

# 27

LIFE ASSURANCE

FINANCIAL REPORTING  
STANDARD



ACCOUNTING  
STANDARDS  
BOARD

*Financial Reporting Standard 27 'Life Assurance' is issued by the Accounting Standards Board in respect of its application in the United Kingdom and by the Institute of Chartered Accountants in Ireland in respect of its application in the Republic of Ireland.*

# 27

**LIFE ASSURANCE**



**ACCOUNTING  
STANDARDS  
BOARD**

*Financial Reporting Standard 27 'Life Assurance' is set out in paragraphs 1-67.*

*The Statement of Standard Accounting Practice, which comprises the paragraphs set in bold type, should be read in the context of the Objective as stated in paragraph 1 and the definitions set out in paragraph 2 and also of the Foreword to Accounting Standards and the Statement of Principles for Financial Reporting currently in issue.*

*The explanatory paragraphs contained in the FRS shall be regarded as part of the Statement of Standard Accounting Practice insofar as they assist in interpreting that statement.*

*Appendix IV 'The development of the FRS' reviews considerations and arguments that were thought significant by members of the Board in reaching the conclusions on the FRS.*

# C O N T E N T S

*Paragraph*

## SUMMARY

### FINANCIAL REPORTING STANDARD

<i>Objective</i>	1
<i>Definitions</i>	2
<i>Scope</i>	3
<i>Life assurance liabilities and assets</i>	4–29
<i>Measurement of with-profits liabilities and related assets</i>	4–21
<i>Disclosure and presentation relating to with-profits business</i>	22–25
<i>Value of in-force life assurance business</i>	26–29
<i>Capital and liabilities</i>	30–60
<i>Capital statement</i>	32–44
<i>Disclosures relating to liabilities and capital</i>	45–52
<i>Disclosure of analysis of liabilities</i>	53–54
<i>Movements in capital</i>	55–60
<i>Date from which effective and transitional arrangements</i>	61–67

### ADOPTION OF FRS 27 BY THE BOARD

### APPENDICES

- I ILLUSTRATION OF THE CAPITAL STATEMENT
- II NOTE ON LEGAL REQUIREMENTS
- III COMPLIANCE WITH INTERNATIONAL ACCOUNTING STANDARDS
- IV THE DEVELOPMENT OF THE FRS



## **SUMMARY**

- a Financial Reporting Standard 27 applies to all entities that have a life assurance business, including a life reinsurance business.
- b For large UK with-profits life assurance businesses falling within the scope of the FSA's realistic capital regime, liabilities to policyholders are required by the FRS to be measured on the basis determined in accordance with that regime, subject to adjustments specified in the FRS. Further adjustments are made to related assets and deferred tax for consistency with the measurement of the realistic liabilities, and the resulting effect on profit and loss account is offset by a corresponding transfer to the fund for future appropriations or, in the case of a mutual, to retained surplus.
- c For all entities within the scope of the FRS, the fund for future appropriations must be separately presented on the balance sheet and an explanation given of a negative FFA balance.
- d The FRS restricts the recognition of the value of in-force business, but permits entities that currently recognise such value to continue to do so, subject to limitations on the way this value may be determined.
- e A capital statement is required setting out the total available capital for sections of the life assurance business of the entity.
- f The capital statement is required to be supported by information on regulatory capital requirements or management's capital targets, the basis of determining regulatory capital, the sensitivity of liabilities and capital to changes in market variables and key assumptions, and the entity's capital management policies.

- g Information is also required to be disclosed on the assumptions used in the measurement of liabilities, and the terms and conditions of options and guarantees relating to life assurance contracts. For those liabilities to policyholders resulting from options and guarantees that are not measured at fair value or on a statistical basis that takes into account all possible outcomes of the option or guarantee, entities must provide additional information on the nature and extent of the options and guarantees and the possible liabilities that may arise.
- h A movements table is also required to show the changes in capital from one reporting date to the next.



## **FINANCIAL REPORTING STANDARD**

---

### **OBJECTIVE**

- 1 The objective of this FRS is to require appropriate measurement of, and disclosures relating to, liabilities and assets of life assurance business; and disclosures relating to the financial strength of entities carrying on life assurance business.

### **DEFINITIONS**

- 2 The following definitions shall apply in the FRS and in particular in the Statement of Standard Accounting Practice set out in **bold type**.

The **Financial Services Authority (FSA) realistic capital regime** is that set out in section 7.4 of its integrated prudential sourcebook.\*

The **realistic value of liabilities** is that element of the amount defined by rule 7.4.40 in the FSA's integrated prudential sourcebook, excluding current liabilities falling within the definition in rule 7.4.190 that are recognised separately on the entity's balance sheet.

An entity's **existing accounting policies** are the accounting policies adopted in its last annual financial statements before adoption of this FRS.

The **modified statutory solvency basis (MSSB)** for determining insurance liabilities is the statutory solvency basis adjusted, in accordance with the Statement of

---

\* *References to the FSA's integrated prudential sourcebook for insurers, and to individual rules therein, are to the rules made on 18 November 2004 by the Integrated Prudential Sourcebook (Insurers and Other Amendments) Instrument 2004.*

Recommended Practice of the Association of British Insurers (the ABI SORP), for the following items:

- (a) to defer new business acquisition costs incurred where the benefit of such costs will be obtained in subsequent accounting periods; and
- (b) to treat investment, resilience and similar reserves, or reserves held in respect of general contingencies or the specific contingency that the fund will be closed to new business, where such items are held within the long term business fund, as reserves rather than provisions. These are included, as appropriate, within shareholders' capital and reserves or the Fund for Future Appropriations.

The **statutory solvency basis** is the basis of determination of insurance liabilities in accordance with rule 7.4.27 of the FSA's integrated prudential sourcebook.

The **Principles and Practices of Financial Management (PPFM)** is the statement that the FSA requires each with-profits life fund to make available to its policyholders containing, inter alia, a description of the fund's investment management and bonus distribution policies.

The **Fund for Future Appropriations (FFA)** is the balance sheet item required by Schedule 9A to the Companies Act 1985 to comprise all funds the allocation of which, either to policyholders or to shareholders, has not been determined by the end of the accounting period.

**Directive friendly societies** and **non-directive friendly societies** are as defined in section 7 of the FSA Interim Prudential Sourcebook for Friendly Societies.

## SCOPE

- 3 The FRS applies to all financial statements that are intended to give a true and fair view of a reporting entity's financial position and profit and loss (or income and expenditure) for a period, where the reporting entity includes a business that is a life assurance business (including reinsurance business).

## LIFE ASSURANCE LIABILITIES AND ASSETS

### *Measurement of with-profits liabilities and related assets*

- 4 For with-profits life funds falling within the scope of the FSA realistic capital regime:
  - (a) liabilities to policyholders arising from with-profits life assurance business shall be stated at the amount of the realistic value of liabilities adjusted to exclude the shareholders' share of projected future bonuses;
  - (b) acquisition costs shall not be deferred;
  - (c) reinsurance recoveries that are recognised shall be measured on a basis that is consistent with the value of the policyholder liabilities to which the reinsurance applies;
  - (d) an amount may be recognised for the present value of future profits on non-participating business written in a with-profits fund if:
    - (i) the non-participating business is measured on this basis for the purposes of the regulatory returns made under the FSA realistic capital regime;

- (ii) the value is determined in accordance with the FSA regulations<sup>\*</sup>; and
  - (iii) the determination of the realistic value of liabilities in that with-profits fund takes account, directly or indirectly, of this value;
- (e) where a with-profits life fund has an interest in a subsidiary or associated entity that is valued for FSA regulatory purposes at an amount in excess of the net amounts included in the entity's consolidated accounts, an amount may be recognised representing this excess if the determination of the realistic value of liabilities to with-profits policyholders takes account of this value; and
- (f) adjustments to reflect the consequential tax effects of (a) to (e) above shall be made.

Adjustments from the modified statutory solvency basis necessary to meet the above requirements, including the recognition of an amount in accordance with paragraph 4(d) or 4(e), shall be included in the profit and loss account. An amount equal and opposite to the net amount of these adjustments shall be transferred to or from the FFA (or, in the case of a mutual, its retained surplus) and also included in the profit and loss account.

- 5 Amounts recognised under paragraph 4(d) or 4(e) shall be presented in one of the following ways:
  - (a) Where it is possible to apportion the amount recognised under paragraph 4(d) or 4(e) between an amount relating to liabilities to policyholders and an amount relating to the FFA, these portions

---

<sup>\*</sup> FSA rule PRU 7.4.37

**shall be presented in the balance sheet as a deduction in arriving at the amount of liabilities to policyholders and the FFA respectively.**

- (b) Where it is not possible to make a reasonably approximate apportionment of the amount recognised under paragraph 4(d) or 4(e), the amount shall be presented on the balance sheet as a separate item deducted from a sub-total of liabilities to policyholders and the FFA.**
- (c) Where the presentation under 5(a) or 5(b) does not comply with statutory requirements for balance sheet presentation applying to the entity, the amount recognised under paragraph 4(d) or 4(e) shall be recognised as an asset.**

- 6 The established accounting treatment for UK life assurance business is to measure liabilities for policyholder benefits on the modified statutory solvency basis (MSSB). The FRS does not require any change to the accounting for those funds not within the scope of the FSA realistic capital regime, but requires those UK with-profits funds that fall under that regime to use the realistic value of liabilities as the basis for the estimated value of the liabilities to be included in the financial statements. Where the entity's returns to the FSA have not been completed at the time of completion of the financial statements, an estimate of the amount may be used provided it is in accordance with the FSA regulations.
- 7 An entity may, but is not required to, adopt the requirements of paragraph 4 for UK\* with-profits funds that do not fall within the scope of the FSA realistic capital regime or for which the FSA has granted a full waiver from compliance with this regime.

---

\* *and Republic of Ireland with-profits funds*

- 8 Overseas insurance businesses that do not fall within the FSA's regulatory remit may determine insurance liabilities in accordance with local regulatory and accounting requirements. Adjustments on consolidation may be made to take account of the different bases of reporting, although insurance entities are exempt from the requirement in the Companies Act 1985\* applicable to other businesses to adjust amounts recognised in the financial statements of subsidiary undertakings onto a consistent basis for the purposes of consolidated financial statements. The FRS does not require any change to the accounting treatment of the liabilities of overseas businesses, but voluntary adoption of the requirements of paragraph 4 is permitted.
- 9 Liabilities determined in accordance with the FSA realistic capital regime include, in addition to amounts attributable to declared bonuses, amounts in respect of future bonuses, estimated in accordance with the entity's published Principles and Practices of Financial Management and representing a constructive obligation to policyholders. A liability is also included for policyholders' options and guarantees, measured at fair value or estimated using a stochastic model that has been calibrated to give market-consistent estimates of option and guarantee values.
- 10 An adjustment is made to the realistic value of liabilities to exclude the portion attributed to shareholders, which represents the shareholders' share of future bonuses. Similar adjustments should be made if other amounts due to shareholders would otherwise be included in the realistic value of liabilities.
- 11 Acquisition costs are deferred under MSSB to offset the effects of 'new business strain', being the requirement to establish liabilities on a statutory solvency basis on inception of a policy in excess of the premiums received. When liabilities are restated in accordance with the FSA realistic

---

\* and equivalent Republic of Ireland and Northern Ireland legislation

capital regime, there is no longer any justification for treating such costs as an asset. The FRS does not alter the treatment of deferred acquisition costs relating to business outside the scope of the FSA realistic capital regime (other than adjustments that may be made to deferred acquisition costs relating to business for which the value of in-force business is recognised under paragraph 4(d) or (e)).

- 12 Amounts recoverable under reinsurance contracts relating to life assurance shall be measured on a basis consistent with the measurement of the related liability, so that the net amount reflects the exposure of the entity. Changing the measurement of the liability may therefore give rise to a change in the related reinsurance asset. The amount of the change in the asset will depend on the terms of the reinsurance contract.
  
- 13 Under the FSA realistic capital regime, a with-profits life fund includes within assets the value of future profits expected to arise from non-participating business (ie life assurance policies that do not have a with-profits feature, such as term assurance, annuities and unit-linked policies) that form part of the with-profits fund—sometimes referred to as the value of in-force business. In the FSA realistic capital regime, this value is also taken into account in determining the returns earned by the fund and its financial strength, and thus gives rise to an increase in the estimated value of future bonuses included in the realistic value of liabilities, although there is not necessarily a direct link between the value of in-force business and the additional amount included in liabilities. To exclude from the balance sheet the value of in-force business whilst recognising the realistic value of liabilities in full, and valuing non-participating liabilities on a statutory basis, would give rise to an inconsistency in the fund's net assets. An entity is therefore permitted to recognise the value of in-force business if that business has been taken into account in measuring the liability, in the circumstances of paragraph 4(d), even though there is not a direct link between the value of the asset and the amount of the liabilities. Where

there is not a direct link between the value of the business and the amount of realistic liabilities, but the value is taken into account in determining those liabilities, it is appropriate to recognise the total value of the business. Although not separately identifiable, any excess value over that included in realistic liabilities will be taken to the FFA. Paragraph 4(d) applies only to non-participating business written in a with-profits fund and not to such business outside a with-profits fund.

- 14 The amount recognised under paragraph 4(d) or 4(e) may be regarded either as an additional asset, representing the value of future cash flows from the related insurance business; or as an adjustment to the measurement of liabilities and the FFA, being the deduction from these items of the obligation to transfer an unrecognised asset or other source of value. The FRS requires entities to adopt the latter interpretation, unless this would not be in compliance with the statutory requirements that apply to the entity, in which case it permits the amount to be recognised as an asset. Where the amount is treated as an adjustment to a liability, the FRS requires an entity to apportion, if practicable, the amount between the amounts that have been taken into account in the measurement of liabilities and other amounts that should be shown as an adjustment to the FFA. Where this is not practicable, the amount recognised should be shown as an adjustment to a sub-total of the FFA and liabilities to policyholders.
- 15 The value of in-force non-participating business recognised within assets for regulatory purposes as described in paragraph 13 is determined as the discounted value of future profits expected to arise from the policies, taking into account liabilities relating to the policies measured on a statutory solvency basis. When adjustments are made onto an MSSB basis for the purposes of the financial statements (for example, to adjust liabilities to exclude certain additional reserves included in the liabilities for regulatory purposes, or where future income included in the value of in-force business covers deferred acquisition costs included



in the MSSB balance sheet), a corresponding adjustment to the value of in-force policies will need to be made in order to ensure a consistent valuation.

- 16 A similar situation may arise where an entity chooses to value an interest in a subsidiary that is held directly in the with-profits fund at a value that includes the value of in-force business within the subsidiary in addition to its net asset value, as permitted by the FSA regulations. In such a case, the value taken into account in determining the realistic value of liabilities is greater than the net assets included in the consolidated accounts. To exclude from the balance sheet the additional value of the investment in the subsidiary whilst recognising the realistic value of liabilities in full would result in an inconsistency in the fund's net assets. An entity is therefore permitted to recognise the excess of the market value of the subsidiary over the net amounts included in the consolidated financial statements as a deduction from the sub-total of the FFA and liabilities to policyholders in the same way as the value of in-force business described in paragraph 13.
- 17 Where the amounts on a 'realistic' basis determined in accordance with paragraph 4 above are different from the amounts on a modified statutory solvency basis, a corresponding amount is transferred to or from the FFA, so that there is no effect on shareholders' funds. However, individual lines in the revenue (technical) account, including the line item for transfers to or from the FFA, will be affected. The potential shareholders' share corresponding to additional bonuses to policyholders that have been included in the policyholders' liability should be accounted for in the FFA. As a result, there will generally be no change in the profit for the financial year and, in the case of an entity that is not a mutual, generally no change to shareholders' funds. However, this will not be the case where the adjustments result in a negative balance on the FFA and the entity determines that this negative balance should result in a deduction from shareholders' funds through the profit and loss account.

- 18 In the case of a mutual, which has no shareholders, an FFA or retained surplus account is maintained that represents amounts that have not yet been allocated to specific policyholders. For such entities, the adjustments required by paragraph 4 will be offset within the profit and loss account by a transfer directly to or from this FFA or retained surplus account, with the result that overall profit or loss for the year will be unchanged.

*Policyholders' options and guarantees*

- 19 Entities with with-profits funds within the scope of the FSA's realistic capital regime are required to measure the liability of those funds in respect of options and guarantees relating to policyholders either at fair value or at an amount estimated using a market-consistent stochastic model in accordance with FSA regulations.
- 20 For all life assurance businesses, the best basis for measuring policyholders' options and guarantees is one that includes their time value\*. Any deterministic approach to valuation of a policy with a guarantee or optionality feature will generally fail to deal appropriately with the time value of the option. In order to capture this time value it is necessary to use stochastic modelling techniques to evaluate the range of potential outcomes unless a market value for the option is available. The FSA realistic capital regime includes a requirement to value options and guarantees on this basis. For the liabilities of businesses not falling within the scope of the FSA realistic capital regime, entities are encouraged, but not required, to adopt these valuation techniques. Where options are not valued on this basis, additional disclosures are required; these are set out in paragraph 48(c).

---

\* *The value of an option or guarantee comprises two elements, the intrinsic value and the time value. The intrinsic value is the amount that would be payable if the option or guarantee were exercised immediately – that is, the amount it is currently 'in the money', or nil if it is 'out of the money'. The time value is the additional value that reflects the possibility of the intrinsic value increasing in future, before the expiry date of the option or guarantee.*

- 21 Under the FSA realistic capital regime, a market-consistent stochastic method for estimating the value of guarantees and options involves:
- (a) determining the market variables whose value will affect the additional amount payable under the guarantee or option, and the period in which they have such effect;
  - (b) determining the likely distribution of each of those variables within that time period, using assumptions calibrated to market observations;
  - (c) constructing a large number of possible scenarios combining different changes in each variable over the time period, reflecting the expected distribution of values determined in accordance with (b);
  - (d) evaluating the additional amounts payable under the option or guarantee under each scenario; and
  - (e) combining these, weighted according to the probability of each scenario occurring, to determine the expected value of the liability.

In determining the amount payable under each scenario, the entity will take into account management actions it anticipates would be taken in response to variations in market variables (such as changing the balance of the investment portfolio between debt instruments and equity, varying the amount charged to policyholders, or varying its bonus policy) that will affect the amount payable under the guarantee or option. Such actions must be realistically capable of being implemented within the time-scale assumed in the scenario analysis, and be consistent with the entity's published Principles and Practice of Financial Management.

*Disclosure and presentation relating to with-profits business*

- 22 **Entities shall present the FFA on the balance sheet separately from technical provisions and other liabilities.**
- 23 **Where the balance on the FFA of a with-profits life fund is negative, as a result of the transfer made in accordance with paragraph 4 or otherwise, the entity shall include in the notes to the financial statements an explanation of the nature of the negative balance and the circumstances in which it arose, and why no action to eliminate it has been considered necessary.**
- 24 The FFA should be disclosed separately on the balance sheet, and not combined with technical provisions. Entities that consolidate interests in a life assurance entity on a basis that combines the FFA and technical provisions into a single amount of liabilities to policyholders are required to show these elements separately.
- 25 A negative balance on the FFA may arise, either under MSSB or as a result of adjustments made under paragraph 4. Sometimes this will result in the entity taking action that results in the elimination of the negative balance. Where no such action has been considered necessary, details of the negative balance are required by paragraph 23, including an explanation of why the entity considers it appropriate not to take action to eliminate this balance. Where an entity has more than one with-profits fund, a negative balance on the FFA in one fund should not be offset against a positive balance in another.

*Value of in-force life assurance business*

- 26 **Where, other than under paragraph 4(d) or 4(e) above, an entity's existing accounting policies include the recognition of the value of in-force life assurance business as an asset (or as a deduction from a liability), it may continue to recognise such an item**

**as an asset, but shall exclude from the value of that asset any value of in-force policies that reflects future investment margins.**

27 Banking and other non-insurance entities with insurance subsidiaries\* sometimes account for the insurance business in their consolidated financial statements on an embedded value or similar basis under which, in addition to the value of the retained surplus in the insurance subsidiary, an asset is recognised for the discounted value of the future profit to shareholders expected to arise from existing insurance business. The FRS permits the continuation of such a practice only if the existing policy is amended, if necessary, to exclude from the measurement of the value of the in-force business any value attributable to future investment margins. Investment margins are the amounts by which assumed investment returns exceed the risk-free return on assets. As a consequence of excluding these margins, the embedded value will not vary with the choice of assets in which the fund is invested (ignoring different tax treatments of various types of asset). An example of an accounting policy that reflects those margins, and is not permitted under the FRS, is projecting the returns on the insurer's assets at an estimated rate of return in excess of the risk-free rate, discounting those projected returns at a lower rate and including the result as part of the measurement of the value of in-force business.

**28 No value shall be attributed to in-force life assurance business other than:**

**(a) in accordance with paragraphs 4(d), 4(e) or 26 above; or**

**(b) amounts recognised as an intangible asset as part of the allocation of fair values under acquisition accounting in accordance with FRS 7 'Fair Values**

---

\* *and insurance entities and groups in the Republic of Ireland*

**in Acquisition Accounting', which are subject to the measurement requirements of that standard and not paragraph 26 above.**

- 29 Where the value attributable to in-force life assurance business recognised under paragraph 26 or paragraph 28(b) includes an amount in relation to non-participating business for which the entity also recognises an amount under paragraph 4(d) or 4(e), the amount recognised under paragraph 4(d) or 4(e) shall be reduced to exclude the amount that is included in relation to that business under paragraph 26 or paragraph 28(b).**

#### **CAPITAL AND LIABILITIES**

- 30 An entity shall present quantitative and narrative disclosures of its regulatory capital position, as set out below.**
- 31 An entity is not required to include the disclosures required by paragraphs 32 to 47 and 53 to 60 if it is:**
- (a) a subsidiary undertaking where 90 per cent or more of the voting rights are controlled within the group; or**
  - (b) a parent entity, in relation to its individual financial statements**

**provided the entity is included in publicly available group financial statements which provide information on a group basis complying with the FRS.**

*Capital statement*

- 32 **An entity shall present a statement setting out its total capital resources relating to life assurance business. The statement shall show, for each section of that business as defined in paragraph 34:**
- (a) shareholders' funds (or in the case of a mutual, the equivalent, often described as disclosed surplus);**
  - (b) adjustments to restate these amounts in accordance with regulatory requirements;**
  - (c) each additional component of capital included for regulatory purposes, including capital retained within a life fund whether attributable to shareholders, policyholders or not yet allocated between shareholders and policyholders; and**
  - (d) the total capital available to meet regulatory capital requirements.**
- 33 Available capital will comprise a number of distinct elements, each of which will be separately disclosed, including:
- (a) shareholders' funds as included in the published balance sheet, represented by surplus held within a life fund or by assets held separately from those of the fund itself;
  - (b) amounts that are wholly attributable to shareholders, but held within a life fund and where the distribution out of the fund is restricted by regulatory or other considerations;
  - (c) surplus held in life funds that has yet to be attributed or allocated between shareholders and policyholders (in the case of a mutual all such surplus is attributable to policyholders but is not treated as a liability); and
  - (d) qualifying debt capital, whether issued by the life entity itself or by another entity within the group.

**34 The capital statement shall show as separate sections:**

- (a) each UK\* with-profits life fund that is material to the group; and**
- (b) the entity's other life assurance business, showing the extent to which the various components of capital are subject to constraints such that they are available to meet requirements in only part of the entity's business, or are available to meet risks and regulatory capital requirements in all parts of the business.**

**35** The purpose of the capital statement is to set out the financial strength of the entity and to provide an analysis of the disposition and constraints over the availability of the capital to meet risks and regulatory requirements. It is particularly important to show the various sources of capital separately and the extent to which the capital in each section is subject to constraint as to its ability to meet requirements in other parts of the entity. Such constraints can arise for any of the following reasons:

- (a) ownership—the capital may be subject to specific ownership considerations (for example, the FFA of a UK with-profits fund, for which the allocation between policyholders and shareholders has not been determined);
- (b) regulatory—local regulatory limitations may require the maintenance of solvency margins in particular funds or countries; or
- (c) financial—the availability of capital in certain cases can be restricted due to the imposition of taxes or other financial penalty in the event of the capital being required to be redeployed across the group.

---

\* or, for an entity in the Republic of Ireland, each with-profits fund in the Republic of Ireland.



