measurement model focused on the insurer's fulfilment of its obligations under a portfolio of insurance contracts; and
c) transparency, with the use of explicit "building blocks" clearly presented in the statement of comprehensive income.

Short-term solution

Do you agree that all aspects of the problem have been identified? If not, what is missing and how to you see it impacting the accounting for insurance contracts?

We believe that the Staff Paper provides a balanced assessment of the problem. It does not, however, consider in detail the potential impact of the adoption of Solvency II on the law regarding preparation of insurance company accounts. There are no current plans to change the UK laws which enact the Insurance Accounts Directive[1]. However, at the very least, there will be a need to revisit the reference[2] to the calculation of technical provisions using the actuarial principles set out in Directive 2002/83/EC. This is because Directive 2002/83/EC is repealed and recast by the Solvency II Directive.

We have not analysed the potential effect of that change in detail. If the effect of any changes made to the law does not permit or require a change to the required basis of calculation for technical provisions, we believe that Solutions III and IV would conflict with the law[3]. If, however, a change to the law is made that requires a change to basis of calculation of provisions, we believe that the accounting standards should not conflict with the law. In that case, we would support whichever solution most closely aligns with the revised law.

As an overarching comment, we note that, if insurers are faced with any changes to the basis of accounting (and in particular, to the basis on which provisions are calculated), then the time taken to put in place systems to collect the necessary information could be significant. If such a change to provisioning is required then we suggest that the ASB clarifies (in FRS 102 and FRS 28) that comparatives for the period commencing 1 January 2013 do not need to be restated.

[1] Schedule 3 of the Large & Medium-Sized Companies & Groups (Accounts & Reports) Regulations 2008, the Insurance Accounts Directive (Lloyd's Syndicate and Aggregate Accounts) Regulations 2008, and the Insurance Accounts Directive (Miscellaneous Insurance Undertakings) Regulations 2008.
[2] For example in paragraph 52(3) of SI 2008/410 Schedule 3.
[3] For example, because the Insurance Accounts Directive prohibits discounting of provisions for claims outstanding unless the expected interval for settlement is at least four years, whereas Solvency II requires discounting in certain circumstances.

What is your preferred solution for insurance accounting in the UK during the gap period? What is your rationale for proposing that solution, including the balance of cost and benefits?

We have considered the merits of the four alternative solutions set out in the Paper for the short-term solution, focussing on how each would measure up against the needs of users during a period of significant change in the solvency regime and the ability of preparers to make changes. Our assessment considers both listed and unlisted insurance companies reporting under both UK GAAP and IFRS as adopted by the EU.

Our preference – Solution II

In our view, Solution II provides the highest degree of stability and least disruption to the financial reporting process. This option would incorporate in UK GAAP the relevant text of the existing FSA rules. Section 34 of proposed FRS 102 would then require compliance with FRS 27 and the ABI SORP. It would also provide a consistent basis for profit reporting which will be understood by users of the financial statements.

The new Solvency II regime will require that the Solvency and Financial Condition Report prepared by insurers includes a reconciliation of the Solvency II balance sheet with the financial statements for the same period. It would be helpful if the capital statement required by FRS 27 and the ABI SORP also required an audited reconciliation of UK GAAP capital and liabilities with those in the Solvency II balance sheet so that shareholders can understand the new capital requirements in light of their impact on a familiar profit reporting basis.

The cost implications of Solution II arise from the need to retain systems to calculate amounts for profit reporting that used to be required under the previous solvency capital requirements at a time when the insurance sector will have moved to the Solvency II rules. We believe that this cost would be an acceptable burden to UK insurers in the short-term to secure the benefit of profit reporting stability.

Solution I

The adoption of Solution I would be our second preference. The adoption of the current text of IFRS 4 (IFRS 4 Phase I) would grandfather the accounting policies that UK insurers have developed under current UK GAAP. Although this solution would appear to produce the same results as those under solution II, it is subject to a number of practical issues:

- Adoption of IFRS 4 Phase I would introduce a new framework for the change of accounting policies that would represent a new and more liberal regime than that under current UK GAAP (paragraphs 22-30 of IFRS 4). Whilst the Staff Paper acknowledges that this may encourage insurers to introduce improvements to their accounting policies, it would not oblige them to do so. This could result in greater fragmentation and diversity across the UK insurance sector than under Solution II. In our experience, few, if any existing UK insurers reporting under IFRS 4 have taken advantage of this freedom, so it is likely to be of little benefit.
- If the way in which IFRS 4 Phase I was embedded into UK GAAP allowed, but did not require, accounting provisions to be calculated on a Solvency II basis, this could give insurers the option to reduce burdens as provisions would only need to be calculated on

one basis. However, as explained above, this approach is likely to conflict with the requirements of UK law.

- Existing insurance companies that report under UK GAAP but have not yet applied FRS 26 would need to carry out the exercise set out in paragraph 6.9 of the Staff Paper in 2014. Whilst some reassessment of such contracts might be required from 2015 under proposed FRS 102, this would bring the costs forward by a year and require two changes of accounting policy, not one.
- The disclosure requirements of IFRS 4 are different and somewhat less prescriptive than those under current UK GAAP. For example, there is no requirement to produce a capital statement as required by FRS 27. This could result in more diverse sets of disclosures than under current UK GAAP for insurance to the detriment of users of the financial statements.
- Finally, were the ASB to take forward this solution, it would nevertheless be necessary to preserve the text of the ABI SORP and FRS 27 and the FSA's current rules somewhere for reference, as this is the grandfathered accounting that anyone applying UK GAAP would need to refer to.

Solution III

Solution III has the attraction of using Solvency II figures for financial reporting and could appear to save costs as only one provisioning calculation would be needed. However, this approach is likely to conflict with the requirements of current UK law.

New standards that use Solvency II figures could fundamentally change UK insurers' reported profit, as they focus on policyholder protection rather than the needs of shareholders. They would also have a fairly limited useful life as IFRS 4 Phase II would apply only a few years later. At that point another (potentially expensive) implementation exercise would be necessary to deal with the inconsistencies that exist between Solvency II and IFRS 4 Phase II set out in Appendix A of the Paper. For this reason we do not support Solution III unless changes to the law force the need to account on a Solvency II basis.

Solvency II is balance sheet focused and does not address issues such as revenue recognition and presentation. An extensive (and costly) standard setting exercise would be needed, and time is running out to get any such standard ready in time for practical application in 2014, even if 2013 comparatives did not need to be restated.

Solution IV

Adoption of the latest draft of IFRS 4 Phase II would be the short-term solution with the most disruptive effect on the stability of reporting within the UK insurance sector, and would not eliminate the need to produce provisioning calculations on both a GAAP and Solvency II basis. The standard is not complete and there is still the potential for significant change (negating any projected savings). There would again be significant costs because of the short implementation period for application for periods commencing on or after 1 January 2014. If the ASB were, nevertheless, to adopt this option, we draw your attention to the need for transitional provisions so that the comparatives for 2013 do not need to be restated.