- 36 An entity must consider how best to present information to meet the requirements of paragraph 34(b) in the particular circumstances of its own business. For example, those requirements might be met by sub-analysis of the part of the entity's life assurance business, other than the UK with-profit life funds, into two sections in the statement, one including amounts of capital that are constrained and the other amounts that are freely available to meet risks and regulatory capital requirements in all parts of the business. Alternatively, this information could be presented by means of a sub-analysis by the nature of the capital constraints applying to each business unit: one section in the capital statement would include those business units where there were no constraints on transferring surplus capital to other parts of the group, and another section in the statement would include those business units where surplus capital was constrained. Under either approach, the information would need to be supplemented by narrative explaining the nature and effect of the constraints. Where the capital constraints are more complex, it may be necessary to add additional sections in the capital statement providing further analysis of the different types of constraint that apply. Another way of meeting this requirement would be to provide aggregated information supplemented by fuller narrative disclosure of the constraints and their effect.
- 37 **The aggregate amount of regulatory capital resources included in the capital statement shall be reconciled to the shareholders' funds, FFA and other amounts shown in the entity's balance sheet, showing separately for each component of capital the amount relating to the entity's business other than life assurance. Where such other business is significant, an explanation shall be given of the extent to which this capital can be used to meet the requirements of the life assurance business.**
- 38 Although the detailed requirements apply to life assurance business, entities will need to incorporate information on other parts of the business, together with consolidation

adjustments, in order to demonstrate how the aggregated capital attributed to the life assurance business reconciles to the total shown in the consolidated balance sheet, and the extent to which capital outside the life assurance business may be made available to meet the capital requirements of the life assurance business. This reconciliation applies to each different type of capital shown in the capital statement.

**39 Where the reporting entity is a subsidiary undertaking, narrative supporting the capital statement shall explain the extent to which the capital of the entity is able to be transferred to the parent or fellow subsidiaries, or the extent to which it is required to be retained within the reporting entity.**

40 For life funds within the scope of the FSA realistic capital regime, in determining available capital, liabilities will be taken into account at their 'realistic' amount (unless the capital requirement is higher on the regulatory basis). Further adjustments are necessary to adjust the capital shown in the balance sheet to the amount for regulatory purposes. The most significant differences are:

- (a) the inclusion in capital of the fund for future appropriations;
- (b) the exclusion from capital of the shareholders' share of accrued bonus;
- (c) the exclusion of goodwill and other intangible assets, such as an amount attributed to the acquired value of in-force business; and
- (d) changes to the valuation of assets and the exclusion of certain non-admissible assets for regulatory purposes, for example any regulatory adjustment to a pension fund deficit that is recognised as a liability.

Disclosure of these adjustments should be sufficient to give a clear picture of the capital position from a regulatory

perspective and its relationship to the shareholders' funds shown in the consolidated balance sheet.

- 41 **Where the amount of a capital instrument that qualifies for inclusion as regulatory capital is restricted (for example, where a limited percentage of total regulatory capital may be in the form of debt) the full amount of the instrument shall be included, with a separate deduction for the amount in excess of the restriction.**
- 42 **Disclosure shall be made of any formal intra-group arrangements to provide capital to particular funds or business units, including intra-group loans and contingent arrangements. Where the reporting entity is a subsidiary undertaking, disclosure shall also be made of similar arrangements between the entity and its parent or fellow subsidiary undertakings.**
- 43 Regulatory capital can include both shareholders' funds and surplus within the fund. Such surplus may be wholly attributable to shareholders, or form part of the fund that has not yet been appropriated and allocated between shareholders and policyholders. In a mutual fund, all surplus is attributable to policyholders. Debt instruments qualifying as capital may also be issued from the fund itself, or may form part of the shareholders' net assets outside the life fund; and a debt instrument issued by the fund to the shareholders may effectively transfer capital from the shareholders to the fund. Separate disclosure of each class of capital is important to an understanding of the funding of the business and the way any future losses would be absorbed or new business financed.
- 44 Intra-group arrangements should be included in the regulatory capital of a section only where they are subject to formal arrangements. Where capital in other parts of a group is available to meet the requirements of a particular section of the business, but no formal arrangement has been

entered into to do so, no allocation of this capital to the section of the business should be shown in the capital position statement.

*Disclosures relating to liabilities and capital*

- 45 **The capital statement shall be supported by the following disclosures:**
- (a) narrative or quantified information on the regulatory capital requirements applying to each section of the business shown in the capital statement, or on the capital targets set by management for that section;**
  - (b) narrative disclosure of the basis of determining regulatory capital and the corresponding regulatory capital requirements and any major inconsistencies in this basis between the different sections of the business;**
  - (c) narrative disclosure addressing the sensitivity of liabilities and the components of total capital to changes in market conditions, key assumptions and other variables, and assumptions about future management actions in response to changes in market conditions; and**
  - (d) narrative disclosure of the entity's capital management policies and objectives, and its approach to managing the risks that would affect the capital position.**
- 46 Although the capital statement itself deals only with capital available to meet regulatory requirements, the narrative discussion should address both this and the related regulatory requirements. Narrative explanation of the capital position, setting out its capital management objectives and risk management policies and the sensitivity to changes in assumptions, is important to the user's ability

to understand the management of capital by the entity, its financial adaptability in changing circumstances, and the resources available to each group of policyholders.

- 47 Narrative discussion of sensitivity to changes in market conditions, assumptions and other variables is required to address both liabilities, including options and guarantees given to policyholders, and the components of total capital. Measurement of liabilities, including options and guarantees, may be determined using stochastic methods that take into account actions that are assumed would be taken by management in response to changes in market conditions. Incorporating management actions in this way can substantially alter the value of liabilities and disclosure of the effect of changes in such assumptions is required. In relation to UK life funds, management actions that are taken into account should be consistent with those disclosed in the life fund's Principles and Practices of Financial Management available to policyholders.
- 48 **In relation to life assurance liabilities, the entity shall include the following additional information:**
- (a) **the process used to determine the assumptions that have the greatest effect on the measurement of liabilities including options and guarantees and, where practicable, quantified disclosure of those assumptions;**
  - (b) **those terms and conditions of options and guarantees relating to life assurance contracts that could in aggregate have a material effect on the amount, timing and uncertainty of the entity's future cash flows; and**
  - (c) **information about exposures to interest rate risk or market risk under options and guarantees if the entity does not measure these at fair value or at an amount estimated using a market-consistent stochastic model.**

- 49 It may be relatively easy to quantify some assumptions that are used in the measurement of liabilities – for example, discount rates or general inflation, where the rate used should be disclosed. For other assumptions, such as mortality tables, it may not be practicable to disclose quantified assumptions because there are too many, or they cannot be expressed as single values, in which case it is more important to describe the process used to generate the assumptions. The description of the process would include the objective – whether a best-estimate or a given level of assurance is intended; the sources of data; whether assumptions are consistent with observable market data or other published information; how past experience, current conditions and future trends are taken into account; correlations between different assumptions; management’s policy for future bonuses; and the nature and extent of uncertainties affecting the assumptions.
- 50 Options and guarantees are features of life assurance contracts that confer potentially valuable guarantees underlying the level or nature of policyholder benefits, or options to change these benefits exercisable at the discretion of the policyholder. For the purposes of this FRS, the term is used to refer only to those options and guarantees whose potential value is affected by the behaviour of financial variables, and not to those features of life assurance contracts where the potential changes in policyholder benefits arise solely from insurance risk (including mortality and morbidity), or from changes in the entity’s creditworthiness. It includes a financial guarantee or option that applies if a policy lapses, but does not include the option to surrender or allow a policy to lapse.
- 51 **The requirements of 48(c) will require, for options and guarantees that are not measured at fair value or at an amount estimated using a market-consistent stochastic model, the following disclosures:**
- (a) a description of the nature and extent of the options and guarantees;

- (b) the basis of measurement for the amount at which these options and guarantees are stated, and the extent to which an amount is included for the additional payment that may arise under the option or guarantee in excess of the amounts expected to be paid under the relevant policies if they did not include the option or guarantee feature;**
- (c) the main variables that determine the amount payable under the option or guarantee; and**
- (d) information on the potential effects of adverse changes in those market conditions that affect the entity's obligations under options and guarantees.**

52 The requirement of 51(d) may be met by disclosing:

- (a) for options and guarantees that would result in additional payments to policyholders if current asset values and market rates continued unchanged (ie those that are 'in the money'), an indication of the change in these amounts if the variables moved adversely by a stated amount;
- (b) for options and guarantees that would result in additional payments to policyholders only if there was an adverse change in current asset values and market rates (ie those that are 'out of the money'):
  - (i) an indication of the change in these variables, from current levels, which would cause material amounts to become payable under the options and guarantees; and
  - (ii) an indication of the amount that would result from a specified adverse change in these variables from the levels at which amounts first become payable under the options and guarantees.

The above disclosures may be made in aggregate for classes of options and guarantees that do not differ materially, or which are not individually material.

*Disclosure of analysis of liabilities*

**53 The capital statement shall show the amount of policyholder liabilities attributed to each section of the business shown in the statement, analysed between:**

- (a) with-profits business;**
- (b) unit-linked business;**
- (c) other life assurance business; and**
- (d) insurance business accounted for as financial instruments in accordance with the requirements of FRS 26 (IAS 39) 'Financial Instruments: Measurement'.**

**The total of these policyholder liabilities shall be the amounts shown in the entity's balance sheet.**

**54** The relationship between capital requirements and policyholder liabilities for each fund or business unit provides additional information on the interrelationship between the capital position and the extent of liabilities.

*Movements in capital*

**55** An entity shall include an explanation of the movements in the total amount of available capital for life assurance business shown in the capital statement with the corresponding amounts at the end of the previous accounting period. This disclosure shall cover individually each UK life fund\* that is separately shown in the capital



**statement required under paragraph 32, and other life assurance business in aggregate.**

- 56 **This disclosure shall set out in tabular form the effect of changes resulting from:**
- (a) changes in assumptions used to measure life assurance liabilities, showing separately the effect of each change in an assumption that has had a material effect on the group;**
  - (b) changes in management policy;**
  - (c) changes in regulatory requirements and similar external developments; and**
  - (d) new business and other factors, describing any material items.**
- 57 An understanding of the underlying causes of changes in the capital position is valuable, giving an insight into the development of the entity's life assurance business. It is important to separate movements relating to changes in assumptions and management policy from other movements arising from the business. Those other movements might arise from changing market prices affecting assets and liabilities and movements resulting from surrenders, lapses and maturities of existing policies and new business written, and would be identified, where material, in accordance with paragraph 56(d).
- 58 The movements analysis distinguishes between assumption changes, changes in management policy, and other factors. Changes in management policy relate to significant changes in the management of the fund such as changes in investment policy or changes in the use of the estate. Where management actions are clearly directly related to

---

\* *or, for an entity in the Republic of Ireland, each life fund in the Republic of Ireland.*

changes in assumptions or other factors, it will be appropriate to show the net impact but the narrative should discuss the constituent factors. An example might be the combined effect of a reduced level of bonuses assumed as a result of a reduction in the assumed level of future investment return and a reduction in investment returns earned in the period.

- 59 Although it is important to explain all movements in liabilities and capital during the period that are material to the group, this does not imply that the impact of each assumption change needs to be shown separately. Where there is a common cause for the change of assumption the impact can be grouped together. As an example, the impact of changes in investment return attributable to changing market circumstances does not need to be broken down between the various classes of investment.
- 60 Determination of the effect of assumption changes involves considerable recalculation of valuations using both old and new assumptions and, particularly in the case of option and guarantee models, this may result in impracticable demands on computer systems. This is especially so in the first year of applying the FRS, when the FSA realistic valuation methodology is relatively new and untried, and estimation and approximation methods for analysing and explaining movements for management purposes are in the early stages of development. Accordingly, less detailed analysis of changes, and less quantification of movements, may be expected in the first year of applying the FRS as a result of these practical difficulties; paragraph 66 permits entities to present this information in non-tabular form for an accounting period ending before 23 December 2006.

**DATE FROM WHICH EFFECTIVE AND  
TRANSITIONAL ARRANGEMENTS**

- 61 Subject to paragraphs 62 and 63, the accounting practices set out in the FRS shall be regarded as standard for financial statements relating to accounting periods ending on or after 23 December 2005. Earlier adoption of all or part of the FRS is permitted.**
- 62 Entities that are directive friendly societies and are not within the scope of the FSA realistic capital regime are not required to apply the FRS for accounting periods ending before 23 December 2006.**
- 63 Entities that are non-directive friendly societies are not required to apply the FRS for accounting periods ending before 23 December 2007.**
- 64 Changes in accounting policy resulting from the adoption of the FRS shall be accounted for by restating prior periods in accordance with FRS 3 'Reporting Financial Performance', except that comparatives in the profit and loss account need not be restated for changes arising from the adoption of a new accounting policy in accordance with paragraph 4 where this is not practicable.**
- 65 For those entities that adopt the measurement requirements of paragraph 4, including adoption of the realistic value of liabilities as the basis of measurement, or adoption of stochastic methods for the measurement of options and guarantees, it may not be practicable to restate profit and loss account comparatives for the first year of adoption. Accordingly, the FRS permits such comparatives not to be restated. FRS 18 'Accounting Policies' sets out requirements for disclosures relating to changes in accounting policies.**

- 66 **For accounting periods ending before 23 December 2006, an entity is not required to set out the analysis of movements in tabular form as required by paragraph 56, but should include quantified disclosure of changes where practicable. The narrative disclosure required by paragraph 55 should address the movements as categorised in paragraph 56. For the first accounting period for which a table of movements is presented, comparatives for the previous period are not required.**
- 67 Comparatives should be disclosed for the capital position statement, for the table of movements in the capital position and for the related disclosures. However, this may not be practicable in the case of the movements table for the first accounting period in which the FRS comes into effect. Accordingly, such disclosure is not required for that period, although it is encouraged if information is available.

## **ADOPTION OF FRS 27 BY THE BOARD**

---

Financial Reporting Standard 27 *Life Assurance* was approved for issue by the nine members of the Accounting Standards Board.

Ian Mackintosh	Chairman
Andrew Lennard	Technical Director
Michael Ashley	
Douglas Flint	
Anthony Good	
Roger Marshall	
Isobel Sharp	
Jonathan Symonds	
Peter Westlake	



## **APPENDIX I**

---

### **ILLUSTRATION OF THE CAPITAL STATEMENT**

---

*The following illustration of a capital statement and its supporting narrative is provided for general guidance only and does not form part of the FRS. It is intended to show a possible format for the capital statement, but is not intended to imply that this is the only form such a statement could take. Entities will need to consider the format for the statement that best meets their individual circumstances.*

Available capital resources	A UK (with- profits)	B UK (with- profits)	UK non- participating	Overseas	Life Business Shareholders' Funds	TOTAL LIFE BUSINESS	Other Activities	Consol. adjsts.	GROUP TOTAL
Shareholders' funds outside fund					850	850	200	(50)	1,000
Shareholders' funds held in fund			350			350			350
<b>Total shareholders' funds</b>			<b>350</b>		<b>850</b>	<b>1,200</b>	<b>200</b>	<b>(50)</b>	<b>1,350</b>
Adjustments onto regulatory basis:									
FFA	350	150				500			500
Adjustment to assets	(25)	(20)				(45)			(45)
Shareholders' share in realistic liabilities	(25)	(30)				(55)			(55)
Other adjustments									
Other qualifying capital:									
Loan capital	300	100	350		850	1,600	200	(50)	1,750
Internal loans		150			(150)		750		750
Allocation of group capital		300		300	(600)				
<b>Total available capital resources</b>	<b>300</b>	<b>550</b>	<b>350</b>	<b>300</b>	<b>100</b>	<b>1,600</b>	<b>950</b>	<b>(50)</b>	<b>2,500</b>



With-profits liabilities on realistic basis:			
Options and guarantees	200	100	300
Other policyholder obligations	1,800	4,000	7,700
<b>Total with-profits liabilities</b>	<b>2,000</b>	<b>4,100</b>	<b>8,000</b>
Unit-linked	1,000	500	2,300
Non-participating life assurance	800	1,400	3,100
<b>Technical provisions in balance sheet</b>	<b>3,800</b>	<b>4,500</b>	<b>13,400</b>

*The following paragraphs illustrate the explanation of the regulatory capital requirements required by paragraph 45(a) and (b), together with the analysis of liabilities required by paragraph 53. Further details of the determination of the regulatory capital position, including discussion of the sensitivity to changes in assumptions and management's policies and objectives, would need to be included to meet the requirements of paragraph 45(c) and (d) of the FRS.*

The Group has two UK with-profit funds, A and B, shown separately in the capital position statement. The Group's UK non-participating business is shown in aggregate. The Group's overseas life businesses are also aggregated for the purposes of the statement.

For the Group's two UK with-profit funds the available capital is determined in accordance with the 'realistic balance sheet' regime prescribed by the FSA's regulations, under which liabilities to policyholders include both declared bonuses and the constructive obligation for future bonuses not yet declared. The available capital resources include an estimate of the value of their respective estates, included as part of the FFA. The estate represents the surplus in the fund that is in excess of any constructive obligation to policyholders. The allocation of the estate between policyholders and shareholders has not been determined. It represents capital resources of the individual with-profits fund to which it relates and is available to meet regulatory and other solvency requirements of the fund and, in certain circumstances, additional liabilities that may arise.

For these with-profit funds, the liabilities included in the balance sheet include only amounts relating to policyholders and do not include the amount representing the shareholders' share of future bonuses. However, the shareholders' share is treated as a deduction from capital that is available to meet regulatory requirements and is therefore shown as a separate adjustment in the capital statement.

Shareholders' funds held outside the life funds and overseas businesses are shown separately in the capital statement. In the case of Fund B and certain overseas funds the capital requirements are met in part from centrally-held Group capital, by means of internal loans, contingent loans and share capital. To the extent that this support is made under a formal arrangement, it is shown as an allocation of Group capital between the sections of the statement.

The total available capital resources for each section of the statement shows the capital on a regulatory basis that is available to meet the regulatory capital requirements of that part of the business, and the targets for the surplus capital management regards as appropriate protection against future adverse changes in circumstances. Such capital is generally subject to restrictions as to its availability to meet requirements that arise elsewhere in the Group. The principal restrictions are:

- (a) *UK with-profits funds A and B* – the available surplus held in the fund can only be applied to meet the requirements of the fund itself or be distributed to policyholders and shareholders. Shareholders are entitled to an amount not exceeding one ninth of the amount distributed to policyholders in the form of bonuses, and the shareholders' share of distributions would also be subject to a tax charge.
- (b) *UK non-participating funds* – the available surplus held in the fund is attributable to shareholders and, subject to meeting the regulatory requirements of these businesses, this capital is available to meet requirements elsewhere in the Group. Any transfer of the surplus would give rise to a tax charge.
- (c) *Overseas businesses* – these include several smaller participating and non-participating businesses. In all cases the available capital resources are subject to local regulatory restrictions which restrict management's ability to redeploy these amounts in other parts of the

Group and in most cases such transfers would also give rise to a tax charge. Because of the complex nature of these restrictions, the Group's management does not regard this capital as available to meet requirements in other parts of the Group.

For the UK life funds the group is required to hold sufficient capital to meet the FSA capital requirements, based on the 'risk capital margin' (RCM) determined in accordance with the FSA's regulatory rules under its realistic capital regime, together with the Individual Capital Assessment (ICA) which takes into account certain business risks not reflected in the RCM. The determination of the RCM depends on various actuarial and other assumptions about potential changes in market prices, and the actions management would take in the event of particular adverse changes in market conditions.

Management intends to maintain surplus capital in excess of the RCM and ICA to meet the FSA's total requirements, and to maintain an appropriate additional margin over this to absorb changes in both capital and capital requirements. For life fund A, the capital was 171% of the RCM of £175 million and for life fund B the capital was 140% of the RCM of £390 million, in line with management's target of maintaining a margin of at least 35% of the RCM.

For UK non-participating business, the relevant capital requirement is the minimum solvency requirement determined in accordance with FSA regulations. For this business, a lower capital surplus is targeted by management, since the capital requirement is less subject to fluctuation and the capital amount is after deducting liabilities that include additional prudential margins. At 31 December the available capital was 130% of the capital requirement of £270 million, in excess of management's target minimum of 120%.

For overseas businesses the amount shown is the minimum requirement under the locally applicable regulatory regimes.

These are determined on various bases, and in practice the local regulators expect a significant margin over these minima to be maintained. Management also carries out its own assessment of the level of capital resources it regards as appropriate, in excess of these regulatory minima. Overall, overseas businesses held capital substantially in excess of management's target minimum capital level of £250 million. No individual overseas business held less than 150% of its regulatory capital requirement.

*Additional narrative disclosures will cover:*

- *sensitivity of liabilities (including options and guarantees) and components of capital (paragraph 45(c));*
- *capital management policies and the approach to managing risks (paragraph 45(d));*
- *information on liabilities, including information on assumptions, terms and conditions relating to options and guarantees, and exposure to risk in relation to options and guarantees not measured at fair value or by using a stochastic modelling method (paragraphs 48 and 51);*
- *information on movements in capital, including a movements table (paragraphs 55 and 56); and*
- *an explanation of the reasons for a negative balance on an FFA of any with-profits fund of the entity, and why no action to eliminate it has been considered necessary (paragraph 23).*

## **APPENDIX II**

### **NOTE ON LEGAL REQUIREMENTS**

#### **GREAT BRITAIN**

##### **Insurance companies and insurance groups**

- 1 For accounting periods beginning prior to 1 January 2005, all insurance companies and insurance groups (as defined by the Companies Act 1985) are required to prepare their financial statements in accordance with Schedule 9A to the Companies Act 1985 (the Schedule). For accounting periods beginning on or after 1 January 2005, the financial statements of some insurance companies and insurance groups will continue to be prepared in accordance with the Schedule. However, other financial statements of insurance companies and insurance groups will be prepared in accordance with EU-adopted IFRS and will, as a result, not be subject to any detailed legal requirements as to their form and content.
  
- 2 The requirements of the Schedule that are relevant to the FRS are set out in paragraphs 3-10 below. It is the requirement in the FRS for some entities to recognise 'realistic' liabilities for certain policyholder liabilities that is most relevant to the Schedule's requirements, and the implications of that are analysed in paragraphs 4.47-4.65 of Appendix IV 'The Development of the FRS'. That analysis is not relevant to entities not required to recognise 'realistic' liabilities, nor is it relevant to entities that *are* required to recognise 'realistic' liabilities but, because they prepare their financial statements in accordance with EU-adopted IFRS, are not subject to the requirements of the Schedule.

***The FFA***

- 3 The Schedule requires disclosure, as a separate item on the face of the balance sheet immediately below ‘Subordinated liabilities’ and immediately above ‘Technical provisions’, of an item called ‘Fund for future appropriations’. Note 19 on the balance sheet format in the Schedule states that the item shall comprise “all funds the allocation of which either to policy holders or shareholders has not been determined by the end of the financial year.”

***Technical provisions***

- 4 The Schedule requires disclosure, as a separate item on the face of the balance sheet, of an item entitled ‘Technical provisions’. That item is to be analysed between the provision for unearned premiums, long-term business provisions, claims outstanding, the provision for bonuses and rebates, the equalisation provision, and other technical provisions.
- 5 Note 21 on the balance sheet format in the Schedule requires that the long-term business provision shall comprise the actuarially estimated value of the company’s liabilities (excluding technical provisions included under ‘Technical provisions for linked liabilities’), including bonuses already declared and after deducting the actuarial value of future premiums.
  - (a) A technical provision should be included under ‘Technical provisions for linked liabilities’ if it is constituted to cover liabilities relating to investment in the context of long-term policies under which the benefits payable to policyholders are wholly or partly to be determined by reference to the value of, or the income from, property of any description or by reference to fluctuations in, or in an index of, the value of property of any description. Any additional technical provisions constituted to cover death risks, operating expenses or other risks (such as benefits

payable at the maturity date or guaranteed surrender values) shall be included under ‘Technical provisions—Long-term business provision’.

- (b) Note 20 permits the provision for unearned premiums to be included within the long-term business provision rather than the provision for unearned premiums.
- 6 Paragraph 43 of the Schedule requires that the amount of technical provisions must at all times be sufficient to cover any liabilities arising out of insurance contracts as far as can reasonably be foreseen.
- 7 Paragraph 46 of the Schedule goes on to require that:
- “(1) The long term business provision shall in principle be computed separately for each long term contract, save that statistical or mathematical methods may be used where they may be expected to give approximately the same results as individual calculations.
- (2) A summary of the principal assumptions in making the provision under sub-paragraph (1) shall be given in the notes to the accounts.
- (3) The computation shall be made annually by a Fellow of the Institute or Faculty of Actuaries on the basis of recognised actuarial methods, with due regard to the actuarial principles laid down in Council Directive 92/96/EEC.”
- 8 The reference in paragraph 46(3) to Council Directive 92/96/EEC is, in effect, a reference to Directive 2002/83/EC of the European Parliament and of the Council.\* That Directive is concerned with prudential regulation, and many parts of the Directive have no relevance to the true

---

\* Directive 2002/83/EC has replaced Council Directive 92/96/EEC, which has been repealed. The cross-reference in paragraph 46(3) has not yet been updated, but it is understood that it will be shortly.



and fair financial statements. However, the following parts of Article 20 appear to have indirect relevance to the financial statements by virtue of the cross reference in paragraph 46(3):

“Establishment of technical provisions

1. The home Member State shall require every assurance undertaking to establish sufficient technical provisions, including mathematical provisions, in respect of its entire business.

The amount of such technical provisions shall be determined according to the following principles.

- A. (i) the amount of the technical life-assurance provisions shall be calculated by a sufficiently prudent prospective actuarial valuation, taking account of all future liabilities as determined by the policy conditions for each existing contract, including:
  - all guaranteed benefits, including guaranteed surrender values,
  - bonuses to which policy holders are already either collectively or individually entitled, however those bonuses are described - vested, declared or allotted,
  - all options available to the policy holder under the terms of the contract,
  - expenses, including commissions, taking credit for future premiums due;
- (ii) the use of a retrospective method is allowed, if it can be shown that the resulting technical provisions are not lower than would be required under a sufficiently prudent

- prospective calculation or if a prospective method cannot be used for the type of contract involved;
- (iii) a prudent valuation is not a 'best estimate' valuation, but shall include an appropriate margin for adverse deviation of the relevant factors;
  - (iv) the method of valuation for the technical provisions must not only be prudent in itself, but must also be so having regard to the method of valuation for the assets covering those provisions;
  - (v) technical provisions shall be calculated separately for each contract. The use of appropriate approximations or generalisations is allowed, however, where they are likely to give approximately the same result as individual calculations. The principle of separate calculation shall in no way prevent the establishment of additional provisions for general risks which are not individualised;
  - (vi) where the surrender value of a contract is guaranteed, the amount of the mathematical provisions for the contract at any time shall be at least as great as the value guaranteed at that time;
- B. the rate of interest used shall be chosen prudently. It shall be determined in accordance with the rules of the competent authority in the home Member State, applying the following principles:
- (a) for all contracts, the competent authority of the assurance undertaking's home Member State shall fix one or more maximum rates of

interest, in particular in accordance with the following rules:

- (i) when contracts contain an interest rate guarantee, the competent authority in the home Member State shall set a single maximum rate of interest. It may differ according to the currency in which the contract is denominated, provided that it is not more than 60% of the rate on bond issues by the State in whose currency the contract is denominated.

If a Member State decides, pursuant to the second sentence of the first subparagraph, to set a maximum rate of interest for contracts denominated in another Member State's currency, it shall first consult the competent authority of the Member State in whose currency the contract is denominated;

- (ii) however, when the assets of the assurance undertaking are not valued at their purchase price, a Member State may stipulate that one or more maximum rates may be calculated taking into account the yield on the corresponding assets currently held, minus a prudential margin and, in particular for contracts with periodic premiums, furthermore taking into account the anticipated yield on future assets. The prudential margin and the maximum rate or rates of interest applied to the anticipated yield on future assets shall be fixed by the competent authority of the home Member State;
- (b) the establishment of a maximum rate of interest shall not imply that the assurance

undertaking is bound to use a rate as high as that;

- (c) the home Member State may decide not to apply paragraph (a) to the following categories of contracts:
- unit-linked contracts,
  - single-premium contracts for a period of up to eight years,
  - without-profits contracts, and annuity contracts with no surrender value.

In the cases referred to in the second and third indents of the first subparagraph, in choosing a prudent rate of interest, account may be taken of the currency in which the contract is denominated and corresponding assets currently held and where the undertaking's assets are valued at their current value, the anticipated yield on future assets.

Under no circumstances may the rate of interest used be higher than the yield on assets as calculated in accordance with the accounting rules in the home Member State, less an appropriate deduction;

- (d) the Member State shall require an assurance undertaking to set aside in its accounts a provision to meet interest-rate commitments vis-à-vis policy holders if the present or foreseeable yield on the undertaking's assets is insufficient to cover those commitments;
- (e) the Commission and the competent authorities of the Member States which so

request shall be notified of the maximum rates of interest set under (a);

- C. the statistical elements of the valuation and the allowance for expenses used shall be chosen prudently, having regard to the State of the commitment, the type of policy and the administrative costs and commissions expected to be incurred;
- D. in the case of participating contracts, the method of calculation for technical provisions may take into account, either implicitly or explicitly, future bonuses of all kinds, in a manner consistent with the other assumptions on future experience and with the current method of distribution of bonuses;
- E. allowance for future expenses may be made implicitly, for instance by the use of future premiums net of management charges. However, the overall allowance, implicit or explicit, shall be not less than a prudent estimate of the relevant future expenses;
- F. the method of calculation of technical provisions shall not be subject to discontinuities from year to year arising from arbitrary changes to the method or the bases of calculation and shall be such as to recognise the distribution of profits in an appropriate way over the duration of each policy.”

### ***Deferred acquisition costs***

- 9 The Schedule includes an item entitled ‘deferred acquisition costs’ to be shown separately on the balance sheet under the heading ‘Prepayments and accrued income’. Note 17 on the balance sheet format requires that the item shall comprise the costs of acquiring insurance policies which are incurred during a financial year but relate to a subsequent financial year, except in so far as:

- (a) allowance has been made in the computation of the long-term business provision made under paragraph 46 of the Schedule and shown under ‘Technical provisions—Long-term business provisions’ or ‘Technical provisions for linked liabilities’ in the balance sheet, for:
    - (i) the explicit recognition of such costs,
    - (ii) the implicit recognition of such costs by virtue of the anticipation of future income from which such costs may prudently be expected to be recovered, or
  - (b) allowance has been made for such costs in respect of general business policies by a deduction from the provision for unearned premiums made under paragraph 44 of the Schedule and shown under ‘Technical provisions—Provision for unearned premiums’ in the balance sheet.
- 10 Note 17 also requires that:
- (a) deferred acquisition costs arising in general business shall be distinguished from those arising in long-term business;
  - (b) there shall be disclosed in the notes how the deferral of acquisition costs has been treated (unless otherwise expressly stated in the accounts);
  - (c) where such costs are included as a deduction from ‘Technical provisions—Provision for unearned premiums’, the amount of such deduction; and
  - (d) where the actuarial method used in the calculation of the ‘Technical provisions—Long-term business provisions’ or ‘Technical provisions for linked liabilities’ has made allowance for the explicit

recognition of such costs, the amount of the costs so recognised.

### **Other entities**

- 11 Paragraphs 1–10 above describe the accounting requirements in the legislation that apply to insurance companies or insurance groups as defined in the Companies Act 1985. The FRS also applies to:
- (a) groups reporting under the Companies Act 1985 that are not insurance groups, including bancassurers and retail groups with life assurance subsidiaries. Bancassurers are required to prepare their financial statements in accordance with Schedule 9 of the Act; retail groups in accordance with Schedule 4 of the Act. Neither Schedule contains specific requirements on how to account for life assurance activities.
  - (b) friendly societies. Friendly societies are required to prepare their financial statements in accordance with The Friendly Societies (Accounts and Related Provisions) Regulations 1994.
    - (i) The financial statements of directive friendly societies are required to prepare in accordance with Schedules 1 – 6 of the Regulations. The requirements on the form and content of the balance sheet are set out in Schedule 2 and are almost identical to the Companies Act requirements summarised above.
    - (ii) The financial statements of non-directive friendly societies are required to prepare in accordance with Schedule 7 of the Regulations. Although Schedule 7 requires a prescribed analysis of liabilities to be provided, that prescribed analysis is, compared to the analysis required by Schedule 9A of the Companies Act, highly abbreviated.

- (c) various other entities that prepare their financial statements in accordance with The Insurance Accounts Directive (Miscellaneous Insurance Undertakings) Regulations 1993. Those Regulations require the entities to which they apply to comply with the requirements of Schedule 9A of the Companies Act in preparing their financial statements.

## **NORTHERN IRELAND**

- 12 The statutory requirements in Northern Ireland that apply to insurance companies and insurance groups are set out in Schedule 9A to the Companies (Northern Ireland) Order 1986. Those requirements are identical to the legislation for Great Britain cited above.

## **REPUBLIC OF IRELAND**

- 13 The statutory requirements in the Republic of Ireland that correspond to those cited above for Great Britain are shown in the following table.

<i>Great Britain</i>	<i>Republic of Ireland</i>
Schedule 9A to the Companies Act 1985 (the Schedule)	European Communities (Insurance Undertakings: Accounts) Regulations, 1996
Note 17 on the balance sheet format in the Schedule	Schedule, Part I, Chapter 2, Section A, Note 17
Note 19 on the balance sheet format in the Schedule	Schedule, Part I, Chapter 2, Section A, Note 21
Note 20 on the balance sheet format in the Schedule	Schedule, Part I, Chapter 2, Section A, Note 23
Note 21 on the balance sheet format in the Schedule	Schedule, Part I, Chapter 2, Section A, Note 25
Paragraph 43 of the Schedule	Schedule, Part II, Chapter 3 – Paragraph 23
Paragraph 44 of the Schedule	Schedule, Part II, Chapter 3 – Paragraph 24



Paragraph 46 of the Schedule	Schedule, Part II, Chapter 3 – Paragraph 26
Paragraph 46(3) of the Schedule	Schedule, Part II, Chapter 3 – Paragraph 26(4)



## **APPENDIX III**

### **COMPLIANCE WITH INTERNATIONAL ACCOUNTING STANDARDS**

- 1 Some of the entities applying the FRS will do so in financial statements prepared in accordance with EU-adopted IFRS; others will be applying it in financial statements prepared in accordance with UK standards and legal requirements.
  - (a) Paragraphs 10.1-10.4 of Appendix IV ‘The Development of the FRS’ discuss the implications of the FRS for the former entities.
  - (b) This appendix is addressed to the entities preparing their financial statements in accordance with UK standards and legal requirements. The appendix explains the extent to which compliance with the FRS will ensure compliance with the international accounting standard on insurance, IFRS 4 ‘Insurance Contracts’.
- 2 IFRS 4 contains definitions of ‘insurance contracts’ and various other insurance-related terms. Although those definitions are not included in the FRS, those that define the scope of IFRS 4, IAS 32 and IAS 39—including the definition of ‘insurance contracts’—are included in FRS 26 and will therefore apply to entities complying with that standard.
- 3 Paragraph 10 of IFRS 4 notes that some insurance contracts contain both an insurance contract and a deposit component. Paragraphs 10-12 require those components in certain specified circumstances to be accounted for as if they were separate contracts (in other words, unbundled); permits, but does not require, them to be unbundled in certain other specified circumstances; and prohibits them from being unbundled in certain other specified circumstances. There is nothing in this FRS or any other UK standard requiring, permitting or prohibiting the

unbundling of insurance contracts, save the general principle in FRS 5 'Reporting the Substance of Transactions' that transactions should be accounted for in accordance with their substance.

- 4 All accounting policies adopted by an insurer are required to meet the criteria set out in paragraph 14 of IFRS 4. Neither this FRS nor any other extant UK standard contains similar criteria. The accounting policies that the FRS requires to be adopted all meet the criteria, but some of the entity's other accounting policies might not.
- 5 Paragraphs 21-23 of IFRS 4 prohibit an insurer from changing its accounting policies for insurance contracts unless two criteria are met.
  - (a) The first criterion is that the new accounting policy shall make the financial statements more relevant to the economic decision-making needs of users and no less reliable, or more reliable and no less relevant to those needs. Although there is no similar requirement in the FRS, compliance with FRS 18 'Accounting Policies' would ensure compliance with this criterion.
  - (b) The second criterion is that the change shall be consistent with the requirements set out in paragraphs 24-30 of IFRS 4, which relate to changes of certain specific accounting policies. Compliance with the FRS would ensure compliance with the requirements in paragraphs 27 and 28 of IFRS 4 concerning the inclusion of future investment margins in the measurement of insurance contracts. However, compliance with the FRS and extant UK standards would not necessarily ensure compliance in all respects with the other requirements in paragraphs 24-30 of IFRS 4.
- 6 Paragraph 34(d) of IFRS 4 requires that, if an insurance contract contains a discretionary feature, a guaranteed element and an embedded derivative that is within the

scope of IAS 39 'Financial Instruments: Recognition and Measurement', that embedded derivative shall be accounted for in accordance with IAS 39. For accounting periods beginning on or after 1 January 2005, some entities are required—and all entities may choose—to apply FRS 26 (IAS 39) 'Financial Instruments: Measurement'.

- (a) Compliance with FRS 26 would ensure compliance with paragraph 34(d) of IFRS 4.
  - (b) For entities not complying with FRS 26, neither this FRS nor any other extant UK standard currently requires embedded derivatives to be separated from their host contract.
- 7 Paragraphs 36-39 of IFRS 4 contain disclosure requirements. The disclosure requirements in paragraphs 37(c), 39(b), 39(e) and 37(d) are virtually identical to requirements in the FRS (paragraphs 48(a), (b) and (c) and paragraph 56(a) respectively), although the scope of the FRS' disclosures is more limited.



## APPENDIX IV

# THE DEVELOPMENT OF THE FRS

### BACKGROUND

#### Life assurance accounting today

- 1.1 In Great Britain, financial reporting by most types of insurance entity is governed by the legislation implementing the EU Insurance Accounts Directive.<sup>\*,†</sup> These requirements are derived in the main from regulatory solvency requirements. The requirements are relatively prescriptive, leaving only a limited amount of scope for accounting developments, although a number of modifications to the underlying solvency principles have been made for the purposes of accounting for life assurance by the Statement of Recommended Practice of the Association of British Insurers (the ABI SORP)—resulting in the financial statements of life assurers being prepared on the so-called Modified Statutory Solvency Basis (MSSB).
- 1.2 The MSSB basis of accounting has a number of distinctive features. They include:

---

<sup>\*</sup> For example, Schedule 9A of the Companies Act 1985 implements the Directive for insurance companies and insurance groups. Schedules 1-6 of The Friendly Societies (Accounts and Related Provisions) Regulations 1994 implement the Directive for certain friendly societies.

<sup>†</sup> The legal framework in Great Britain is, as explained more fully in Appendix II, broadly similar to the framework that exists in Northern Ireland and the Republic of Ireland. However, for simplicity this appendix refers only to British legislation. Similarly, although the intention is that the FRS should apply in Great Britain, Northern Ireland and the Republic of Ireland, the text tends for simplicity to refer to 'UK entities', 'UK standards' etc rather than 'entities in the UK and the Republic of Ireland' and 'standards that apply in the UK and the Republic of Ireland'. However, the system of prudential regulation that applies in the UK differs from that that applies in the Republic of Ireland. so in that context 'UK' is not used to include 'the Republic of Ireland'.

- (a) *A non-standard liability model*—The liability model differs from the model that applies to other entities in at least three important respects:
- (i) Liabilities are recognised for legal obligations but not constructive obligations (such as constructive obligations in respect of terminal bonuses in with-profits funds). FRS 12 ‘Provisions, Contingent Liabilities and Contingent Assets’ requires liabilities to be recognised both for legal obligations and constructive obligations.
  - (ii) Recognised liabilities are measured on a particularly prudent basis. FRS 12 requires a best estimate measurement to be used.
  - (iii) The Fund for Future Appropriations (FFA) is classified as a liability even though parts of it do not meet the definition of a liability set out in accounting standards.\*
- (b) *Deferred acquisition costs*—In part to compensate for this liability model, life assurance policy selling costs are recognised as assets (deferred acquisition costs).
- (c) *Profit recognition model*—The MSSB profit recognition model involves the use of statutory transfers from the with-profits fund and profit smoothing techniques such as the amortisation of deferred acquisition costs in line with margin earned. This is a very different profit recognition from the asset/liability framework that is now informing most developments in financial reporting.

---

\* The FFA represents the balance of surplus of a with-profits fund that has neither been declared as a bonus to policyholders nor distributed as profit to shareholders. The eventual allocation of the FFA between shareholders and policyholders will depend on future appropriations of bonus and profit, hence the name.



- 1.3 This reporting framework also does not reflect well the distinctive features of with-profits life assurance: the participatory nature of the entity's relationship with its policyholders; policyholders' expectations about future bonus declarations; the nature of the options granted and guarantees given; and the ownership and nature of any estate\* and of the capital more generally.
- 1.4 The resulting financial statements do not report on life assurance activities in as meaningful a way as they might.

### **The Penrose Report**

- 1.5 In March 2004 the Accounting Standards Board (the Board or the ASB) received a request from the Financial Secretary to the Treasury to initiate an urgent study into accounting for with-profits business by life insurers. That request was part of the Financial Secretary's response to the Report of the Equitable Life Inquiry, prepared by the Right Honourable Lord Penrose (the Penrose Report).
- 1.6 The Penrose Report criticised a number of aspects of existing with-profits accounting:
- (a) *The treatment of future bonuses.* The report found that the current practice of recognising (as part of the technical provision) a liability for bonuses declared, but not recognising a specific liability for accrued terminal bonuses was unsatisfactory. The conclusion was that the financial statements would not show a realistic position of the life office unless a liability was recognised for the constructive obligation in respect of terminal bonuses.
  - (b) *Reserves available to cover bonuses.* Insufficient information was provided about the amount of reserves available to meet expected future bonuses. The conclusion was that

---

\* *The estate of a with-profits fund is the excess of a fund's assets over its obligations—legal and constructive—to policyholders.*

financial statements should include a disclosure that compares the value of the liability for such bonuses with the reserves available to cover them.

- (c) *Changes during the period.* It was unsatisfactory that, under existing practice, life assurers could make important changes affecting policyholders without those changes being apparent from the financial statements. In particular, the report highlighted in this context changes in actuarial assumptions and reductions made to guaranteed benefits as a result of:
- (i) altering the mix of bonus between declared and final elements progressively towards terminal bonus; and
  - (ii) changing policy conditions to reduce the scope of contractual benefits and increase the scope for allotting terminal bonus.

It was suggested that the financial statements should provide an analysis of the movements over the year in the amount of realistic liabilities.

- (d) *Complexity.* Addressing the complexity of life assurers' regulatory returns and financial statements and the inter-relationship between them, the report suggested that policyholders and other users should be provided with simplified summary versions of both reports. Furthermore, the objective in the longer-term should be to move to a single accounting basis for both reports.
- (e) *The information needs of policyholders.* There was a danger in focusing exclusively on the information needs of investors when preparing financial statements covering life assurance products. Policyholders' interests needed to be taken into account; they were investors in the entity's products and their interests, in financial terms in

with-profits funds, usually exceeded those of shareholders by a factor of about 9:1.

- 1.7 The Financial Secretary's letter to the Board requested that the Board's study into accounting for with-profits business should be made against the background of the developments in the Financial Services Authority's (FSA's) regulatory regime and the requirement for listed companies to use EU-adopted International Financial Reporting Standards (IFRS) in their consolidated financial statements from 1 January 2005.

### **The FSA's regulatory regime**

- 1.8 Until recently, the system of prudential regulation for UK with-profits funds has been the basis that underlies Schedule 9A—the Statutory Solvency Basis (SSB). The FSA has, however, introduced a new system of prudential regulation for UK with-profits funds, which applies from 31 December 2004 to the UK with-profits funds of entities with UK with-profits liabilities of £500m or more. This new methodology is known as the Realistic Balance Sheet (RBS) approach.\*†
- 1.9 The FSA has designed the RBS approach to be based on notions that are much closer than existing regulatory practice to the liability model in general financial reporting standards. For example, the policyholder liabilities are required to take into account both legal and constructive obligations, and they are required to be

---

\* 'Realistic' is the FSA's term for the methodology it has developed. In using the term in the FRS, the Board is not intending to imply anything other than that the items involved have been calculated by applying the FSA's RBS methodology. There is, for example, no suggestion that entities should be required to use the term in their true and fair financial statements.

† The RBS approach has been implemented alongside the existing SSB) as part of a 'twin peaks' approach under which the higher of the RBS approach's 'realistic peak' and the SSB's 'regulatory peak' will be the regulatory requirement.

measured on a basis that is much closer than the current MSSB liability to FRS 12's best estimate approach.

- 1.10 The development of the RBS approach has implications for the way in which the existing legal requirements are interpreted and, as a result, means the Board has been able to contemplate making changes to life assurance accounting that would not have been possible hitherto. (This is explained more fully in paragraphs 4.47-4.65.)
- 1.11 The RBS approach therefore appears to provide both an opportunity and a means for the Board to improve life assurance accounting.

### **The move to IFRS**

- 1.12 From 1 January 2005, listed UK entities will be required\* to prepare their consolidated financial statements in accordance with EU-adopted IFRS, rather than UK standards and legal requirements. In addition, from that date most unlisted entities will be permitted to use EU-adopted IFRS, rather than UK standards and legal requirements, in their financial statements.
- 1.13 Entities reporting under EU-adopted IFRS are, by definition, not reporting under the existing UK legal requirements and, as such, are free of the constraints imposed on their accounting policies by the Companies Act 1985 (the Act). Thus, the move to EU-adopted IFRS provides a further opportunity for improvements in insurance accounting to be made. However, during the initial stages of this project the Board took the view that from 2005 those improvements would have to be made by the industry or by the International Accounting Standards Board (IASB) because the Board's standards would not apply to entities following EU-adopted IFRS. For that

---

\* By EU Regulation 1606/2002.

reason, the Board's focus initially was on the changes it could make in 2004 that would remain in place after 2005.

- 1.14 For UK reporting entities with life assurance activities, one of the key standards in 2005 for those following EU-adopted IFRS will be IFRS 4 'Insurance Contracts', which was issued in March 2004. Under IFRS 4, issuers of insurance contracts are permitted in the main to continue to use their pre-2005 accounting policies in preparing their financial statements from 2005 even if those policies do not meet the requirements of other IASB standards ('the grandfathering provisions'). However, if the entity wishes to change an accounting policy, it can do provided that the new accounting policy will make the financial statements more relevant to the economic decision-making needs of users and no less reliable, or more reliable and no less relevant to those needs.
- 1.15 The Board viewed these grandfathering provisions as highly relevant to its project because they provided a means by which the Board could make changes to life assurance accounting policies that would remain in place for some time after 2005. In other words, although IFRS 4 itself makes few improvements to insurance accounting, the timing of its introduction provided a one-year window of opportunity for a national standard-setter to do so.
- 1.16 IFRS 4 fulfils another important role. By setting out the criteria that need to be met if a new accounting policy is to be adopted, it provides an indication of the direction in which the IASB expects insurance accounting to develop. This enabled the UK Board to make changes to life assurance accounting and be reasonably confident that those changes would not be reversed by the IASB in the near future.

## APPROACH ADOPTED BY THE BOARD

### A two-part project

- 2.1 Bearing in mind the opportunity offered by the development of the RBS approach to prudential regulation of with-profits insurance business and the timing constraint imposed by the move to EU-adopted IFRS in 2005, the Board concluded that its project should comprise two parts:
- (a) *To consider what improvements could be made to life assurance accounting in time for the 2004 accounts and to develop a standard requiring those improvements.* Within this timescale, it would not be realistic to make wholesale change to the existing insurance accounting framework nor would it be appropriate to do so ahead of phase 2 of the IASB's insurance project. However, it would be realistic to make limited improvements which could be implemented for 2004 reporting and would point in the direction of the further improvements the IASB has indicated it would like to see.
  - (b) *To develop views on the direction in which insurance accounting more generally should develop over the next few years and on the key issues that will need to be addressed in securing the changes necessary.* Although the Board may have less direct influence on the shape of insurance accounting from 2005, it intends to continue to play an active and influential role in phase 2 of the IASB's project and will therefore continue to develop its thinking on the issues that need to be addressed. Where the Board identifies potential improvements that it cannot introduce across the industry as a whole, it will recommend them to the IASB for consideration. In some cases, it might also incorporate them into UK standards.
- 2.2 In considering which issues it should attempt to address in the first part of the project, the Board recognised that,

although the issues raised by Lord Penrose would represent an important part of its work, it would need to consider addressing other issues and concerns as well. The broad issues and concerns that the Board considered initially are summarised briefly in paragraphs 2.3–2.17 and those dealt with in this Financial Reporting Standard (the FRS) are explored more fully in sections 3–8 of this appendix.

### **Financial strength**

- 2.3 As mentioned in paragraph 1.3, the existing reporting framework struggles to reflect in the financial statements a number of the distinctive features of with-profits life assurance. One of those features is the rather unusual nature of the capital resources involved. Although some of the capital is fungible, much of it is subject to a variety of restrictions as to its availability and use. Some of the capital is shareholders' capital but the ownership of some other capital—and for with-profits funds this capital can be very significant—is uncertain and is perhaps best viewed as being jointly owned by policyholders and shareholders. Unless the nature, fungibility and extent of the capital available to a life assurer is properly explained in the financial statements, users of those financial statements will struggle to understand the insurer's prospective ability to continue to treat customers fairly whilst meeting all other obligations to third parties and providing an appropriate and secure return to shareholders. In other words, they will struggle to understand the insurer's financial strength.
- 2.4 The Penrose Report also raised some concerns in this area, emphasising the importance of disclosing the amount of the reserves the insurer is holding against actual and contingent liabilities.
- 2.5 The Board therefore concluded that one of the issues it should seek to address through its limited improvements project was the provision of information about the financial strength of UK with-profits funds.

## **Liability accounting**

- 2.6 The Board decided that another priority was to consider ways of improving the existing liability recognition, measurement and presentation model. This is one of the areas in which existing life assurance accounting is most out-of-step with general accounting principles. It is an issue that the Board highlighted in the statement it attached to the November 2003 revision of the ABI SORP; it is mentioned in the Penrose Report as a significant concern; and it is the aspect of with-profits life assurance accounting for which the FSA's new RBS approach has the most implications.
- 2.7 Another of the issues raised by the Board in its statement attached to the November 2003 revision of the ABI SORP concerned the balance sheet classification of the FFA. The Board decided to consider this issue in its limited improvements project (although it eventually decided not to address the matter in the FRS).

## **Options and guarantees**

- 2.8 Many life funds over the last few years have experienced major reductions in their capital position as a consequence of the need to fund options and guarantees provided to policyholders. These options and guarantees can take a variety of forms, and some expose the entity to insurance variables such as mortality and morbidity, while others expose the entity to financial variables such as market prices.
- 2.9 Historically, UK entities with life assurance activities have tended to recognise a liability for an option or guarantee that exposes it to financial variables only if it is 'in the money'. The financial statements have, as a result, reported the impact on the estate and net assets of such options and guarantees as being more sudden and severe than might have been the case had the liability measurement basis taken appropriate account of the potential for future changes (for



example, through stochastic modelling of possible outcomes or some form of fair valuing).\*

- 2.10 The RBS approach requires the options and guarantees liabilities of large UK with-profits funds to be measured at fair value or at a stochastically modelled value. This makes it reasonable to consider whether the liability should be measured on the same basis in the true and fair financial statements, and also whether the treatment in the financial statements of other options and guarantees (for example, those granted on overseas life assurance contracts) could be improved. As the Board has previously made clear the importance it attaches to treating options and guarantees properly, it decided to consider these issues further in its limited improvements project.

### **Profit recognition and performance reporting**

- 2.11 The Board recognised that the existing profit recognition, measurement and presentation model used by insurers is in need of improvement. It was also conscious though that, in looking predominately at with-profits reporting, any improvements it made to the model would inevitably be only a partial solution to a wider problem. It therefore decided that, to the extent that changes to the balance sheet were to be proposed, it would address the consequential profit recognition and performance reporting issues but, that apart, profit recognition and performance reporting issues would not be considered in the first part of the project.

### **Complexity and lack of transparency**

- 2.12 The financial statements of an insurance company or group are complex and difficult for anyone who is not an expert to use. This complexity only partly derives from the nature of the business. The terminology used is not always helpful and

---

\* A stochastic modelling approach involves valuing the item by reference to the weighted average value under a large number of possible future market price scenarios.

the presentation of information calculated on different bases—without proper disclosure of how these different sets of information relate to each other—can be very confusing.

- 2.13 The complexity and lack of transparency of insurance financial statements was highlighted in the Penrose Report, which criticised both the regulatory returns and the financial statements for not being readily understandable.
- 2.14 This is an important issue. The purpose of financial statements is to communicate information. Financial statements that cannot be understood by a user with general financial knowledge, applying reasonable diligence, do not fulfil their purpose. However, the Board decided that it should not carry out a study of how the existing formats and terminology might be improved during the first part of its work because the formats and terminology used were largely determined by legislation and legislative change was not feasible in 2004.
- 2.15 The Penrose Report concluded that another source of complexity was the existence of multiple statements—regulatory returns, true and fair financial statements, and embedded value supplementary information—prepared on different bases with no means for the user to navigate their way between the statements. This is a matter which the Board considered in its limited improvements project.

### **The use of embedded value in the primary financial statements**

- 2.16 Generally speaking, entities with life assurance activities respond to the perceived inadequacies of MSSB financial statements by trying to focus users' attention on the value of in-force business. Some do this by supplementing the MSSB financial statements with information prepared on an embedded value basis. Some others recognise assets based on those embedded values in their primary financial statements and use them to drive the profit recognition

model. This means that the same transactions are accounted for in the financial statements of different entities in fundamentally different ways.

- 2.17 Such inconsistencies are unsatisfactory, so the Board decided to consider the use of embedded value—even though the matter is a more general concern and is not specifically linked to with-profits reporting—in its limited improvements project in order to determine whether it was appropriate and possible to achieve greater consistency..

### **Summary**

- 2.18 In summary, the Board decided to focus on the following issues in the first part—the limited improvements project part—of its work:
- (a) the provision of information that helps users to assess the financial strength of UK with-profits funds (section 3);
  - (b) the liability model for with-profits policyholder liabilities (section 4);
  - (c) the balance sheet classification of the FFA (section 5);
  - (d) the treatment of options and guarantees not taken appropriately into account in measuring policyholder liabilities (section 6);
  - (e) recognising the value of in-force life assurance business (ie embedded value) in the primary financial statements (section 7); and
  - (f) the complexity caused by multiple statements prepared on different bases (section 8).
- 2.19 In July 2004 the Board issued Financial Reporting Exposure Draft (FRED) 34 ‘Life Assurance’. Sections 3 to 8 explain the issues the Board considered in developing the proposals in the FRED, as well as how the Board has addressed the

main comments made on those issues by those responding to the FRED.

- 2.20 The other sections of this appendix discuss:
- (a) other issues arising from the FRED 34 consultations (section 9);
  - (b) the memorandum of understanding and the application of the FRS by entities applying EU-adopted IFRS (section 10);
  - (c) future developments (section 11); and
  - (d) the ASB's advisory panel on life assurance (section 12).

## **FINANCIAL STRENGTH**

- 3.1 Generally speaking, it is possible for users of financial statements to develop a good understanding of the financial strength of most entities from their balance sheet and supporting disclosures. This is possible because the capital of such entities is largely fungible. However, one of the unique features of with-profits life assurers is that their capital often comprises elements that exhibit widely different characteristics. These characteristics—which relate to the ownership, certainty of valuation and availability of use—mean that some analysis of the components of capital is needed to enable the entity's financial strength to be understood by both policyholders and shareholders. This is not information that the financial statements currently provide.
- 3.2 At first, the Board considered the possibility of changing the presentation of the balance sheet to provide this information. For example, the entity's capital could be shown as a series of layers each subject to a different set of restrictions. However, the Board concluded that such a presentation would not be able to do justice to the capital structures that currently exist. What was needed was a

disclosure that focused on the amount and nature of capital held by, or available to, the life assurer, and that showed where the capital is held and the extent to which it is available to other parts of the business. (The FRS refers to this disclosure as a ‘capital statement’.)

- 3.3 The remainder of section 3 discusses the main issues that the Board considered in developing its requirements on the capital statement.

### **ED 7**

- 3.4 The Board issued the FRED that preceded this FRS in the same month that the IASB issued ED 7 ‘Financial Instruments: Disclosures’. ED 7 proposed, inter alia, that entities should be required to disclose certain information about the amount of their capital resources, their target capital levels and the way they manage their capital. The proposal was that the final standard would be published early in 2005 and would be mandatory from 2007, although entities could adopt it from 2005 if they wished. The Board issued ED 7 as a UK exposure draft (FRED 33 ‘Financial Instruments: Disclosures’) and proposed that it should be implemented as a UK standard when it is implemented internationally.
- 3.5 A number of respondents to FRED 34 argued that, in view of the proposals in ED 7, the capital statement proposals in FRED 34 were superfluous. Some argued that the two sets of proposals merely set out alternative ways of achieving the same objective and, in the interests of convergence, FRED 34’s proposals should be withdrawn in favour of ED 7’s. However, the Board does not consider the proposals to be interchangeable; although the disclosures described in FRED 34 would meet most of the proposed capital disclosure requirements set out in ED 7, the opposite would not be the case because an entity could comply with proposed requirements in ED 7 without providing any information about the fungibility of its capital. During the development of the FRED the Board saw the two sets of

proposals as complementary because, while ED 7 proposed some important, extremely useful general disclosures, FRED 34 proposed extending those disclosures to highlight some specific factors of particular importance in the life assurance industry. In finalising the FRS, the Board has emphasised the complementary nature of the two sets of disclosures.

### **Entity level or group level?**

- 3.6 The Board took the view in developing the proposals in the FRED that, if a good understanding is to be obtained of a UK with-profits fund's overall financial strength, its capital position needs to be put in the context of the consolidated group of which it is a part. In the Board's view, such a presentation ensures that due account is taken of the extent to which shareholder or other finance exists in other parts of the Group and might be available to the UK with-profits funds. The FRED proposed therefore that, if the reporting entity has general insurance and other activities, these should be included in the disclosure—grouped together but shown separately from the life funds—with an indication of the availability or otherwise of this capital. In doing so, the Board recognised that the complex structure of many of the largest insurance and bancassurance groups, with intra-group and inter-fund lending and investing arrangements, made it likely that the consolidation of the various individual capital positions would be complicated and consolidation adjustments could be significant. It believed however that this was itself relevant to an understanding of the different aspects of the entity's capital position. The contrast between the simplicity of the capital position of the large, single fund of a traditional UK mutual and the complex capital structure of a diversified global group was important and was of relevance to users.
- 3.7 Some of those responding to the FRED disagreed with this focus on group-wide information, particularly as the FRED also exempted some single entities that are part of groups from the need to include the capital disclosures in their

individual financial statements. Those respondents argued that what policyholders needed was information about financial strength at the level of their individual fund and, because of materiality and the inevitable need to aggregate, the information provided at the entity level was the nearest policyholders would get to that. Some respondents also argued a group-wide presentation could be misleading if the funds are ring-fenced.

3.8 The Board has not been persuaded by these arguments for the following reasons:

- (a) Although prima facie a policyholders' interest lies at the individual fund level, it does not follow that policyholders are not interested in the financial strength of the group as a whole. Many groups seek to market on the basis of their group level financial strength and it is therefore reasonable to provide policyholders with an analysis that relates the position of the individual funds to the overall group capital position. Even if a group manages its individual funds on a strictly ring-fenced basis, it is of value to the policyholder to see the overall financial strength of the group and how 'their' fund fits in, thereby gaining some understanding of the likely financial imperatives that are going to govern the fund's management. Indeed, it is important for policyholders to know whether the group manages their fund on the basis of strict ring-fencing or on the basis of group-level financial strength (taking advantage of the benefit of financial diversification, for example). During discussions with major life assurers, the Board had both these diametrically opposing positions explained to it as the basis on which the capital position of that particular group was managed. Setting out which approach applies would be a key part of the narrative disclosures that should accompany the capital statement.
- (b) Most insurers manage their capital both at the individual fund level and at the group level. For example, an entity

with most of its available capital resources tied up in funds that it cannot easily access (for example a UK with-profits fund) might need a capital injection to raise capital for other purposes even if the capital resources within particular funds are substantial. Users need information that helps them understand the interrelationship between the financial position of individual funds and the group's capital position. The great variety of intra-group financial arrangements (such as reinsurance, contingent loans, guarantees etc) that can apply means there will often need to be careful explanation of the consolidation adjustments that are made in producing the group level information.

- 3.9 Some respondents recognised the objective behind the capital statement but argued that the objective would not be achievable unless the statement reflected the benefits of diversification. However, the fact that diversification benefits *are* particularly important for some groups—though not for those that manage their funds on a strictly ring-fenced basis—is one of the main reasons why it is essential for the aggregate of the individual entities' capital positions to be clearly reconciled to the group position as shown in the balance sheet. Without this reconciliation, there is a significant risk of the capital statement being unable to be related to other aspects of the group financial position.
- 3.10 As mentioned earlier, the FRED not only proposed that the capital statement should be prepared at a group level, it also proposed that some single entities should be exempt from the requirement to provide the statement. The proposal was that the exemption would apply to:
- (a) an entity that is a wholly-owned subsidiary undertaking, if its ultimate or intermediate parent entity includes a capital statement complying with the FRS in its consolidated financial statements; and



(b) in a parent entity's own financial statements when presented together with the parent's consolidated financial statements.

- 3.11 In the light of the comments received in response to the FRED, the Board reconsidered the appropriateness of this exemption. The Board noted that, without the exemptions, much of the information provided by the subsidiary or parent company would be available to policyholders in the consolidated financial statements and, as such, there would be some duplication if the exemptions were deleted. On the other hand, it recognised that the information would often be provided at a higher level of aggregation in the consolidated financial statements than in, say, the subsidiary's financial statements and that some smaller funds would be 'visible' only at a subsidiary level.
- 3.12 In the Board's view, neither of the options available to it was ideal. It nevertheless decided, for pragmatic reasons, to retain the exemptions; entities would not be forced to provide disclosures at a subsidiary level but also would not be prevented from doing so if they considered the benefit of doing so justified the cost.
- 3.13 For consistency with other standards, the Board decided to amend the exemption for subsidiaries so that it applies to 90%-owned subsidiaries, rather than just wholly-owned subsidiaries.

### **Level of aggregation**

- 3.14 As the focus of the capital statement should be on the different types of capital the entity has, the statement needed to show a disaggregated view of capital. On the other hand, showing each segment of capital and each restriction separately would, in some cases, make the disclosure so voluminous that it would be of little value. A balance needed to be found.

- 3.15 The Board took the view in the FRED that the primary focus should be on the individual UK with-profits funds (or, for an entity in the Republic of Ireland, on the individual with-profits funds in the Republic of Ireland) because it is in that context that the need for detailed information about financial strength is greatest. Respondents largely agreed with this view. Paragraph 34(a) of the FRS therefore requires information about each UK with-profits fund to be shown separately if the fund is material.
- 3.16 The FRED proposed that the information about the entity's other life assurance business should be provided separately for each material section of that business. It went on to propose that, for this purpose, a fund or business unit would be a separate section if the capital attributable to that business was subject to material restriction or limitation as to its availability to other parts of the business.
- 3.17 A number of respondents criticised this proposal. Some argued that the level and manner of aggregation it implied was not appropriate for their business; some argued that, bearing in mind that the capital in most business sections would be subject to some constraints, the aggregation principle proposed was not particularly useful. Some respondents were concerned about how the information on the separate sections would be interpreted, with some arguing that the aggregation of fungible capital should be permitted to avoid confusion and others arguing that aggregating capital that is subject to different restrictions implies it is fungible when it is not. Concerns were also raised about whether showing funds that had interdependencies separately would be helpful. It was also clear that there was some confusion as to how the restrictions over the use of capital would be portrayed.
- 3.18 The Board reconsidered its proposals in the light of the comments received, and decided that the FRS should be more flexible as to how the information about life assurance activities other than UK with-profits funds is presented. Paragraphs 34(b), 35 and 36 of the FRS now require that

the disclosures show the extent to which the various components of capital are subject to constraints or are available to other parts of the business—how that is done is up to each entity. The result is that entities will be able to adopt a presentation that best suits their particular circumstances.

**Should the capital statement focus on capital resources, or also show capital requirements or targets?**

- 3.19 The FRED proposed that the capital statement should show not only an analysis of the entity’s capital resources but also the regulatory capital requirements relevant to each section of that capital. Disclosing the regulatory capital requirements provided context for the information about capital resources. Furthermore, as the regulatory capital requirements impose restrictions on the use of capital in other parts of the business, including them in the disclosure helped focus attention on available capital *after meeting regulatory capital requirements*.
- 3.20 The proposal to require disclosure of the regulatory capital requirements in the capital statement was criticised by a significant number of respondents.
- (a) Some commentators argued that the target capital levels set by management, rather than the regulatory capital requirements, should be disclosed because what matters most is the basis on which the business is being managed and that would be by reference to target capital. These commentators also pointed out that ED 7 proposed the disclosure of information about internally-set capital target levels.
  - (b) Some commentators argued, in a similar vein, that disclosing a single regulatory capital requirement for each section would be misleading in jurisdictions where there was more than one regulatory requirement or where the requirements comprise a series of action

levels or trigger points. In such jurisdictions, it is not immediately clear which regulatory requirement would be the most useful to use in the capital statement. The FRED's suggestion—that in such circumstances the disclosure should focus on the minimum requirement—was thought by many to be inappropriate.

- (c) Under the proposals in the FRED, the regulatory requirements shown would be calculated on different bases. This, some respondents argued, meant they were inconsistent and, as a result, not additive.
  - (d) Some commentators suggested that the Board should not adopt a regulatory approach because it would not be practicable to prepare the relevant numbers to the required quality until after the end of the annual statutory reporting process.
- 3.21 The Board has not accepted all these arguments. For example, although those arguing that the requirements are not calculated on a consistent basis and are therefore not additive are right in pointing out that the insurance industry is not as fortunate as the banks in having a common approach, the numbers nevertheless *are* the regulatory capital requirements and hence *are* relevant. Similarly, although there may be some practical difficulties in preparing the relevant numbers to the required quality at short notice, this is an argument for deferring the disclosure, not for abandoning it.
- 3.22 The Board nevertheless concluded that the role of the regulatory capital requirements in the capital statement should be downgraded because a surplus of capital over the regulatory minimum is not a true surplus, and could even represent a shortfall below the target capital level; as a result, complex and lengthy notes would need to be provided to enable users to understand the true position. The regulatory capital requirements are just one of the constraints placed on the free use of capital. Therefore, rather than insist on the

amount of the requirement to be disclosed for each business section disclosed separately in the capital statement, paragraph 45(a) of the FRS requires the capital statement to be supported by “narrative or quantified information on the regulatory capital requirements applying to each section of the business shown in the capital statement, or on the capital targets set by management for that section.”

### **Clarity**

- 3.23 In developing its proposals on the capital statement, the Board was very aware of the comments in the Penrose Report about different pieces of information in the financial statements being prepared on different bases with no explanation of those differences. For that reason the Board considered it important to ensure that the information in the capital statement could be reconciled to the balance sheet. This matter is discussed in more detail in section 8.

### **Practicalities of obtaining information**

- 3.24 The proposal in the FRED was that the capital statement should be provided for the first time in the 2004 year-end financial statements. Some commentators expressed the view that, due in particular to the sequential process that is adopted by companies in the preparation of their year-end financial information—with the preliminary announcement and published financial statements preceding the regulatory returns—it would not be possible to include in their 2004 year-end financial statements information that, currently, is only required to be disclosed in the regulatory returns. This would be an issue in 2004 for information calculated on the FSA’s RBS basis and for overseas regulatory information (which is often not produced until much later in the year).
- 3.25 Although the decision to downgrade the role of the regulatory capital requirements in the capital statement (see paragraph 3.22 above) changed the significance of this issue, it did not mean it was no longer a concern because:

- (a) the Board still envisaged that the available capital amounts shown in the capital statement would be calculated on a regulatory basis; and
  - (b) some disclosures about the regulatory capital requirements would still be required.
- 3.26 The Board decided to defer the implementation of its capital statement disclosure requirement by one year to accounting periods ending on or after 23 December 2005.
- (a) As explained more fully in paragraphs 4.67–4.72 and section 10 of this appendix, the Board decided to defer for a year the changes it is making to the UK with-profits liability model. Having taken that decision, there were strong arguments for deferring the capital statement requirement as well.
  - (b) Allowing entities a year in which to prepare for this disclosure would, the Board believed, give them time to experiment with different forms of presentation and find a presentation that best fits their circumstances.
  - (c) The current expectation is that a standard based on ED 7 will be issued in 2005 and will be available for early adoption in accounting periods beginning on or after 1 January 2005. Deferring the capital statement requirements a year enables entities to implement the capital statement requirements at the same time as their ED 7 capital disclosures should they wish to do so.

### **Commercial sensitivity**

- 3.27 Another concern that respondents raised was the commercial sensitivity of the information. The financial strength of an insurer is a key aspect of its customer proposition and is often used in marketing products. It is also of interest to shareholders. Requiring UK entities to disclose detailed information about the fungibility of their available capital when non-UK competitors in a similar

position can remain silent or can point to an inappropriate indicator (such as the value of funds under management) would put UK entities at a disadvantage. Financial strength matters to current and prospective investors and policyholders, so putting an insurer at a competitive disadvantage could impact both on new business levels and on perception amongst the investor community.

- 3.28 The Board did not find these arguments persuasive. Given the importance of financial strength to the commercial success of an insurer, it is inevitable that the requirement for a capital statement will be viewed as sensitive by companies (and very relevant and important by users). It is true that different standards of financial reporting requirements have been and continue to be a problem. It does not follow, however, that entities that are more forthcoming in their disclosures are at a disadvantage compared to those that remain wrapped in a cloak of silence and ambiguity. The principal reason for the movement in Europe to the use of improved and international accounting standards is that markets have rewarded companies that have been open about their financial position and performance and discussed frankly the strategy options facing them. Regulators, too, have moved from believing that secrecy was an essential means of maintaining public confidence in the financial system to acknowledging that early identification and public discussion of problems is a surer way of avoiding potential crises. Experience also shows that better disclosures and management discussion by leading entities serve to educate users and create pressures on their competitors to emulate their example.

### **Communication to policyholders**

- 3.29 The Penrose Report urged that policyholders, as well as shareholders, should be kept better informed on the financial strength of an insurer. It is outside the Board's remit to require this directly. However, the capital statement required by the FRS has been designed with the idea that it could be extracted from the financial statements and sent to policyholders on an annual basis—or

included as an annual annex to the Principles and Practices of Financial Management (PPFM)\*—together with an appropriate introduction as to its purpose and explanation as to its form.

### **Movements analysis**

- 3.30 One of the concerns expressed in the Penrose Report was that financial statements contain insufficient information on the changes over the accounting period in key numbers (such as liabilities) and the causes of those changes. As a result, changes that an insurer has made to assumptions and in policy might not be apparent to users of those financial statements.
- 3.31 The Board shares those concerns and, as a result, it proposed in the FRED that a movements analysis should be provided in support of the proposed capital statement. That analysis should show how the capital position had developed in the period in the light of changes in assumptions and policies; the impact of new business, surrenders and maturities; and changes in asset mix. It should also be show a separate analysis for each category of capital or fund set out in the capital statement.
- 3.32 A number of respondents expressed concerns about the practicality of what the FRED proposed. There were three common concerns. Two related to how the FRED proposed the movement during the year should be analysed.
- (a) Respondents thought the difference between a change in assumption and a change in a management policy needed to be clarified and that guidance was needed on how to distinguish between the effect of an assumption change and the effect of a management policy caused by

---

\* The PPFM is a new document that the FSA requires UK with-profits life funds to make available to their policyholders. It contains a description of the fund's investment management and bonus distribution policies.



an assumption change. Additional guidance has now been provided in the FRS.

- (b) Respondents also argued that the complexities of the stochastic models involved made it difficult to isolate the effect of new business on available capital and liability levels and that this would not be information they would need for management purposes. The FRS now does not require the effects of new business to be shown separately.

3.33 The third concern related to the difficulty of isolating the effect of any specific change when the numbers involved are calculated on a stochastic basis. For example, the Board has been told by some entities that it will take them nearly a month to run the stochastic models necessary to estimate their 'realistic' liabilities. Their intention had been to run these models just at the end of each accounting period. However, in order to produce the FRED's proposed movements analysis it would be necessary to run the models after every change. That would involve a substantial amount of additional work.

- (a) The Board considered this to be a short-term difficulty caused by an understandable reluctance on the part of preparers to use short-cut methods to estimate the effects of changes until the stochastic models used are better understood.
- (b) In the Board's view, even if some relief needs to be given for a year or so until preparers are comfortable using short-cut methods, the longer-term objective should still be to require entities to provide a full, quantitative analysis of the reasons for the movements in available capital.

3.34 The FRS therefore retains the disclosure proposed in the FRED (subject to the amendment described in paragraph 3.32(b) above). However, for the first year (ie for 2005 year-ends), significant flexibility is given as to the form the

disclosure should take. The Board believed that this additional flexibility would ease significantly the practical difficulties that would otherwise arise in the first year of implementation.

## LIABILITY ACCOUNTING

### Existing accounting practice

- 4.1 As explained in Appendix II ‘Note on legal requirements’, most UK entities with life assurance activities are required to follow either the accounting requirements set out in Schedule 9A of the Companies Act 1985 (Schedule 9A) or requirements that are almost identical to those in Schedule 9A (for example, The Friendly Societies (Accounts and Related Provisions) Regulations 1994) in presenting their balance sheet information. The items in the prescribed format that relate in whole or in part to with-profits activities are:

### DEBIT BALANCES

- (a) *Investments*. Included within this item will be the aggregate fair value of the investments held within the with-profits fund.
- (b) *Prepayments and accrued income: Deferred acquisition costs (DACs)*. Selling a with-profits policy typically involves the insurer incurring significant up-front costs (acquisition costs). Under existing accounting practice, those costs are usually not charged immediately to the profit and loss account; instead, they are carried forward on the balance sheet and amortised over the period in which they are expected to be recoverable out of margins earned by the insurer from the policy at a rate commensurate with the pattern of such margins. The unamortised costs are shown on the balance sheet as ‘deferred acquisition costs’.
- (c) *Reinsurers’ share of technical provisions*. If the exposure on a with-profits policy has been reinsured, an asset may be

recognised under this heading. The amount of any such asset will be determined by reference to the amount recognised as a liability for that reinsured risk and the nature of the reinsurance.

## CREDIT BALANCES

- (d) *Technical provision for long-term business.* Currently this item represents an extremely prudent provision for bonuses already declared and claims incurred but not yet reported. It is calculated in accordance with regulatory guidance (the MSSB basis).
  - (e) *The FFA.* The FFA comprises all funds the allocation of which either to policyholders or shareholders has not been determined by the end of the financial year.
- 4.2 In its work on insurance liability accounting, the Board focused on:
- (a) *Recognition*—The technical provision for long-term business currently recognised takes into account the insurer’s legal obligations to policyholders (for example, to pay declared bonuses), but not its constructive obligations (for example, in respect of future bonuses).
  - (b) *Measurement*—The liability to policyholders that is recognised (under technical provisions for long-term business) is measured using extremely prudent (and therefore biased) estimates; under general accounting principles a best estimate measurement basis is usually used.
  - (c) *Presentation*—The FFA is presented in the balance sheet amongst liabilities, even though significant elements of the FFA appear not to meet the definition of a liability.
- 4.3 Reporting entities that have insurance business but are not subject to Schedule 9A requirements or the equivalent—for example, bancassurers and some retail groups—tend to

include the assets arising from their insurance business on one line of the balance sheet and the liabilities arising from their insurance business on another. Those recognising the value of in-force life assurance business in their primary financial statements also recognise, on a separate line in the balance sheet, an asset that represents the value of in-force business.\* The analysis included in the notes of liabilities tends to follow Schedule 9A conventions, so a technical provision for long-term business and an FFA are shown. As such, the recognition, measurement and presentation liability issues that arise in Schedule 9A financial statements also arise in the context of these statements.

- 4.4 The remainder of this section focuses on the recognition and measurement issues; the presentation issue is addressed in section 5.

## **FRS 12**

- 4.5 The liability recognition and measurement principles that apply to most entities are those set out in FRS 12. Liabilities are required to be recognised when:
- (a) an entity has a present obligation (legal or constructive) as a result of a past event;
  - (b) it is probable that a transfer of economic benefits will be required to settle the obligation; and
  - (c) a best estimate of the expenditure required to settle the present obligation at the balance sheet date can be determined reliably.
- 4.6 However, FRS 12 does not apply to provisions, contingent liabilities and contingent assets that arise in insurance entities from contracts with policyholders. There were two main reasons for this exemption: the constraints imposed by

---

\* *Embedded value is discussed further in section 7 of this appendix.*

Schedule 9A and the uncertainty as to how to apply the notion of a constructive obligation to with-profits business because of the ill-defined nature of the obligations owed to with-profits policyholders.

- 4.7 Although there may have been difficulties in applying FRS 12 to with-profits obligations, the Board has never doubted that the principles in the standard are just as applicable to those obligations as to any other obligation. In its view, policyholder liabilities should be recognised for constructive obligations, not just legal obligations, and those liabilities should be measured on a best estimate basis, rather than on an overly prudent basis.
- 4.8 The objective of the Board's work on insurance liability accounting has been to identify improvements that point in the direction in which insurance accounting is likely to develop and are capable of being implemented quickly. In the Board's view it is clear that the direction in which insurance liability accounting will develop will be to converge on the principles in FRS 12. However, the Board did not believe that it was possible to remove the FRS 12 scope exemption for insurance contracts without developing a substantial amount of additional guidance and without addressing certain key issues—neither of which the Board would have been able to do in the time available for this project.

### **The RBS approach**

- 4.9 Having concluded that it was not practicable in the short-term to remove the FRS 12 exemption for with-profits business, the Board considered what other options were available to it. In its view, any approach adopted needed to meet the following criteria:
  - (a) If improvements are to be made in the near-future, time constraints suggest that they would have to be based either on a method that already exists and is widely used

or on a new method for which preparations for implementation are already well underway.

- (b) If the direction in which insurance liability accounting should develop is towards the principles in FRS 12, it seems reasonable to suppose that any change in the liability model that is in the direction of those principles will be an improvement, as long as it does not bring with it offsetting disadvantages. Any change being considered therefore needs to be closer to FRS 12 than the existing basis.
  - (c) Any proposed new liability model would need to be consistent with the relevant legal requirements and capable of being implemented in true and fair financial statements in the timescales envisaged by the project.
- 4.10 The Board saw the FSA's RBS approach as the only approach that might meet all these criteria.

**Is the 'realistic' liability closer to the FRS 12 basis than the existing basis?**

- 4.11 The Board therefore examined the RBS method in detail to determine whether it was, in theory at least, an improvement on the existing basis.
- 4.12 The RBS method involves restating the assets and liabilities of a with-profits fund onto a 'realistic' basis. The FSA's rules envisage that the 'realistic' liability\* will comprise the 'with-profits benefits reserve' and 'future policy-related liabilities'.
- (a) The most significant element is the with-profits benefits reserve, which can be calculated in one of two ways: the retrospective method (ie asset share) or the prospective benefit method (ie the bonus reserve approach).

---

\* This appendix uses the term "realistic liability" as short-hand for the 'realistic value of liabilities', which is the term used in the FRS.

- (b) Where not already taken into account in the with-profits benefits reserve, the future policy-related liabilities, among other things, add to the benefits reserve provisions for:
  - (i) future costs of options and guarantees, of smoothing, and of non-contractual commitments and other amounts needed to ensure that customers are treated fairly;
  - (ii) any past miscellaneous surplus or deficit that the entity intends to attribute to the benefits reserve and any future planned enhancements to the benefits reserve ; and
  - (iii) other long-term insurance liabilities.

4.13 The objective of the calculation is to estimate the discounted value of future payments on policies in force.

4.14 Thus, the liability is not restricted to legal obligations—constructive obligations are taken into account as well—and the liability is not measured on an extremely prudent basis. This is similar to FRS 12’s approach. However:

- (a) there are a number of detailed differences in approach that the Board explored before concluding that the ‘realistic’ liability is an improvement, for accounting purposes, on the existing basis. These are considered in paragraphs 4.15–4.19;
- (b) the estimate of future payments to be made on in-force policies used in the ‘realistic’ liabilities calculation takes into account the fair value of the investments held in the with-profits fund (because the future payments will, by-and-large, in normal circumstances be a distribution of the part of the fund that does not represent the estate). If some assets are taken into account in calculating the ‘realistic’ liability but are not recognised in the financial

statements—or are not measured on the same basis—it could be argued that there will be a mismatch between the asset and liability sides of the balance sheet. The Board’s approach to this issue is set out in paragraphs 4.20–4.31; and

- (c) the FSA is requiring initially only some with-profits funds—those UK with-profits funds of entities with UK with-profits liabilities that are at least £500m in size—to implement the RBS method. RBS information is likely therefore to be available initially for only those funds. The implications of this are considered in paragraphs 4.32–4.35.

*Differences between a ‘realistic’ liability and an FRS 12 liability*

- 4.15 With most UK with-profits policies, when a bonus is declared an allocation is made both to policyholders and to shareholders. (For example, assume that policyholders and shareholders share fund profits on a 90:10 basis: if a bonus to policyholders of £90 is declared, an allocation of £10 will be made to shareholders.) When calculating the provision to be made for constructive obligations in respect of additional undeclared bonuses, the RBS approach requires both the constructive obligation to policyholders and the related shareholder allocation (the shareholders’ share of undeclared bonus) to be included in the ‘realistic’ liability. Under FRS 12, the shareholders’ share of undeclared bonus would not be treated as a liability. If the shareholders’ share of undeclared bonus was to be left in the amount recognised for policyholder liabilities, that liability would always be overstated and in many cases that overstatement would be significant. However, as it appears to be a relatively straightforward matter to eliminate the shareholders’ share of the undeclared bonus from the ‘realistic’ liability, this appears not to create any difficulties for the possible use of ‘realistic’ liabilities in true and fair financial statements.
- 4.16 The FSA’s rules make it clear that, in estimating future payments to be made on in-force policies in order to



estimate the ‘realistic’ liability, account should be taken of any intention of management to enhance (or reduce) permanently allocations to policyholders. Under FRS 12 such an intention would create a constructive obligation only where:

- (a) an established pattern of past practice, published policies or a sufficiently specific current statement has meant that the entity has indicated to other parties that it will accept certain responsibilities; and
- (b) as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

Thus a management intention to enhance (or reduce) allocations to policyholders might be reflected in the ‘realistic’ liability even though it does not give rise to a constructive obligation as defined by FRS 12.

- 4.17 There are also potential differences in the way that options and guarantees are measured. Under existing generally applicable accounting principles, options and guarantees giving rise to liabilities would usually be measured either on a best estimate basis or at fair value; under the RBS method they can be measured at either fair value or at a stochastically modelled value. Although the stochastically modelled value will often be the closest approximation to fair value that is available, it is not the same thing.\*
- 4.18 Another apparent difference between the ‘realistic’ liability and the FRS 12 liability is the treatment of future premiums and future investment gains. Under the RBS method, if the ‘realistic’ liability is being determined by estimating the future payments to be made on in-force business, the entity will project the eventual outcome (using, inter alia, the expected rate of future investment gains) and deduct from

---

\* *The measurement of options and guarantees is discussed further in section 6.*

that the expected future premiums. Although this is the technically most accurate way of estimating the future payments to be made on in-force business, it does involve the anticipation of future events.

- 4.19 The Board's understanding is that there is no easy way to adjust for the potential differences described in paragraphs 4.16–4.18 because the differences go to the core of the methodology used. Therefore, if the RBS method is to be used as a basis for insurance liability accounting, it has to be used with the 'potential differences' unresolved. The Board's judgement in developing the FRED was that, despite the potential differences, the 'realistic' liability would still be closer than the existing liability to FRS 12 and is therefore to be preferred. Few of those responding to the FRED disagreed with this view.

*Potential balance sheet mismatches*

- 4.20 In order to estimate the 'realistic' liability, it is necessary to estimate the future payments to be made on in-force policies. That estimate will need to take into account the fair value of all the investments in the with-profits fund since it is the overall financial strength of the fund that will be taken into account when determining bonuses. If non-participating business has been written in the with-profits fund, that business will be one of the with-profits fund's investments, and the fair value of that investment will be one of the fair values to be taken into account in estimating the amount of the 'realistic' liability. It seems to follow from this that, if 'realistic' liabilities are to be recognised, the fair value of non-participating business written in the with-profits fund—referred to in this appendix as the value of in-force, non-participating business (or the VIF of non-participating business)—needs to be recognised as well.
- 4.21 The VIF of non-participating business is, in effect, an embedded value. The Board has been asked to consider the merits of embedded value methodologies several times in

the past and on each occasion has concluded that it could not support their use in true and fair financial statements. For that reason, when faced with the VIF of non-participating business issue, the Board's response was to consider whether recognition of the VIF could be avoided.

- 4.22 It could be argued that the basis on which the assets were being recognised and measured ought not to matter. FRS 12 takes no account of the basis of asset recognition and measurement; it focuses exclusively on the present obligations the entity has as a result of a past event to transfer economic benefits. On that analysis, the notion of a mismatch between assets and liabilities would not exist and there would be no reason why the VIF of non-participating business would need to be recognised just because the 'realistic' liability is recognised.
- 4.23 Another way to look at the issue is to ask how one should account for an obligation to transfer to another party some or all of the valuable benefit to be derived from an item that is not recognised on the balance sheet—because, unless either the item was recognised on the asset side of the balance sheet or that element of the obligation is measured at nil, there would be a mismatch. For example, assume that an entity enters into an arrangement that involves it agreeing to pay a specified percentage of the next five years' profits to a third party. As future profits are not usually considered to be assets, they would not be recognised on the balance sheet; nor therefore is the liability under generally accepted practice.
- 4.24 The simplest treatment to adopt would be to show the VIF of non-participating business as an asset and to recognise as a liability the full amount of the 'realistic' liabilities. Under this approach the 'realistic' liabilities would be clearly shown, and the fair value of the investments being held against that liability would be shown on the asset side of the balance sheet. This was the approach proposed in the FRED.

- 4.25 Some respondents argued however that the VIF asset does not meet the definition of an asset and therefore should not be recognised on the balance sheet. Others argued that an insurance contract might meet the definition of an asset; the key question for them was whether measuring that asset by reference to the VIF of non-participating business would be appropriate bearing in mind that the value was an embedded value and the Board had not previously permitted the use of embedded values in the financial statements. As will be explained later in this section of the appendix, the Board has decided to defer implementation of the FRS until 2005, which has meant that the implications for the FRS of EU-adopted IFRS need also to be taken into account.
- (a) The Board's view is that it may be difficult to recognise the VIF asset in full—and perhaps even at all—in financial statements prepared in accordance with EU-adopted IFRS if that VIF asset is recognised for the first time in 2005 financial statements.
- (i) IFRS 4 does not permit the introduction of new accounting policies in 2005 that involve including a value for future investment risk margins (and for investment management fees in excess of fair value) in an embedded value. It is possible that the amount at which the VIF asset has been measured for regulatory purposes would include some amounts for such items.
- (ii) The effect of paragraph 11 of IAS 8 'Accounting Policies, Changes in Accounting Estimates and Errors' is that entities are required to refer to and consider the applicability of "the definitions, recognition criteria and measurement concepts for assets" set out in the IASB's 'Framework for the Preparation and Presentation of Financial Statements' (the IASB's Framework). The VIF asset probably would not qualify for recognition on the balance sheet as an asset under the IASB's Framework, although some might argue that the

reference to the need to “consider the applicability of” the IASB’s Framework, coupled with IFRS 4’s acceptance of the recognition of embedded value assets makes the position much less clear cut than that.

- (b) In theory similar difficulties would arise for an entity preparing its financial statements in accordance with UK standards and legal requirements as the FRS would contain IFRS 4’s embedded value restrictions and the Board’s Framework (the ‘Statement of Principles for Financial Reporting’) is similar to the IASB’s. However, the Board’s Framework does not form part of the hierarchy of authoritative accounting literature that preparers are required to take into account.

4.26 An alternative approach more in keeping with the discussion in paragraph 4.23 would be to deduct the VIF of non-participating business from liabilities. Such an approach could be justified on the grounds that the liabilities would be calculated by taking into account the value of the fund’s investments (including the VIF of non-participating business); if it is not appropriate to recognise the VIF of non-participating business as an asset, its effect on the liabilities should be removed. As one element of the VIF of non-participating business is often an amount to compensate for the excessive prudence included in the measurement of the non-participating business liabilities, deducting the VIF of non-participating business from liabilities would have the effect of netting off that compensation for over-prudence against the over-prudent liability, which seems reasonable.

- (a) In an ideal world, when applying this approach one would deduct that part of the VIF of non-participating business included in the policyholder liabilities from the ‘realistic’ liability number, that part of the VIF of non-participating business included in the FFA from the FFA, and that part of the VIF of non-participating business relating to the excessive prudence included in

the non-participating liabilities from those liabilities. However, the Board's understanding is that it will seldom be practicable to allocate the VIF of non-participating business in this way.

- (b) Another approach might be to deduct the whole of the VIF of non-participating business from policyholder liabilities, or alternatively to deduct the whole of the VIF from the FFA. The Board rejected both these alternatives, believing that neither method represented faithfully the actual underlying position (unless by coincidence). As such, the resulting information could be misleading.
  - (c) The Board then considered the possibility of deducting the VIF of non-participating business from the aggregate of policyholder liabilities and the FFA, while still displaying separately on the face of the balance sheet all three items. The Board concluded that such a presentation—showing the three elements separately—was superior to showing a single (net) number of the balance sheet (supported by a breakdown of the net number in the notes) because the three elements are so different in nature.
- 4.27 Such an approach appears consistent with the requirements of EU-adopted IFRS, especially as those standards contain flexibility as to the liability model to be adopted in accounting for insurance. However, it is not clear that such an approach could be reconciled with the requirements set out in Schedule 9A, which appear not to contemplate that amounts not calculated in accordance with the legal requirements could be shown as deductions from balance sheet items that have been calculated in accordance with those requirements (ie policyholder liabilities and the FFA).
- 4.28 On the basis of the above analysis, it would appear that the 'asset presentation' approach described in paragraphs 4.24 and 4.25 might be the only option available for financial statements prepared in accordance with UK standards and

legal requirements, while the ‘liability presentation’ approach described in paragraphs 4.26 and 4.27 might be the appropriate option for entities prepared in accordance with EU-adopted IFRS. Faced with the prospect of having to permit a choice on the issue, the Board considered whether it might be preferable to abandon the proposal to include ‘realistic’ liabilities on the balance sheet.

- 4.29 The Board has always understood that the improvement it is seeking to make to insurance accounting through the recognition of ‘realistic’ liabilities on the balance sheet is just one step on what will be a long journey for insurance accounting. The improvement tackles a number of issues (such as the recognition of liabilities based on legal obligations only and not constructive obligations, the use of overly prudent measures and the recognition as assets of deferred acquisition costs), but leaves some other issues to be addressed another day. The objective throughout has been to ensure that the benefits (ie the advantages gained by tackling the various issues) continue to outweigh the disadvantages (ie the unresolved issues). The Board believes that this continues to be the case regardless of whether the asset or liability presentation approach is adopted.
- 4.30 The other issue that arose from FRED 34 concerned the extent to which the VIF of non-participating business has actually been taken into account in determining the amount of the ‘realistic’ liabilities. The FRED stated that the VIF of non-participating business could be recognised “to the extent that...the determination of the realistic value of liabilities ...takes account of this value”. The objective of this statement was to prevent entities from recognising the VIF of non-participating business if it was not taken into account in determining ‘realistic’ liabilities. However, a number of respondents pointed out that there would generally be no direct link between the value of the VIF of non-participating business and the value of ‘realistic’ liabilities; in other words, if the former increased by a certain amount, it would not follow that the latter would

increase by the same amount. The relationship between the two would be rather more indirect. Respondents were concerned that the FRED expected a direct link between the two to be present before it permitted the VIF of non-participating business to be recognised. The FRS has been amended to make it clear that a direct link of this kind is not expected and that the amount of the VIF to be recognised is not restricted to the value taken into account in determining the amount at which to measure the liabilities.

- 4.31 A similar potential mismatch situation to the VIF issue discussed above arises where the with-profits fund has an investment in a subsidiary undertaking. In some cases that subsidiary will be valued for the purposes of estimating the 'realistic' liability at a market value or other value in excess of the net amount at which the subsidiary is included in the consolidated balance sheet. For similar reasons to those outlined above, the Board concluded that in such circumstances a mismatch could be avoided only by allowing the recognition as part of the with-profits fund of the excess of the amount at which it is valued for regulatory purposes over the amount at which it would normally be included in the consolidated balance sheet.

*Implications of the FSA limiting the application of its RBS method*

- 4.32 Initially, only entities with UK with-profits life liabilities of at least £500m will be required by the FSA to implement the RBS method, and then only for their UK with-profits funds; the method will not have to be adopted for smaller firms or for other UK life funds or any overseas life funds. It is understood that this means initially between thirty and forty large UK funds will be applying the RBS method. They will together represent approximately 95% in value of UK with-profits funds, but probably less than 50% in value of all UK life office funds.
- 4.33 When the Board was developing FRED 34, it considered the possibility of including within the scope of its 'realistic' liability requirement some or all of the funds that are not



within the scope of the FSA's RBS regime. However, at that time the proposal was that the Board's requirement would be implemented for 2004 year-ends and the Board took the view that the FSA was in the best position to judge how practicable it is to expect a fund to apply the RBS method in 2004 and had the FSA thought it possible to apply the RBS method more widely in 2004, it would have done so.

- 4.34 Later, when it became apparent that the FRS would not be implemented until 2005 year-ends, the Board considered the possibility again. However, the FSA had no immediate plans at that time to extend the scope of its RBS requirements or of the other FSA requirements that make it possible to apply the notion of a constructive obligation to with-profits business. That would have meant that the Board would have had to develop substantial additional guidance of its own. While that was feasible given time, it was not feasible given that the Board had decided that the FRS had to be finalised before the end of 2004.
- 4.35 That meant that, if the Board were to require 'realistic' liabilities to be used in the true and fair financial statements, it would have to accept that 'realistic' liabilities would be used only for the funds required by the FSA to prepare RBS information. The Board considered whether a 'partial' implementation of this kind of accounting was appropriate. If the amount currently recognised for policyholder liabilities had been calculated on a consistent basis, that might have represented a powerful argument for not adopting a partial implementation approach. However, Schedule 9A does not require uniform accounting policies to be adopted, and local regulatory constraints mean that full advantage of this relief is often taken. As such, requiring the UK with-profits liabilities of some entities to be calculated using the RBS method would therefore not introduce inconsistency or additional diversity in those entities' accounting. It would, however, mean that an important element of the amount of the total liability would be calculated on a basis closer to that of FRS 12.

*Summary*

- 4.36 The Board examined the RBS method to determine whether it was, in theory at least, an improvement on the existing basis. It concluded that:
- (a) there were differences between the ‘realistic’ liability basis (as amended to exclude the shareholders’ share of undeclared bonus) and FRS 12;
  - (b) in order to state the with-profits assets and liabilities on the same basis, if a ‘realistic’ liability is to be recognised on the balance sheet it will be necessary also to recognise the value of in-force business written in the with-profits fund if that business has been taken into account in determining the ‘realistic’ liability. A similar adjustment would also be made if the amount of the ‘realistic’ liability takes into account, for an investment that the with-profits fund has in a subsidiary undertaking, a value that is in excess of the amount at which that investment is shown in the consolidated balance sheet; and
  - (c) it is not practicable initially to require the whole of the policyholder liability to be calculated on an RBS basis.
- 4.37 In the Board’s view it would nevertheless still be an improvement for ‘realistic’ liability amounts to be used wherever they were available.

**Implications of recognising ‘realistic’ liabilities in the balance sheet for other balance sheet and profit and loss items**

- 4.38 Recognising ‘realistic’ liabilities in the balance sheet has implications for a number of other balance sheet items and, potentially, the profit and loss account.

*Reinsurers' share of technical provisions*

- 4.39 If the exposure on a with-profits policy has been reinsured, an asset called “Reinsurers’ share of technical provisions” will be recognised. That asset will be measured at an amount that reflects the amount recognised as a liability for that reinsured risk. Therefore, if the basis used to determine the amount of the liability is to change, so must the basis used for the reinsurance asset.

*Deferred acquisition costs*

- 4.40 Under MSSB accounting, where liabilities are measured on an excessively prudent basis, acquisition costs are deferred in order to reduce the distortion to reported financial performance that results from overly prudent provisioning. Under the RBS approach, the need to recover acquisition costs incurred is taken into account in the estimate of future bonus levels used to calculate the amount of the ‘realistic’ liability, so it would be inappropriate to continue to defer such costs.

*Tax effects of the proposed changes*

- 4.41 It would also be necessary to account fully for the tax effects of the changes described above.

*Implications for the FFA and for the profit and loss account*

- 4.42 The implications of the changes suggested for the FFA and the profit and loss account also needed to be considered. (To summarise, those suggestions involve, for the balance sheet items relating to a UK with-profits fund falling within the scope of the FSA’s RBS method:
- (a) adjusting the liability onto a ‘realistic’ basis and making consequential adjustments to any reinsurance assets;
  - (b) removing the related deferred acquisition costs from the balance sheet;

- (c) recognising the value of non-participating in-force business written in the with-profits fund;
  - (d) recognising the amount by which the value of an interest in a subsidiary undertaking held in the with-profits fund as estimated for the purposes of the 'realistic' liability calculation exceeds the net amount that would otherwise have been included in the consolidated balance sheet; and
  - (e) adjustments to reflect the consequential tax effects of the above adjustments.)
- 4.43 The Board took the view in developing the FRED that, in the case of an entity with shareholders, all these adjustments should be made to the profit and loss account with an offsetting transfer to the FFA. That would mean that, for such an entity, the proposals would have no direct net effect on the profit and loss account or shareholders' funds. Mutuals have no shareholders, and all the surplus is attributable to policyholders (though not yet allocated to specific policyholders). In some cases that retained surplus account is called 'the FFA'. The FRED therefore proposed for mutuals that the adjustment to liabilities should be offset by a direct transfer to or from this retained surplus account. Few of those responding to the FRED disagreed.

*Shareholders' interest in the liability for undeclared bonuses*

- 4.44 The RBS method requires a liability to be set up for a life assurer's constructive obligation in respect of additional bonuses. For the FSA's purposes, that liability is required to include the shareholders' share of the undeclared additional bonus but, as explained in 4.15, the FRS requires this shareholders' share to be excluded from the liability recognised in the financial statements. The effect of this is that for financial reporting the shareholders' share would remain in the FFA.

4.45 Some commentators argue that the shareholders' share should be treated as part of shareholders' funds. They reason that:

- (a) if the FFA is supposed to contain only funds the allocation of which has not been determined, and
- (b) the undeclared additional bonuses to which the constructive obligation relates is deemed to have had its allocation,

the shareholders' interest in those undeclared bonuses should also be deemed to have been allocated—which means it should be excluded from the FFA.

4.46 However, in most cases the amount that would be allocated to shareholders is not fixed until the bonus is declared. The terms of the policy often state that the entitlement of shareholders is up to 10% but there are examples of shareholders taking less than 10% and in some cases not taking anything at all. In addition, as explained in more detail in section 5, providing for the 'realistic' liability does not mean that the balance of the FFA represents equity. After meeting policyholders' reasonable expectations the FFA will still include material elements of surplus the ownership of which remains uncertain. For that reason the Board believes it appropriate to leave the shareholders' share in the FFA.

### **The legal position**

4.47 The form and content of insurance financial statements are the subject of detailed legal requirements.\* A number of those requirements have in the past been cited as constraining the ability of insurance entities to improve their liability model. Therefore, when the Board was developing the FRED it considered the implications of those requirements for the balance sheet changes it was contemplating making. In particular it considered the following issues:

- (a) If 'realistic' liabilities are to be recognised in the balance sheet for some UK with-profits funds, for some funds the technical provision would comprise just liabilities arising out of legal obligations and in other cases it would also include liabilities arising out of constructive obligations. Does the law permit the inclusion of liabilities arising out of constructive obligations in the technical provision and, if so, does it also permit the inclusion of such liabilities for some funds but not others?
- (b) Another implication of recognising 'realistic' liabilities in the balance sheet for some UK with-profits funds is that some liabilities included in the technical provision would be measured using an extremely prudent basis and some would not. Does the law permit liabilities to be included in the technical provision on a less prudent basis than at present and, if so, does it also permit some liabilities to be measured on that less prudent basis while some others are measured on the existing extremely prudent basis?
- (c) If a 'realistic' liability is being recognised for a particular fund, the intention is that the recognition of an asset for deferred acquisition costs arising on that fund would be prohibited. Is that consistent with the legal requirements?
- (d) Are there any legal difficulties in recognising the value of in-force non-participating business written in the with-profits fund or the value of an interest in a subsidiary undertaking in excess of the net amount that would otherwise have been included in the consolidated balance sheet?

---

*As explained more fully in Appendix II, the detailed requirements that apply to British insurance entities are either contained in or almost identical to those contained in Schedule 9A of the Companies Act 1985. Similar requirements apply to insurance entities in Northern Ireland and the Republic of Ireland.*

- 4.48 The Board's view at the time that it was developing the FRED was that there were no legal difficulties arising from any of those issues. The Board has since received legal advice that confirms that view. It has also considered the views expressed by respondents as to the meaning of some of Schedule 9A's requirements but has not changed its view that the changes it is making to the insurance liability model (and the consequential changes that are being made to other balance sheet items) are consistent with Schedule 9A's requirements.
- 4.49 The Board's detailed analysis of the issues highlighted above is set out in the paragraphs that follow.

*Including constructive obligations in the technical provision*

- 4.50 Currently, the liability to policyholders recognised in the technical provision for long-term business relates only to legal obligations owed to policyholders; it does not include constructive obligations in respect of additional bonuses. Some commentators argue that the law prohibits the inclusion in the technical provision of liabilities for bonuses not yet declared. That may well have been the case in the past, but the Board believes that the development of the RBS method and, with it, a means of applying FRS 12's constructive obligations notion to UK with-profits business has had the effect of making possible a wider range of interpretations of the legal restrictions than hitherto. One consequence of this is that it is now reasonable to interpret the law as permitting the inclusion of liabilities for additional bonuses in the technical provision. The analysis leading to this conclusion is set out in the following paragraphs.
- 4.51 Paragraph 16 of Schedule 9A requires "all liabilities and losses which have arisen or are likely to arise in respect of the financial year" to be taken into account in determining the amount at which to show items in the financial statements. This makes it clear that a liability should not be ignored; the Board believes it also means that all liabilities

that have been identified should be recognised on the balance sheet. This interpretation seems to be supported by note 21 of the balance sheet format in Schedule 9A, which states that the long-term business provision shall comprise “the actuarially estimated value of the company’s liabilities (excluding technical provisions [included under ‘Technical provisions for linked liabilities’]), including bonuses already declared and after deducting the actuarial value of future premiums.”

- (a) The reference to “bonuses already declared” appears not to be restrictive because it is preceded by the word ‘including’, which implies that the list is not exhaustive.
- (b) The reference to the provision comprising “the company’s liabilities” suggests that, if a liability is identified, note 21 expects it to be included in the long-term business provision. Under the MSSB basis the only liabilities identified were for bonuses already declared; under the RBS method liabilities are also identified in respect of additional bonuses not yet declared.

4.52 Paragraph 46(3) of Schedule 9A states that the computation of the long-term business provision “shall be made annually by a Fellow of the Institute or Faculty of Actuaries on the basis of recognised actuarial methods, with due regard to the actuarial principles laid down in Council Directive 92/96/EEC.” This reference to Council Directive 92/96/EEC is in effect a reference to Directive 2002/83/EC.\* Article 20 of that Directive states, inter alia, that the amount of such technical provisions “shall be calculated by a sufficiently prudent prospective actuarial valuation, taking account of all future liabilities as determined by the policy conditions for each existing contract, including: all guaranteed benefits, including guaranteed surrender values; bonuses to which policy holders are already either collectively or individually entitled, however those bonuses are described—vested, declared or allotted; all options available to the policy holder



under the terms of the contract; expenses, including commissions, taking credit for future premiums due...”

- (a) Again, the use of the word ‘including’ means that the list at the end of this quote is not restrictive and, therefore, not significant. The technical provision must include bonuses to which policyholders are already entitled, but could also include other amounts relating to future bonuses. This is reinforced by the explanation in the Article (paragraph 1D) that “in the case of participating contracts, the method of calculation for technical provisions may take into account, either implicitly or explicitly, future bonuses of all kinds, in a manner consistent with the other assumptions on future experience and with the current method of distribution of bonuses.”
- (b) The reference to “taking account of all future liabilities” is significant in that it makes it clear that no liability should be ignored. ‘Taking account of’ is however a rather imprecise term open to interpretation in different ways. One interpretation which the Board believes is reasonable—though not necessarily the *only* interpretation that is reasonable—is that the paragraph requires all liabilities to be recognised in the balance sheet.

4.53 Paragraphs 4.50–4.52 analyse the legal requirements dealing with the items to be included in the long-term business provision. The legal requirements as to the content of the FFA are also relevant because, if an item is required to be included in the FFA, it cannot also be included in the long-term business provision. Note 19 of the balance sheet format in Schedule 9A states that the FFA should comprise “all funds the allocation of which either to policyholders or shareholders has not been determined by the end of the

---

*Directive 2002/83/EC has replaced Council Directive 92/96/EEC, which has been repealed. The cross-reference in paragraph 46(3) has not yet been updated, but it is understood that it will be shortly.*

financial year.” This means that amounts for which the allocation has not been determined should not be recognised in the long-term business provision. Some commentators have suggested that an allocation is determined only when a bonus is declared. Such a view would mean that amounts relating to constructive obligations for additional bonuses would be required to be included in the FFA rather than the technical provision. However, although the reference to ‘allocations being determined’ could be interpreted in that way, it could also be interpreted in other ways—for example, it could be that an allocation can be determined through the identification of a constructive obligation—and there is no reason to believe that the first interpretation is more appropriate than the second.\*

4.54 So, to summarise, a reasonable interpretation of:

- (a) paragraph 16 of Schedule 9A is that all liabilities that have been identified should be recognised on the balance sheet;
- (b) note 21 of Schedule 9A’s balance sheet formats is that the long-term business provision is required to show the company’s liabilities; and
- (c) paragraph 46(3) of Schedule 9A requires all future liabilities to be recognised in the long-term business provision.

None of these paragraphs—nor indeed any other legal requirements—suggest that ‘liabilities’ can comprise only liabilities for bonuses already declared. Furthermore, it is reasonable to interpret the description of the contents of the FFA in note 19 of Schedule 9A’s balance sheet formats as not prohibiting liabilities for additional bonuses not yet

---

\* *The discussion, in paragraphs 4.44-4.46, on the balance sheet treatment of the shareholders’ interest in the liability for undeclared bonuses is also relevant here.*

declared from being included in the long-term business provision.

4.55 As a result, there appears no legal restriction on including liabilities for additional bonuses in the long-term business provision. Indeed:

(a) in the case of funds for which ‘realistic’ liabilities are determined, constructive obligations (for additional bonuses not yet declared) that give rise to liabilities have been identified, so those liabilities should be recognised in the technical provision.

(b) for other funds, the only liabilities that have been identified are those based on legal obligations. As such, it seems reasonable to recognise only those amounts in the technical provision.

4.56 As explained more fully later in this appendix, the FRS requires entities to start recognising ‘realistic’ liabilities in their financial statements from December 2005 year-ends. This raises a further issue: is there an inconsistency between the conclusion (in subparagraph (a) above) that all liabilities that have been identified should be recognised in the financial statements and the Board’s decision not to require recognition of ‘realistic’ liabilities for 2004 year-ends even though the FSA requires the RBS method to be used in prudential returns from December 2004? The Board does not believe so. In its view, there are issues surrounding the recognition of ‘realistic’ liabilities in financial statements that mean, for many entities, that it is not yet practicable for them to be recognised in financial statements for 2004 year-ends—and there seems no reason to suppose that Schedule 9A would require their use in such circumstances. However, if they are not recognised, as explained more fully under the next heading it will be necessary to take that into account in determining the amount of prudence to include in the measurement of the liabilities that are recognised.

*Less prudent measurement bases*

- 4.57 Currently those liabilities recognised in the technical provision are measured on an extremely prudent basis. ‘Realistic’ liabilities are measured on a less prudent basis and it has been suggested that the existing legal requirements prevent these ‘less prudent’ measures from being used in the financial statements. The Board does not agree. Its analysis is set out below.
- 4.58 The legal requirements are that the long-term business provision is measured at “the actuarially estimated value” (note 21 of the balance sheet format in Schedule 9A), the computation of the technical provision to be made “on the basis of recognised actuarial methods” (paragraph 46(3) of Schedule 9A), the amount of the technical life-assurance provisions shall be calculated “by a sufficiently prudent prospective actuarial valuation” (Directive 2002/83/EC). Legislation also makes clear that “a prudent valuation is not a ‘best estimate’ valuation, but shall include an appropriate margin for adverse deviation of the relevant factors”. There is therefore no requirement that an extremely prudent measurement basis should be used.
- (a) Both an MSSB measure and a RBS measure would meet the requirement that the liability be measured at the “actuarially estimated value” and on the basis of “recognised actuarial methods”. Similarly, both would meet the requirement that a prudent measurement basis should be used rather than a best estimate measurement basis. (Although the RBS measure is closer than the MSSB measure to a best estimate, it still includes certain margins for adverse deviations.)
- (b) Although the law requires that the measurement basis should be “sufficiently prudent” and that the measure should include “an appropriate margin” for adverse deviation, it provides no further guidance and, in particular, does not make clear the purpose for which the measure should be sufficiently prudent or for which

the margin needs to be appropriate. For example, it has been argued that more prudence has been needed to date in arriving at a measure that is to be used for prudential regulatory purposes than in arriving at a measure for true and fair financial statements. It seems reasonable to argue therefore that what is sufficient and appropriate should be judged in the context in which the measurement is to be used.

In an accounting framework in which liabilities are not recognised for constructive obligations in respect of additional bonuses, substantial margins are necessary to take account of those obligations. However, in an accounting system in which liabilities are recognised for those constructive obligations, a less (possibly much less) prudent measurement basis can be used because the prudence ‘margin’ does not need to take account of those obligations.

4.59 Paragraph 43 of Schedule 9A states that “the amount of technical provisions must at all times be sufficient to cover any liabilities arising out of insurance contracts as far as can reasonably be foreseen.” The meaning of this paragraph is open to different interpretations.

- (a) For example, some commentators suggest that it requires the maximum liability that might arise from an uncertain event to be recognised. This, they suggest, means that using a measurement basis in the financial statements that is as close to a best estimate basis as the RBS method would not be consistent with the law. Others point out that, if this interpretation were correct, options and guarantees would be measured by reference to the worst case scenario, assuming a catastrophe. Such a measurement approach is impractical and potentially misleading. It is also not how options and guarantees are measured currently.
- (b) In the absence of any other indications as to its meaning, it seems reasonable to assume that the requirement has

the same objective in mind as the requirements discussed in paragraph 4.53–4.54—a liability amount should be determined on a basis that is sufficiently prudent for the purpose to which the number is to be used, bearing in mind the context in which it is to be placed and taking appropriate account of the various risks and uncertainties in arriving at the measure.

*Deferred acquisition costs*

- 4.60 Note 17 of the balance sheet format in Schedule 9A states that the deferred acquisition costs line of the balance sheet shall comprise “the costs of acquiring insurance policies which are incurred during a financial year but relate to a subsequent financial year” (except for certain allowances not relevant to this discussion). Some commentators have suggested that this means that any accounting standard that prohibits deferral of acquisition costs (as the FRS does) is not consistent with the law.
- 4.61 When costs are incurred is largely a matter of fact and nothing in the FRS seeks to change the existing view on when acquisition costs are incurred. However, which period such costs relate to is a matter of accounting convention and is therefore something that standards help determine. In effect, the FRS requires that, for funds required by the FSA to prepare RBS information, the acquisition costs should be treated as relating to the period in which they were incurred. For other funds, the FRS does not prevent acquisition costs from being treated as relating to future periods.

*Recognising the value of in-force non-participating business and the excess value of any investment that the with-profits fund has in a subsidiary*

- 4.62 As explained above, the FRS permits entities to recognise the value of in-force (VIF of) non-participating business written in the with-profits fund as an asset or as a deduction from liabilities, although in both cases only if it has been

taken into account in determining a ‘realistic’ liability that is recognised on the balance sheet. Some commentators have questioned whether the recognition of this amount is permitted by Schedule 9A.

- 4.63 Considering first the ‘asset presentation’ approach, Schedule 9A sets out in some detail the items that should be disclosed on the balance sheet and where they should be disclosed. An implication of this is that, if an entity intends to recognise a particular type of asset that has a line item allocated to it by Schedule 9A—for example, deferred acquisition costs—the only place that asset can be recognised on the balance sheet is on the deferred acquisition costs line. Some have suggested that the value of in-force non-participating business includes items that should more properly be disclosed under Schedule 9A’s prescribed line items; and as such recognising the value separately is not consistent with the law. The Board does not share these concerns. Although the VIF of non-participating business may well be derived, *inter alia*, from the use of assets and liabilities shown on other lines in Schedule 9A’s format that is not the same as saying the value comprises those other assets and liabilities and should therefore be shown on the lines allocated for those assets and liabilities by Schedule 9A.
- 4.64 The Board believes that a similar argument applies to the recognition of the excess value of any investment that the with-profits fund has in a subsidiary.
- 4.65 The FRS describes two different approaches to ‘liability presentation’.
- (a) The first approach will usually not be feasible but should be adopted if it is. It requires that part of the VIF of non-participating business included in the policyholder liabilities to be deducted from the ‘realistic’ liability number, and that part of the VIF of non-participating business included in the FFA to be deducted from the FFA. The Board believes that this approach would be consistent with Schedule 9A’s requirements analysed

above in that it is still a prudent measure derived from an actuarial valuation—it is just that no value has been attributed to an obligation to transfer an item that is not recognised as an asset.

- (b) On the other hand, the Board believes that the ‘liability presentation’ approach that is usually feasible—deducting the VIF of non-participating business from the aggregate of policyholder liabilities and the FFA, although showing each of the three items separately on the face of the balance sheet—might not meet Schedule 9A’s requirements. That is because Schedule 9A requires policyholder liabilities and the FFA to be shown separately, and that seems to require the VIF of non-participating business to be allocated between them rather than deducted from the sum of them.

### **Practicality**

4.66 To summarise the discussion in section 4 so far:

- (a) Although there were certain conceptual difficulties with ‘realistic’ liabilities, the Board still considers their use where available preferable to the continued use of the existing MSSB basis.
- (b) If ‘realistic’ liabilities were to be used, it would be necessary to make certain consequential changes to other balance sheet items. However, those changes would not be problematical.
- (c) It was possible to use ‘realistic’ liabilities where available and make the consequential balance sheet amendments deemed necessary and still comply with the requirements of Schedule 9A (and equivalent requirements).



*Deferral until 2005*

- 4.67 During the development of the FRED, the Board heard from a number of commentators who suggested that, regardless of the technical merits of recognising ‘realistic’ liabilities, there are practical considerations that mean that such a change should either not be made at all or should not be made for 2004 year-ends.
- (a) Some commentators questioned whether the FSA’s rules on the RBS method will be sufficiently robust to bear the burden that the Board is proposing to put on them. These commentators characterised the RBS method as involving a negotiation with the FSA and this, they argued, was not a good basis for an accounting standard. It would also mean that the reporting timetable would become crucially dependent on the FSA’s ability to provide timely input into the estimation process. They also argued that the estimation of the ‘realistic’ liability amount was a highly subjective exercise; too subjective for the information to be included in financial statements intended to show a true and fair view.
  - (b) Some had fewer doubts about the long-term practicality of the proposals, but questioned the wisdom of implementing the proposals for 2004 reporting. They argued that, as with any major change in practice, the RBS method would take time to ‘bed down’ and would be very approximate until it does. They also suggested it would take longer to implement in the first year than in subsequent years. In their view it would be better to defer implementation for a year rather than jeopardise the timeliness of the financial statements and significantly increase the risk of those statements containing errors or misstatements.
  - (c) Some argued that, even though auditors would be required to give an opinion on the FSA’s 2004 regulatory returns which would include RBS

information, the FRED's proposals would raise important audit issues that were not capable of resolution in time for 2004.

- 4.68 At the time the Board was developing the FRED, it did not find these arguments persuasive. In its view, 'realistic' liability numbers would be no less subjective than other numbers—such as loan loss provisions, provisions for decommissioning costs, perhaps even pension liabilities. Furthermore, although the Board recognised that the proposed FRS would set preparers and auditors a challenge—particularly in the first year of implementation—it was not convinced that this would be any more difficult to overcome than the difficulties that some other entities have had to overcome in preparing their financial statements. In its view it would not be credible for entities to publish financial statements including liabilities measured on the existing basis whilst, at the same time, measuring liabilities in publicly available regulatory returns on a basis that is generally perceived to be better. The Board therefore proposed in the FRED that the changes to the liability model should be implemented for 2004 year-ends.
- 4.69 Implementation in 2004 also had the advantage of ensuring that the FRS would apply to the whole industry in 2004 and would, in the main, continue to be applied by the whole industry in subsequent periods—including, because of the grandfathering provisions in IFRS 4, entities preparing their financial statements in accordance with EU-adopted IFRS. On the other hand, if the FRS was not implemented until 2005, entities preparing their financial statements in accordance with EU-adopted IFRS would not fall within its scope. The Board considered it important that the FRS should be applied across the industry.
- 4.70 Most of those responding to FRED 34 criticised the proposal that the FRS should be implemented for 2004 year-ends. Some simply stated that the timetable was impracticable; others suggested a one year deferral.

- 4.71 The Board noted that a number of entities due to be preparing their financial statements in accordance with EU-adopted IFRS from 2005 had offered, either in their formal responses to FRED 34 or in their discussions with the Board's staff, to implement the FRS from 2005 if the Board decided not to require its adoption in 2004. It therefore had discussions with the Association of British Insurers, the British Banking Association and some of those bodies' members about that possibility. As explained more fully in section 10 of this appendix, those discussions were positive, thus enabling the Board to consider the proposed implementation timetable in isolation from its desire to issue a standard that would be adopted across the industry as a whole.
- 4.72 The Board then reconsidered its proposal to implement this part of the FRS in 2004 and concluded that implementation should be deferred by a year. The advantage to be gained by implementing this part of the FRS in 2004 rather than 2005 were marginal and there was a risk that, if more time for implementation was not allowed, the information provided could prove misleading.

*Implications of IFRS 4 for a delay in implementation of the proposed standard*

- 4.73 IFRS 4 imposes restrictions on the accounting policies that can be used from 2005 in financial statements prepared in accordance with EU-adopted IFRS. Those restrictions differ depending on whether the accounting policy is an existing policy (ie was also used in 2004) or a new policy (ie is being implemented for the first time in 2005). When the Board was developing the proposals in FRED 34, it kept its eye firmly fixed on the former restrictions but ignored the latter restrictions. The decision to delay implementation of the proposed FRS until 2005 meant that the latter restrictions were now relevant.
- 4.74 The Board believed there were three restrictions to consider. The first is set out in paragraph 22 of IFRS 4.

That paragraph requires that, subject to certain exceptions (none of which are relevant here), an accounting policy can be changed only if it represents an improvement; in other words, if the change makes the financial statements more relevant and no less reliable, or more reliable and no less relevant. Does a change of accounting policy to one that involves the recognition of 'realistic' liabilities represent an improvement under IFRS 4? The Board believes that it does and its reasons for reaching that conclusion are as follows:

- (a) The Board believes that it is beyond dispute that 'realistic' liabilities are a more relevant measure of the obligation to policyholders than the existing MSSB basis. The question is therefore whether they are less reliable.
- (b) IFRS 4 requires reliability to be judged by the criteria in IAS 8. Paragraph 10(b) of IAS 8 makes it clear that reliability should be judged by considering whether an accounting policy results in financial statements that:
  - (i) represent faithfully the financial position, financial performance and cash flows of the entity;
  - (ii) reflect the economic substance of transactions, other events and conditions, and not merely the legal form;
  - (iii) are neutral; in other words, free from bias;
  - (iv) are prudent; and
  - (v) are complete in all material respects.

There is no doubt that 'realistic' liabilities are generally 'softer' numbers than MSSB liabilities (because they are significantly affected by assumptions and non-market inputs). However, as IAS 8 makes clear, the reliability test is not about the softness (or otherwise) of the

numbers per se. Rather it is about attributes such as faithful representation (the MSSB number is not a faithful representation of policyholder liabilities because it omits a major element of the obligation to the policyholders—the constructive obligation for future bonuses); neutrality (the ‘realistic’ liability is a more neutral number than the MSSB liability because the latter is prepared on a very prudent basis), and prudence (both bases are prudent, it is just that the MSSB basis is overly prudent). On that analysis, ‘realistic’ liabilities are also more reliable than MSSB liabilities.

4.75 The second restriction relates to paragraph 25(c) of IFRS 4, which stipulates that, except as permitted by paragraph 24 of the IFRS, an accounting policy change cannot be made if it would involve the use of non-uniform accounting policies for the insurance liabilities of subsidiaries. The question here is, is a requirement to change the basis of recognising and measuring the policyholder liabilities of some entities’ UK with-profits liabilities—and at the same time making changes to the treatment of the deferred acquisition costs and reinsurance assets arising from such funds—without changing the basis for all with-profits liabilities permitted by IFRS 4? The Board believes that it does; its reasoning is as follows:

- (a) Most groups with UK life assurance activities currently adopt a wide diversity of accounting policies in determining their policyholder liabilities, especially in respect of various overseas subsidiaries. For them, the change from the MSSB basis to the ‘realistic’ basis can be described as changing one basis that is used for UK with-profits policyholder liabilities but no other policyholder liabilities to another basis that is used for UK with-profits policyholder liabilities but no other policyholder liabilities.
- (b) An alternative way of viewing the change to ‘realistic’ liabilities is a move from applying a partial recognition basis to the recognition of with-profits liabilities

(because it takes account only of declared bonuses) to a basis that attempts to recognise constructive obligations for future bonuses as well. Viewed in this way the change can be seen as improving the uniformity of accounting policies used in the group, because the recognition bases used in other parts of the group—including non-participating business and general insurance business—will also be close to a full recognition basis.

- (c) The exemption in paragraph 24 of the IFRS also appears relevant and clearly demonstrates that partial changes are not prohibited by the standard:

“An insurer is permitted, but not required to change its accounting policies so that it remeasures designated insurance liabilities to reflect current market interest rates and recognises changes in those liabilities in profit or loss. At that time, it may also introduce accounting policies that require other current estimates and assumptions for the designated liabilities. The election in this paragraph permits an insurer to change its accounting policies for designated liabilities, without applying those policies to all similar liabilities as IAS 8 would otherwise require.”

The adoption of realistic liabilities would represent the introduction of an accounting policy that requires the use of current estimates and assumptions and as such is envisaged by the IFRS.

- 4.76 The third restriction relates to the recognition of the VIF of non-participating business written in a with-profits fund. The FRS permits the whole of the amount to be recognised if the non-participating business is measured on that basis for the purpose of the regulatory returns, the value is determined in accordance with the FSA’s requirements, and the ‘realistic’ liabilities amount took account of the value. However, most UK entities recognising this VIF amount in their balance sheet will be doing so for the first

time in their 2005 financial statements, which means that entities preparing their financial statements in accordance with EU-adopted IFRS will need to be able to implement the changes the FRS requires under EU-adopted IFRS. The Board believes that they can. That is because paragraph 5 of the FRS gives entities a choice of ways in which to incorporate the VIF amount on the balance sheet and although recognising the VIF as an asset will not be possible under IFRS 4 unless that amount includes neither future investment risk margins or excess investment management fees—and may not be possible under the IASB’s Framework—the other two approaches allowed by the FRS envisage the VIF amount being taken into account in determining liabilities and IFRS 4’s embedded value restrictions will have no implications for such a treatment.

- 4.77 The Board’s view is therefore that it is possible to implement the requirements of the FRS in full in 2005 in a set of financial statements that comply fully with EU-adopted IFRS.

## **BALANCE SHEET CLASSIFICATION OF THE FFA**

### **What is the FFA?**

- 5.1 As already explained, under existing UK requirements entities with with-profits funds recognise an item called the Fund for Future Appropriations (or FFA) amongst their liabilities. The FFA is the cumulative amount that is available for allocation to policyholders (current and future) and, where applicable, shareholders but remains unallocated at the balance sheet date. Therefore, for an entity with shareholders one of the issues concerning the FFA is its ownership. For all entities there will also be the inter-generational issue: how much of the FFA belongs to which generation of policyholders?
- 5.2 Currently the FFA includes amounts relating to obligations (for example, amounts relating to the constructive

obligations that exist in respect of additional bonuses) . However, in many cases it also includes an ‘estate’. The ownership and future application of the estate is uncertain; although the expectation might be that 90% or so of it will be allocated to policyholders, there is no current obligation to allocate or pay any of the estate to anyone—it can be held indefinitely or used for any or all of the following purposes:

- (a) meeting the expenses incurred in writing new business;
- (b) meeting investment or other losses arising on the assets backing the estate;
- (c) meeting losses arising from non-participating business written by the with-profit fund;
- (d) meeting liabilities to the with-profit policyholders arising from non-participating features of the policies (such as options or guarantees);
- (e) distribution to current and or future policyholders through the declaration of bonuses in excess of their measured obligations. (This could, for example, be as a consequence of a marketing initiative or a tontine effect\*); or
- (f) distribution to shareholders in accordance with their rights of participation in bonus declaration or by way of a scheme of arrangement agreed with policyholders.<sup>†</sup>

5.3 The FRS requires changes to the existing liability model that would have the effect, inter alia, of removing from the FFA, for those funds required by the FSA to prepare RBS information, amounts relating to the fund’s constructive obligations in respect of additional bonuses and amounts relating to options and guarantees. As a result, it seems reasonable to consider whether for those funds the FFA should continue to be classified, as it is currently in the UK, amongst liabilities. (Many entities will also have funds not required to prepare RBS information and the FFA for those



funds will continue to have an element that is related to constructive obligations in respect of additional bonuses.)

- 5.4 IFRS 4, which applies from 2005 to those entities preparing their financial statements in accordance with EU-adopted IFRS, requires the FFA to be classified as either equity or liability or in part as equity and in part as a liability. The standard allows almost total flexibility as to how the classification (and any split) is done and does not, for example, appear to require it to be based on the existing equity and liability definitions. However, it does require that all guaranteed elements are classified as liabilities and that, if the guaranteed element is not distinguished from other parts of the with-profits contract, all the amounts relating to the contract should be classified as a liability.
- 5.5 Under most US GAAP approaches and under embedded value principles the FFA is classified on the assumption that it is to be shared between policyholders and shareholders, generally in a 90:10 ratio. In other words, 90% of the FFA is treated as a liability and the balance is classified as equity.

### **Should the FRS address the classification of the FFA?**

- 5.6 Against this background, the Board considered whether the FRS should address the classification of the FFA. Bearing in mind that the FFA appears to comprise both equity and liability elements, it seemed unlikely that accounting would be improved by requiring the entire FFA to be treated as a

---

*If a closed fund has a surplus but those leaving the fund are paid an amount that is equal to the constructive obligation, the value of the fund per remaining policyholder will increase as policyholders leave until there is only one remaining policyholder, who would be entitled to the entire surplus. (The principle of the tontine is that the last remaining policyholder is entitled to the surplus.) To avoid the tontine effect, funds over-distribute when they foresee a tontine arising.*

*Normally in a life company that has shareholders, when a surplus is declared as a bonus, 10% of the surplus involved is attributed to shareholders and 90% to policyholders. A scheme of arrangement may allow a higher amount to be attributed to shareholders. This is generally as part of an agreement to share the surplus with current policyholders.*

liability or to be classified as equity.\* The options the Board considered were:

(a) to require the FFA to be classified as equity to the extent that no liability is involved (in other words, classify the estate as equity) and as a liability to the extent that the liability definition is met; or

(b) to adopt a similar approach to that set out in IFRS 4.

5.7 In order to apply the change described in option (a) to entities preparing their financial statements in accordance with UK standards and legal requirements, a change would be required to the law and the Board understands there is little prospect of such a change in the near-future. However, rather than dismissing this option out of hand because of the legal difficulties, the Board considered whether it would want to make the change, legal requirements permitting.

(a) The case for classifying the estate as equity is simply stated: the estate (if correctly calculated) is not a liability as defined and any credit balance that is not a liability is equity under the Board's Framework. Arguments that the estate does not have the characteristics that one would normally associate with something that is equity miss the point: the only characteristic that equity has is that it is a residual and the estate possesses that characteristic. However, as the Board's Framework itself admits, definitions of items like liabilities are developed with current and past accounting problems in mind and, although they will often help in tackling new accounting problems, those new problems will sometimes point up shortcomings that need to be addressed. Indeed, recent work by a number of

---

\* The Board's Framework envisages that credit balances will be classified as liabilities if they meet the definition of a liability and as part of the ownership interest (which might be called by a number of different names, including 'equity') otherwise. The FRS uses the term 'equity'.

standard-setters has revealed the need for the principles that underlie the equity/liability classification to be reviewed. The US standard-setter, FASB, is carrying out a review for the IASB and that project is likely to inform the IASB's work in phase 2 of its insurance project.

- (b) In order to classify as equity all of the FFA other than the portion identified as a liability, the Board would want to be confident that its definitions of 'liabilities' and of 'equity' were appropriate in the context of with-profits activities. It would also want to be confident that all the liabilities had been recognised and appropriately measured because it would not be appropriate to classify as equity a balance that might contain some element of liabilities. Although the development of the FSA's RBS approach has made it possible to get much closer to identifying the liability element (as defined by FRS 12) for the funds to which the methodology relates, 'realistic' liabilities are not the same as 'liabilities calculated on an FRS 12 basis'. There also remains considerable difficulty in attempting to identify the liability element for other funds.
- (c) A consequence of classifying some or all of the FFA as equity would be a fundamental change to the profit recognition model. The Board would not want to make changes of this kind without a more detailed consideration of the profit recognition model than has been possible in this project.

The Board therefore decided not to propose the reclassification of some or all of the FFA as equity.

- 5.8 The other change the Board could have made was to adopt a similar approach to that set out in IFRS 4. However, such a change would have no effect on entities preparing their financial statements under UK standards and legal requirements unless there was a change of law—and there is no prospect of that in the near-future. Adopting the IFRS

4 approach in the UK would also have created the possibility of a diversity of practice where currently there is uniformity. The Board therefore decided not to pursue this option.

- 5.9 The FRS therefore remains silent on the classification of the FFA. This means that:
- (a) in financial statements prepared in accordance with UK standards and legal requirements, the FFA will be classified as a liability; and
  - (b) in financial statements prepared in accordance with EU-adopted IFRS, there will be almost complete flexibility as to how the FFA is classified, subject only to the caveats explained in paragraph 5.4 above and pending completion of phase 2 of the IASB's insurance project.

### **Showing the technical provision and the FFA separately on the balance sheet**

- 5.10 Currently Schedule 9A requires that the FFA and the technical provision are shown on separate lines of the balance sheet. However, for entities applying EU-adopted IFRS are not subject to that legal requirement. Furthermore, IFRS 4 permits, but does not require, entities to combine the technical provision and FFA on a single line of the balance sheet.
- 5.11 Combining the technical provision and the FFA on a single line of the balance sheet would lose the improvements that the FRS is requiring because, rather than a technical provision that is prepared on a basis that is closer than the existing basis to FRS 12 and an FFA, there would just be an aggregated liability that would bear no resemblance whatsoever to the FRS 12 liability. The Penrose Report's desire to see the financial statements show a realistic position of the life office would also have been frustrated.

- 5.12 Furthermore, although the Board decided that it should not for the time being propose reclassification of any of the FFA, it did not consider the FFA to be like any other liability and believed it would be inappropriate for the FFA and the technical provision to be combined together on a single line of the balance sheet.
- 5.13 The Board therefore took steps to preserve the improvement the FRS makes to insurance liability accounting and to preserve the distinction between the FFA and other liabilities by including in the FRS a requirement that the technical provision and FFA should always be shown separately on the face of the balance sheet.
- 5.14 The Board recognised that this would involve a change in balance sheet presentation for those non-insurance entities with insurance activities that show the FFA and the technical provision, together with all other insurance liabilities, on a single line of the consolidated balance sheet. However, it believed the change to be justified for the reasons explained above.

## **OPTIONS AND GUARANTEES**

- 6.1 Many life assurance policies include option or guarantee features, such as guaranteed surrender values or guaranteed annuity options on vesting of a pension accumulation product. Such options and guarantees are, furthermore, not unique to UK with-profits funds. They can also arise, for example, in non-participating funds and overseas funds.
- 6.2 Some of these options and guarantees expose the entity to insurance variables (for example, mortality or morbidity); some to financial variables (for example, market prices). The latter are similar to financial options in that the amount payable will depend on the level of a variable, relative to a predetermined value, on a specified maturity date (or in a specified time period).

- (a) If at the specified time the variable is lower than the predetermined value, an amount is payable—the exact amount depending on the amount of the variable—and, if the variable is higher than the predetermined value, no amount is payable.
  - (b) An option contract is ‘in the money’ if the current level of the variable is below the predetermined value such that, were the current value to remain unchanged, an amount would be payable under the option. It is ‘out of the money’ if, were the current value to remain unchanged, no amount would be payable on maturity. Of course, a contract that is in the money prior to maturity may be out of the money when it matures, and vice versa.
  - (c) The fair value of such a contract at any time prior to its maturity will reflect both the amount (if any) by which the option is in the money at that time (its ‘intrinsic value’) and the risk that the intrinsic value will change in the period to maturity (its ‘time value’). A contract that is out of the money will still have value, unless there is no possibility that it could be in the money when it matures. Therefore, an accounting practice that considers merely the extent to which the contract is in the money at the valuation date (or on a single forecast of the position at maturity date)—and thus ignores the time value of the contract—does not reflect the fair value of the contract.
- 6.3 The Board has long held the view that in principle all financial derivatives should be measured in the primary financial statements at an amount that takes into account both intrinsic value and time value (ie typically fair value),\* and it sees no reason why options and guarantees exposing the life assurer to financial variables life assurers should be any different.
- 6.4 The Board noted in this context that, in calculating the ‘realistic’ liability arising from options and guarantees on

UK with-profits policies within the scope of its RBS approach, the FSA requires the options and guarantees to be measured at an amount that takes into account both intrinsic value and time value. Currently, there are two ways of doing this:

- (a) *Fair value derived from a market value comparison.* Contracts traded on financial markets are traded at their fair value so, if an option or guarantee feature of a with-profits policy is similar to a traded contract (or is similar to a combination of traded contracts), its fair value can be estimated by reference to that (those) observable market value(s).
- (b) *A probabilistic or stochastic valuation method.* For many option and guarantee features incorporated in with-profits policies, equivalent traded instruments do not exist. In such circumstances, in order to capture the time value involved a probabilistic or stochastic modelling approach has to be adopted. Under such an approach, all possible outcomes are considered and weighted according to the probability of that outcome occurring, and the weighted average of the outcomes calculated.

- 6.5 Stochastic models need careful calibration, with the probabilities used in the model being adjusted to ensure that the values produced are consistent with observable market values for similar traded instruments. The models are further complicated by the need to reflect future management actions that may be taken in response to changes in conditions. For example, it may be that, were equity market prices to fall by 10% from current levels, the intention would be to change the mix of the fund's investment portfolio so that a greater proportion of bonds is held. It may alternatively be that management would respond by varying bonus rates or charges to policyholders.

---

See 'Derivatives and other Financial Instruments' Discussion Paper, which was issued in July 1996.

Both these courses of action could reduce the cost of the options. Stochastically modelled values need to take account of such management actions to the extent that such actions are realistically possible in the timescale envisaged and are consistent with the PPFM.

- 6.6 Although the Board believed that options and guarantees written by life assurers should in principle be included in the balance sheet at amounts that take into account both intrinsic value and time value, it accepted that major difficulties would arise in the short-term were it to require that time value should be taken into account for options and guarantees which do not have to be measured on that basis currently.\* Accordingly, it decided that it should not at this stage *require* all options and guarantees to be measured on that basis.
- 6.7 Instead the proposal in the FRED was that detailed disclosure should be provided about all the options and guarantees written by a life insurer that are not measured at amounts that include time value, including options and guarantees written in non-participating funds and overseas funds. Disclosure is a poor substitute for proper accounting, but it helps ensure that users of accounts are aware of such options and guarantees.
- 6.8 One option open to the Board was to implement in the UK some or all of IFRS 4's disclosure requirements. Such an approach would achieve convergence with international standards. The Board took the view that, although the IFRS 4 requirements set out the high-level disclosure principle involved, they were not detailed enough to ensure that the disclosure would be focused on the aspects of the options and guarantees on which the Board thought the

---

\* ie non-participatory funds, the smaller UK with-profits funds and some overseas with-profits funds. It is understood that some overseas regulators already require the use of a measurement basis that takes into account both intrinsic value and time value.



disclosure should focus. It therefore developed its own disclosure proposals.

- 6.9 Mixed views were expressed about the FRED's proposals, with some respondents expressing the view that their scope should be extended to include options and guarantees that were shown in the balance sheet at fair value or at market-consistent stochastic values, and others arguing that the disclosure should be narrowly scoped. A number of respondents also thought the proposed disclosures would be onerous to produce and should be simplified.
- 6.10 On the question of scope:
- (a) the Board reconsidered whether it was appropriate to restrict the scope of the disclosures just to those options and guarantees not shown on the balance sheet at fair value or at a market-consistent stochastic value. It noted that, for those entities preparing their financial statements in accordance with EU-adopted IFRS, the IFRS 4 disclosure requirements would apply to all options and guarantees. The Board thought there was a need for some general disclosures (similar to some of those required by IFRS 4) for all options and guarantees, and that those disclosures should be supplemented with some more targeted disclosures (similar to those in FRED 34) for options and guarantees not shown on the balance sheet at fair value or at a market-consistent stochastic value. Therefore, in the FRS the general disclosure principle (in paragraph 48) is based on requirements in IFRS 4, and the disclosure requirement for options and guarantees not shown on the balance sheet at fair value or at a market-consistent stochastic value (in paragraph 51) is based on FRED 34; and
  - (b) the Board recognised that the FRED had not been clear as to what exactly was meant by 'options and guarantees' and, as a result, it was possible to interpret the phrase much more widely than the Board intended.

The intention had been for the disclosures to focus on the financial risk aspects of the options and guarantees granted, rather than the insurance risk. Paragraph 50 of the FRS now makes this clear.

- 6.11 As already mentioned, some respondents thought the disclosures would be extremely burdensome. This was thought to be a particular problem if the information provided had to be audited at the 2004 year-end, because there was little time to put in place the systems needed to gather the necessary information.
- (a) In the light of these comments, the Board reconsidered its disclosure proposals but concluded that it was essential that there should be disclosures that enable users to understand the main variables that determine the amount payable under options and guarantees granted and the potential effects of adverse changes in those variables. However, it accepted that there are different ways of presenting that information and that the most appropriate presentation would often depend on the circumstances involved. The FRS is therefore more flexible than the FRED on the detailed nature of the disclosures to be provided.
  - (b) Furthermore, to give preparers more time to put in place the necessary systems (and in line with the decisions taken on other aspects of the FRS), the Board decided to defer implementation of the options and guarantee disclosure requirements until 2005 year-ends. At the same time, a number of the biggest entities with life assurance activities have volunteered to provide the FRS's disclosures on options and guarantees in their OFR (or equivalent statements) for 2004 year-ends (see section 10 of this appendix).

## RECOGNISING THE VALUE OF IN-FORCE LIFE ASSURANCE IN FINANCIAL STATEMENTS

### Background

- 7.1 One aspect of the embedded value debate—the recognition of an asset that represents the VIF of non-participating business written in a with-profits fund—has already been discussed in this appendix (see paragraphs 4.20–4.30 and 4.62–4.65). A different but related issue was also considered in this project: the recognition in the primary financial statements as an asset of the value of in-force life assurance business (the VIF of life assurance business). In other words, the recognition on the balance sheet by some entities of an asset that represents the value to shareholders of in-force life assurance business and (usually) the recognition in the profit and loss account of changes in the value of this asset (after adjustment for any capital transfers into or out of the fund in the period).\*
- 7.2 The objective of embedded value techniques is to reflect the estimated economic value of the existing in-force life business and of any existing surplus in the life fund from the shareholders' perspective. For example, for a with-profit life fund, VIF comprises two elements:
- (a) *The shareholders' share of any surplus of the assets of the fund over the 'realistic' liabilities to current policyholders.* This surplus represents the estate of the fund and is usually held to meet solvency requirements and as working capital.
  - (b) *The net present value of the shareholders' share of the future bonuses expected to be declared in respect of in-force policies.* This represents the capitalised future returns on existing

---

\* This use of embedded values in the primary financial statements is most commonly—though not exclusively—seen in consolidated financial statements when a non-insurance group is consolidating an insurance subsidiary.

business and, as such, is derived from expected future profits and, in some cases, assumptions about the distribution of the estate.

- 7.3 There is not one single, precisely designed embedded value methodology; there are a number of similar, but different techniques.\*

### **The issue**

- 7.4 Existing insurance accounting focuses more on the needs of prudential regulation than on the information needs of investors. As a result, the true and fair financial statements are not very good at providing shareholders with useful information about the value of their interest in the business. Many entities have sought to address this by including in the annual report information prepared on an embedded value basis. Some entities provide this embedded value information as supplementary information. Others include embedded values in the primary financial statements.
- 7.5 When the ABI was carrying out its latest revision of its SORP, it discussed with the Board the then practice of several insurance groups of recognising the VIF of life assurance business in the primary financial statements. The Board's view was that an asset for the internally-generated VIF of life assurance business should not be recognised in a balance sheet prepared on an MSSB basis, and that was the view that prevailed in the 2003 revision of the SORP. As a result, entities within the scope of the SORP—British insurance companies and insurance groups—no longer recognise the internally-generated VIF of life assurance business in their primary statements. Instead, they usually provide supplementary embedded value information.

---

\* A number of different terms are also used, some of which describe different techniques and some of which do not. These include: embedded value, European embedded value, market-consistent embedded value, certainty equivalent embedded value, achieved profits, and value of in-force business. The discussion that follows uses the term 'embedded value' in its widest sense.

- 7.6 However, there are entities that have insurance activities but do not fall within the scope of the SORP (for example, bancassurers, Irish insurance entities and some retail groups), and a number of them still recognise the VIF of life assurance business in their primary financial statements. Thus, the same transactions are accounted for in fundamentally different ways depending on the type of entity involved. Although the effect on the profit and loss account is only a timing difference, the impact can be significant and the periods involved can be very long.
- 7.7 The Board believes that there is no reason in principle why all entities should not account for life assurance in the same way. It has therefore been considering how it should respond to this inconsistency.

### **Courses of action open to the Board**

- 7.8 One possible option was to reverse the position the Board took during its discussions with the ABI and allow entities falling within the scope of the SORP to recognise the VIF of life assurance business in their primary financial statements without restriction. The Board rejected this approach. It has long-standing concerns about aspects of the embedded value approach and was not prepared to put aside those concerns—at least not without undertaking a comprehensive analysis of embedded value methodologies.\*
- 7.9 Another possible option was to prohibit all entities from recognising the VIF of life assurance business in their financial statements. Such an approach would achieve consistency between different types of entity, and appears to be consistent with the position the Board took in its discussions with the ABI in 2003. It would however mean forcing entities that currently recognise the VIF of life assurance business back on to a basis of accounting that the Board has acknowledged is very unsatisfactory—the MSSB basis (albeit modified by the FRS). A standard that achieves convergence by requiring some entities to move from a

useful basis of accounting to a less useful basis is not a good accounting standard.

- 7.10 The Board concluded therefore that its approach should lie somewhere between these two extremes.
- 7.11 The aspect of embedded value that has caused the Board greatest concern in the past is the inclusion of future investment risk margins in the VIF of life assurance business.\* Under ‘traditional’ embedded value methodologies, the expected future bonuses element of the VIF of life assurance business is determined after estimating the projected investment returns on each of the asset classes held in the funds, then discounting those returns using a single discount rate. Thus, the projected differential investment risk premium from asset classes is included in the embedded value; in other words, as the investment mix of the fund’s portfolio changes, so will the amount of the VIF. This, the Board believes, is not appropriate.
- 7.12 For that reason, the Board was interested to see that a recent development of an embedded value methodology (known as market-consistent embedded value or MCEV) under which the expected future investment return on each asset class is discounted using a discount rate that is equal to that assumed return—thus ensuring that the future investment risk margins for the different asset classes are not anticipated in the VIF of life assurance business recognised as an asset. The Board might view more favourably embedded values that exclude those margins.

---

\* IFRS 4 uses the term ‘future investment margins’. The FRS does as well because it is implementing IFRS 4 requirements. This appendix uses ‘future investment risk margin’ because that is a more precise description of what is being discussed.

IFRS 4 uses the term ‘future investment margins’. The FRS does as well because it is implementing IFRS 4 requirements. This appendix uses ‘future investment risk margin’ because that is a more precise description of what is being discussed.

- 7.13 Before the Board would be able to form a view on embedded value methods that exclude future investment risk margins, it would need to study carefully a number of other aspects of the methodology. Those aspects include:
- (a) *Future bonus assumptions*—Embedded value approaches for with-profits business generally make a number of simplifying assumptions in respect of future bonuses. For example, it is generally assumed that the whole of the estate will be distributed to existing policyholders, and that this distribution will be achieved by a proportionate uplift in the projected level of bonuses. The effect of this assumption is to spread the distribution of the estate over the run off period of the existing policies. It could be argued that this is not appropriate because it in effect assumes artificially that the fund is going to go into run off with no new policies being written and therefore no need to maintain an estate to meet future solvency or other requirements.
  - (b) *'Lock in'*—Embedded value calculations generally reduce the value of the shareholders' interest in the life business if that capital is considered to be 'locked in' the fund by the requirement to maintain regulatory solvency margins and prudential margins. For example, some—though not all—life assurers assume under that basis that the amounts are available for shareholders only as the solvency margins decline and therefore apply a discount. It could be argued that this reduction in value is inconsistent with usual accounting practice, which generally does not impose measurement limitations when there are restrictions as to distributability.
  - (c) *'Burn through' of the estate*—Generally embedded value calculations do not at present stochastically model all possible outcomes for the fund, and in particular do not take full account of the asymmetry of the shareholders' interest. For example, although embedded value methodologies generally assume that the shareholders' interest is 10% (with the policyholders taking 90%), they

do not necessarily take account of extreme adverse circumstances in which the estate is exhausted (burnt through) and the shareholders' exposure might increase. (The shareholders' exposure can become 100% of the increase in the liability, although the exact exposure will depend on the contract terms and the PPFM of the fund concerned.) Taking these extreme circumstances into account in the stochastic model will reduce the embedded value.

(d) *Movements analysis*—Currently there are a number of differing conventions as to how the movement in the VIF of life assurance business in a period—particularly the impact of changing assumptions—is presented. This movements analysis is an important part of the embedded value information set.

7.14 The suggestion at the end of paragraph 7.12—that embedded value with future investment risk margins excluded might be the way forward—seems to be echoed in IFRS 4. Although IFRS 4 does not require an entity already recognising an embedded value that includes future investment risk margins to change that accounting policy, it makes it difficult for an entity not recognising future investment risk margins to start recognising them. (It adopts a similar approach to excess investment management fees—see paragraph 7.19 below.)

7.15 The Board decided that it should propose a prohibition on including, as part of an asset of the VIF of life assurance business, any value attributed to future investment risk margins. Such a proposal had three advantages:

(a) It addressed the aspect of embedded value that most concerns the Board.

(b) It appeared to be in line with the direction IFRS 4 indicates the IASB is taking.



- (c) If applied to all entities prior to them preparing their financial statements under EU-adopted IFRS, it would ensure that under EU-adopted IFRS they were all subject to the same restriction on the use of future investment risk margins (rather than different restrictions depending on whether the entity is already recognising such margins).
- 7.16 When the FRED was being developed, the intention was to implement the above proposal for 2004 year-ends. Against this background some commentators suggested that, in the interests of achieving immediate convergence on future investment risk margins, the Board should allow the ABI to amend its SORP to permit the recognition by insurance entities of assets representing the VIF of life assurance business. That amendment, plus the proposal in the FRED, would mean that all entities—whether or not they were within the scope of the SORP and whether reporting under UK standards or EU-adopted IFRS—would be subject to the same restrictions in 2004. However, the Board decided instead that the FRED should propose that:
- (a) those entities currently recognising an asset that represents the VIF of life assurance business could continue to recognise such an asset as long as, from 2004, that VIF did not include future investment risk margins; and
  - (b) there should be no change in the Board’s position towards entities preparing their financial statements in accordance with UK standards and not currently recognising the VIF of life assurance business unless and until the Board had studied embedded value methodologies that do not include future investment risk margins and concluded that they were acceptable for use in financial statements.
- 7.17 These proposals allowed an inconsistency in existing practice to persist for 2004 but, because of IFRS 4’s grandfathering provisions, would mean that all entities

preparing their financial statements in accordance with EU-adopted IFRS would be subject to the same restrictions from 2005.

- 7.18 The proposal to prohibit a value being attributed to future investment risk margins received a mixed response.
- (a) Some respondents claimed that embedded value was outside the scope of the life assurance project, because the Financial Secretary to the Treasury had made no reference to the subject in her letter to the Board. However, it is the Board that decides the scope of its project work and it decided in this case that, as the objective was to improve life assurance accounting, the scope of its work should not be limited to the concerns raised in the Penrose Report—the use of embedded value in the primary financial statements should also be considered.
  - (b) Some respondents argued that the restriction should be omitted because it would have no effect on the amount at which the VIF asset was recognised. On the other hand, others argued that, even if it had no effect on the amount recognised, the restriction would ensure that a more disciplined approach would be taken to the valuation of the VIF asset.
  - (c) Some respondents argued that the Board was misdirecting itself by seeking to achieve convergence on the restrictions that apply to the recognition of the VIF asset; it would not result in practice converging because recognising the VIF asset was optional. The Board was aware that convergence would not be achieved in the short-term, but did not believe that invalidated the proposal.
  - (d) Some respondents criticised the proposal that the restriction should be implemented for 2004 year-ends, arguing that it was too late in the year to require entities already recognising the VIF of life assurance business to

make a potentially major change to their basis of profit recognition. They also pointed out that they would have to make changes to the VIF of life assurance business in 2005 when they implemented IAS 39 'Financial Investments: Recognition and Measurement' and it would be preferable if they could make all the changes at the same time. One reason the Board was seeking to implement the change in 2004 was because it would not be able to mandate the change in 2005 for entities preparing their financial statements in accordance with EU-adopted IFRS. The Board therefore had discussions with the largest entities currently recognising a VIF asset in their financial statements about the possibility of deferring the implementation of the restriction in exchange for a commitment to implement the restriction in 2005. Those discussions proved positive and the Board decided that the FRS should apply for accounting periods ending on or after 23 December 2005.

- 7.19 As mentioned in paragraph 7.14, IFRS 4 also prohibits entities from changing their accounting policies to start recognising in their VIF for life assurance business a value attributed to future investment management fees that exceeds the fair value of those future fees. In line with the Board's objective of trying to ensure that all types of entity would be subject from 2005 to the same restrictions on the use of embedded value, the Board proposed in the FRED that the FRS should include a similar restriction. However, it was clear from the comments received that the restriction was not being interpreted consistently and that the differences in interpretation could have a significant effect on the amount at which the VIF asset was recognised. As the source of the ambiguity seemed to be the wording taken from IFRS 4 and the Board was reluctant to include a clarification of that wording in the FRS (because that would involve interpreting an IFRS), it was eventually decided that the restriction should be omitted from the FRS.

## **MULTIPLE STATEMENTS PREPARED ON DIFFERENT BASES**

- 8.1 The financial statements of life assurers are not easy to follow. Partly that is because life assurance is a complex business that has to date proved difficult to represent faithfully and simply in financial statements—the uncertainty of ownership of the estate is, for example, difficult to portray simply, as is the measurement uncertainty that is involved in any insurance entity. This is not a matter that is easily fixed. Partly the complexity stems from the unfamiliar technical jargon and formats used. However, for entities preparing their financial statements in accordance with UK standards and legal requirements, that terminology and those formats are largely dictated by law and the Board understands that there is no prospect of the law being changed in the near future. Entities preparing their financial statements in accordance with EU-adopted IFRS are not constrained in the same way, but the Board has no ability to mandate change for such entities.
- 8.2 For these reasons, the Board believes that there is little it can do about the unfamiliar technical jargon and formats used in the short-term.
- 8.3 Another source of complexity is the publication of multiple statements: the true and fair financial statements, the supplementary embedded value statements, and the regulatory returns—each of which is prepared on a different basis, designed to serve a distinct (but often unexplained) purpose, and all of which are typically presented with little or no means for the users to navigate their way from one statement to another. The complexity this creates was a particular concern noted in the Penrose Report. It is also an issue that the Board believes it can do something about.
- 8.4 The Penrose Report makes the case for convergence of true and fair financial statements with regulatory returns. However, the statements and returns serve different

purposes—regulatory returns are primarily focused on solvency whereas true and fair financial statements have a broader remit—and statements that have different purposes will in their optimal form often involve different structures and bases. Therefore, although alignment of regulatory and financial reporting is desirable, this is best achieved through convergence around the structure and basis that are ‘right’ for the true and fair financial statements. The Board has been able to base so much of the FRS on the FSA’s methodology because that methodology is to some extent an attempt by the FSA to converge aspects of regulatory returns with the approach applied generally in financial statements.

- 8.5 Where differences between the statements remain, the Board’s preference is to seek to improve the clarity of the information provided by requiring reconciliations between the statements.
- 8.6 If two statements have been prepared on bases that have nothing in common, a reconciliation between them is not very useful because it tends to involve simply the substitution of one set of numbers with a second set. Therefore, reconciliations between statements should be required only if they would be meaningful.
- 8.7 The Board believes that, although the various statements currently prepared are each serving a different purpose, there is an underlying convergence of approach which means that it is reasonable to expect reconciliations between the true and fair financial statements and the prudential returns to be meaningful. For example:
  - (a) apart from a few isolated exceptions, the same asset recognition and measurement model is used in all the statements;
  - (b) as a result of the changes in the liability model required by the FRS, the same basic liability model will underlie the big UK with-profits funds’ policyholder liability

numbers in the true and fair financial statements, the regulatory returns, and in many cases (depending on the exact methodology used) the embedded value information; and

- (c) embedded value methodology seems to be developing in the direction of valuing options and guarantees written in policies in a manner consistent with that required for 'realistic' balance sheets (ie on a fair value or stochastic basis).
- 8.8 These developments mean that reconciliations can provide a useful service in highlighting the remaining issues of difference between the various statements. On implementing the FRS, the main areas of difference would be:
- (a) any adjustments to asset valuation required by solvency regulation; and
  - (b) the treatment as a liability for RBS regulatory returns of the shareholders' share of future bonus.
- 8.9 The Board believes that the proposed capital statement lends itself well to a reconciliation requirement, which is why paragraph 37 of the FRS requires the aggregate amount of the capital resources included in the capital statement to be reconciled to the shareholders' funds, FFA and other amounts shown in the entity's balance sheet. The effect is that the capital statement provides a reconciliation between regulatory and financial reporting at the available capital level.
- 8.10 The Board has not included in the FRS any requirement to provide a reconciliation between the supplementary embedded value information and the other statements. That is primarily it seems likely that such a reconciliation would have to be included in the supplementary information rather than the financial statements (because otherwise at least some of the embedded value information

would be brought within the scope of the true and fair view requirement and the implications of that have not yet been fully explored). The Board has no means of insisting on a reconciliation if it is not to be included in the financial statements.

## **OTHER ISSUES ARISING FROM THE FRED 34 CONSULTATIONS**

### **Scope**

- 9.1 FRED 34 proposed that the FRS should apply to all entities that include a life assurance business, regardless of how they are constituted, whether life assurance is their main business and their size.
- 9.2 A number of respondents thought the proposals were inappropriate for some friendly societies or for smaller entities. Some suggested exemptions; others suggested deferred implementation.
- 9.3 Friendly societies are either ‘directive friendly societies’ or ‘non-directive friendly societies’.
  - (a) Directive friendly societies are those whose premium income exceeds 5 million euro. They are required to prepare true and fair financial statements and, in doing so, to comply with detailed legal requirements that are almost identical to those set out in Schedule 9A .
  - (b) Non-directive friendly societies are also subject to a true and fair requirement, although the requirements as to the form and content of their financial statements are much less onerous and less prescriptive than those applying to directive friendly societies.
- 9.4 Another way of categorising friendly societies is as either ‘incorporated friendly societies’ or ‘registered friendly societies’.

- (a) An incorporated friendly society is a friendly society constituted under the Friendly Societies Act 1992. That Act accords a friendly society a separate legal identity.
  - (b) A registered friendly society is a friendly society constituted under the Friendly Societies Act 1974. Such friendly societies have no separate legal identity and, as a result, they carry out their transactions in the name of the appointed trustees.
- 9.5 The main implications of the FRS for friendly societies and for smaller entities can be summarised as follows.
- (a) The recognition of ‘realistic’ liabilities—Only a few of the biggest friendly societies are required by the FSA to adopt the RBS method in their prudential returns and will therefore be required by the FRS to recognise ‘realistic’ liabilities in their balance sheets. Unless and until the FSA extends the scope of its regulations to entities that have UK with-profits liabilities of less than £500m, this aspect of the FRS will not apply to other friendly societies or to the other smaller entities with life assurance activities.
  - (b) Capital statement—Policyholders have the same level of interest in financial strength, and fungibility of capital, in the case of a friendly society as for any other life insurer. The same is true regardless of the entity’s size. As such, there seems to be no reason why the capital statement and its supporting disclosures would not be relevant for a friendly society or for a smaller entity.
  - (c) Options and guarantees—The objective of these disclosures is to highlight the existence of any options and guarantees, to provide information that helps users to understand the extent to which the options and guarantees granted expose the entity to risk, and to explain what that exposure is. This objective is valid regardless of the size or type of entity involved.



- 9.6 There seems therefore to be no technical reason why the requirements of the FRS are any less applicable to friendly societies than to any other type of entity with a life assurance business. Nor does there seem to be any technical reason why the requirements should not be applied to smaller entities.
- 9.7 However, directive friendly societies do not have to submit prudential returns to the FSA until six months after their year-end. (From 2006 this will be reduced to four months, and from 2007 to three months.) As a result, their current practice tends to be to publish their true and fair financial statements and hold their AGMs long before the completion and submission of their prudential returns.
- 9.8 If an FRS were to require the inclusion in the 2005 financial statements of regulatory information, it will be necessary either to delay the financial statements (perhaps until six months after the year-end) or to accelerate the computation of regulatory numbers. , which could be difficult for some friendly societies. The Board weighed this against the advantages to be gained by applying the FRS as soon as possible. It also noted that, by issuing the FRS in December 2004 for application to December 2005 year-ends, it was giving entities more time to prepare for the standard's implementation than the FRED had proposed. The Board decided:
- (a) to require friendly societies applying the RBS approach for the FSA's regulatory returns to implement the FRS from the same date that all other life assurers applying the RBS approach were implementing it; and
  - (b) for purely pragmatic grounds, to defer the FRS's application to all other directive friendly societies for a further year (ie until 2006 year-ends).
- 9.9 The smallest friendly societies—non-directive friendly societies—are subject to a less rigorous prudential reporting regime than directive friendly societies. For

example, a full actuarial valuation for the prudential return is computed only triennially and, although interim valuations are made for the purposes of the financial statements, they are often no more than ‘no material change’ confirmations. Although the Board can see no reason why policyholders and other users of the financial statements of such friendly societies should not be as well-informed as any other policyholders about the financial position of their life assurer, it accepts that the application of the FRS will cause considerable practical difficulties for these friendly societies and they will struggle to overcome those difficulties quickly. For that reason, the Board decided to give such friendly societies a further year to prepare for the FRS; in other words, it will not apply to non-directive friendly societies until 2007 year-ends.

### **Terminology**

- 9.10 The FRS uses the term “‘realistic’ liabilities” to describe the basis of liability recognition and measurement that it requires to be adopted for certain with-profits funds. That term has been used because it is the term that the FSA also uses (and it *was* the FSA that developed the basis). Although there is little doubt that the new basis is “more realistic” than the existing (MSSB) basis, some of those responding to the FRED thought it was an exaggeration—and therefore potentially misleading—to call it the ‘realistic’ basis. They suggested that the Board use a different term.
- 9.11 One of the things that makes insurance accounting difficult for many users to understand is the terminology used. The Board does not wish to add to that difficulty. However, the FSA’s new methodology *is* universally known as the ‘realistic’ basis, and the Board believed it would be unhelpful to use any other term in the FRS. However, entities are not required by the FRS to use the term in their financial statements.

## Changes to the FSA’s ‘realistic’ capital regime

- 9.12 The FRS requires what is, in effect, a slightly amended regulatory number (the ‘realistic’ liabilities number) to be recognised in the financial statements. When this was proposed in the FRED, several respondents sought clarification as to the implications of a change in the regulations from which the number is derived.
- 9.13 There are two possible types of regulatory change that could be made:
- (a) The scope of the regulations could change, so that they apply to funds or entities not currently within their scope. The FRED was worded so that, if the FSA extends the scope of its regulations to include other with-profits funds, entities would automatically be required by the FRS to show ‘realistic’ liabilities for those funds in their financial statements. However, if the scope was extended to include non-with-profits funds, that change would be treated in the same way as the changes described in (b). This approach has also been adopted in the FRS.
  - (b) The basis of the calculation could be changed. Although the Board believes the current ‘realistic’ capital regime is a satisfactory basis to use in the financial statements, it recognises that—because prudential regulation and true and fair financial statements serve different purposes—a future version of the ‘realistic’ capital regime may not be a satisfactory basis for the financial statements. For that reason, the FRS makes it clear (through the footnote to the definition of the ‘Financial Services Authority realistic capital regime’) that the FRS is based on the original version of the regime (ie the 18 November 2004 version) and will continue to be based on that version if the ‘realistic’ capital regime is amended unless and until the FRS is amended. Similarly, if the scope of the ‘realistic’ capital regime is extended by the FSA to include non-with-profits funds, the scope of the FRS

would not extend to such funds unless and until the FRS is amended.

### **Negative FFAs**

- 9.14 Some funds currently have a negative FFA—in other words, the aggregate of the fund-related debits recognised on the balance sheet is lower than the aggregate of the fund-related credits (other than the FFA) recognised. As a result of the changes the FRS requires to be made to the liability model, it is likely that more negative FFAs will arise in the future.
- 9.15 There are a number of reasons why a negative FFA might arise, and only some of those reasons would result in the entity taking action to eliminate the negative FFA. For example, if the negative FFA was caused by the measurement of a liability at an amount that takes into account unrecognised assets or by the excessive prudence that will continue to be incorporated in many policyholder liabilities, it may be that corrective action would be deemed unnecessary. However, in other cases corrective action might be expected. Some types of corrective action would address the cause of the negative FFA but would not be accounted for in a way that would result in the negative FFA as shown in the balance sheet being eliminated, some would not.
- 9.16 A number of respondents noted that FRED 34 was silent on the accounting treatment of negative FFAs and suggested that the FRS should make clear the treatment to be adopted. Some suggested that a negative FFA should always be eliminated as soon as it arises by making a charge to the profit or loss account.
- 9.17 The Board considered these comments, but concluded that the FRS should remain silent on the accounting treatment. To adopt a blanket requirement that a negative FFA should always be written off to profit and loss account would not be appropriate in all cases. On the other hand, it would be

difficult to identify all the circumstances in which it *would* be appropriate.

- 9.18 The FRS requires entities with a negative FFA to explain how the negative balance arose and why it is that corrective action is not considered necessary.

### **ABI SORP**

- 9.19 Because of the FRS, the ABI's SORP will, for accounting periods ending on or after 23 December 2005, no longer be consistent in all respects with UK standards. The Board intends to discuss with the ABI how best to amend the SORP to eliminate the inconsistencies.

### **Corresponding amounts**

- 9.20 The FRED's proposals on the restatement of the corresponding amounts were based on the FRS being implemented for 2004 year-ends, and are therefore not relevant to the final FRS, which is to be implemented for 2005 year-ends.
- 9.21 Currently the Act requires corresponding amounts to be presented for all the amounts included in the primary financial statements and for those corresponding amounts to be calculated on the same basis as the amounts for the current period. However, paragraph 64 of the FRS states that, when the FRS is first adopted, it will not be necessary to restate certain corresponding amounts in the profit and loss account. That is because, if all the corresponding amounts in the profit and loss account are to be restated, it will be necessary to produce a restated opening balance sheet for 2004. The Board accepts that this will often not be practicable.
- 9.22 EU-adopted IFRS permit entities not to restate corresponding amounts if it is impracticable to do so. Although there is no equivalent provision in UK standards or legislation, the Board has asked the Department of Trade

and Industry to consider amending the legal requirements to achieve the same effect.

## **THE MEMORANDUM OF UNDERSTANDING AND EU-ADOPTED IFRS**

- 10.1 As has already been mentioned, the proposal in FRED 34 was that the FRS would be implemented for accounting periods beginning on or after 23 December 2004. There were two main reasons for this:
- (a) The Board believed that improvements to life assurance accounting were needed urgently and that the improvements it was proposing were capable of being implemented for 2004 year-ends.
  - (b) The Board wished the improvements to be adopted by all UK entities with life assurance activities. If it did not implement the FRS until 2005 year-ends, its standard would not apply to entities preparing their financial statements in accordance with EU-adopted IFRS. On the other hand, if it implemented the FRS in 2004, the grandfathering provisions of IFRS 4 meant that entities preparing their financial statements in accordance with EU-adopted IFRS were likely to be required to continue to adopt the accounting policy changes required in the FRS in 2005 and thereafter.
- 10.2 Almost all respondents questioned whether implementation of the proposals for 2004 year-ends was as practicable as the FRED suggested. In the light of those comments, the Board decided to discuss with the largest entities with life assurance activities a suggestion that they had made to the Board on several occasions: the possibility of the Board deferring its FRS until 2005 and entities preparing EU-adopted IFRS financial statements still complying with the FRS as if it applied directly to them.
- 10.3 The Board has entered into a memorandum of understanding with a number of large entities and with

the ABI along exactly those lines. The preparers signing the memorandum have also volunteered to provide most of the information that the FRS requires to be provided in the financial statements from 2005 in the OFR (or equivalent document) in 2004. A copy of the memorandum of understanding, together with details of the entities that have signed it, can be downloaded from the Board's website ([www.frc.org.uk/asb](http://www.frc.org.uk/asb)).

- 10.4 When the FRED was being developed, the Board considered how the standard would work in the context of existing UK standards and what the implications of IFRS 4 would be for those entities applying the FRS in 2004, then moving onto EU-adopted IFRS in 2005. The implications of IFRS 4 differ depending on whether an accounting policy is being changed in 2004 (and is therefore an existing accounting policy in 2005) or 2005. This meant that, before it could consider deferring the FRS, the Board had to consider the implications of EU-adopted IFRS for a 2005 implementation of the FRS.
- (a) One issue that the Board considered was whether the changes that the FRS requires to be made to accounting policies could be made in 2005, bearing in mind IFRS 4's restrictions on changing accounting policies. As explained in paragraphs 4.73-4.77, the Board concluded that they could.
  - (b) Another issue concerned the implications for the FRS of IAS 39's requirement that contracts that have in the past been viewed as insurance but actually meet the definition of a financial instrument (savings business) should be accounted for in accordance with IAS 39 rather than IFRS 4. The question the Board asked itself was would the changes required by IAS 39 have any effect on the accounting and disclosures required by the FRS and, if they would, was that effect troublesome?
    - (i) The FRS's 'realistic' liability requirements apply only to certain UK with-profits funds and, under

IFRS 4, all UK with-profits activities would be ‘insurance contracts that contain discretionary participation features’ and would be accounted for in accordance with IFRS 4 rather than IAS 39. As mentioned in subparagraph (a), there is nothing in IFRS 4 that prevents the FRS’s ‘realistic’ liabilities requirements from being complied with. Therefore, IAS 39 has no significant effect on the FRS’s ‘realistic’ liability requirements.

- (ii) IAS 39 appears to have no significant impact on the capital statement disclosures.
- (iii) The FRS requires certain disclosures to be provided in respect of those options and guarantees described in paragraph 50 of the FRS that are not measured at fair value or on the basis of a market-consistent stochastic model. Some of the options and guarantees described in paragraph 50 (and not merely those not measured at fair value or on the basis of a market-consistent stochastic model) will fall within the scope of IAS 39 and will therefore be covered by the disclosure requirements in IAS 32 ‘Financial Instruments: Disclosure and Presentation’ as well.
- (iv) Entities already recognising the value of in-force life assurance business that are reporting under EU-adopted IFRS in 2005 but wishing to comply with this FRS at the same time will find they may have to make three changes to the VIF asset in 2005: in order to comply with IAS 39 they will need to exclude any embedded value that arises on the contracts that IFRS treats as savings business rather than insurance business; in order to comply with IFRS 4 they will need to comply with that standard’s restriction on excess investment management fees and, in order to comply with this FRS they will need to exclude any amounts attributed to future investment risk margins.



None of this seemed to suggest that implementing the FRS would be particularly troublesome.

## **FUTURE DEVELOPMENTS**

- 11.1 The Board recognises that the FRS will not be the final word on insurance accounting. Further improvements are still necessary, but the Board has taken the view that it is not reasonable for it to require further substantial changes in accounting policy at this time.
- 11.2 The Board has, over the last seven years, taken a close interest in the international project on insurance accounting which was started by the International Accounting Standards Committee (IASC) and was taken up by the IASC's successor body, the IASB. The Board continues to see this international project as the best chance of achieving a fundamental and long-lasting improvement in insurance accounting. It intends to do all that it can, working with the IASB, the FSA and others, to secure that improvement.
- 11.3 In this context, the FRS can be seen as outlining the direction in which the Board believes insurance accounting should develop over the next few years—away from the excessively prudent, deferral, matching and smoothing model of today towards a model consistent with the reporting framework that applies more generally, supplemented in ways that ensure that the distinctive features of insurance activities can properly be reflected in financial statements. The Board hopes that the industry, freed as most of the biggest UK entities with life assurance activities are from the constraints of Schedules 9 and 9A, will make further improvements in their accounting in this direction.
- 11.4 The FRS is the first output from the Board's insurance project. The Board will also be making a formal response to the Financial Secretary on some issues not addressed in the FRS. It intends also to develop its thinking on a range of

insurance-related issues and to use that thinking to help the IASB in its work.

### **THE ASB'S ADVISORY PANEL ON LIFE ASSURANCE**

- 12.1 To assist the Board in the development of the FRS and in its ongoing consideration of improvements needed to insurance accounting, the Board set up an Advisory Panel, chaired by Mr Julian Hance. Although the Board reached its own conclusions and those conclusions were not necessarily the same as those of individual Panel members, it reached those conclusions only after taking fully into account the advice of Panel members. The Board found the Panel's advice and expertise invaluable during the development of the FRS, and it wishes to place on record its gratitude to Panel members for their work over the last eight months.

Further copies, £10.00 post-free, can be obtained from:

ASB PUBLICATIONS

145 LONDON ROAD

KINGSTON UPON THAMES

SURREY KT2 6SR

TELEPHONE: 020 8247 1264

FAX: 020 8247 1124

OR ORDERED ONLINE AT: [www.asbpublications.com](http://www.asbpublications.com)