Financial Reporting Council

Minutes of a meeting of the Special Actuarial Council held on Tuesday 8 October 2013 in the Boardroom at Aldwych House, 71-91 Aldwych, London, WC2B 4HN

Present:

Olivia Dickson	Chair of Council
Keith Barton	
Martin Bradley	
Ashok Gupta	
David Hindley	
Joanne Livingstone	

Apologies:

Angela Darlington
Howard Jacobs
Paul Johnson
Martin Miles

In Attendance:

Jenny Carter	Project Director, Accounting & Reporting Policy Team (to minute 4)
Francesca Chittenden	Council Secretary
Robert Inglis	Project Director, Actuarial Policy Team
John Instance	Project Director, Actuarial Policy Team
Seema Jamil-O'Neill	Project Director, Accounting & Reporting Policy Team
Roger Marshall	Accounting Council Chair (to minute 2.6)
Melanie McLaren	Executive Director, Codes & Standards

1. Welcome and apologies for absence

1.1 The Chair welcomed Roger Marshall (Chair of the Accounting Council) to the meeting.

2. IFRS4 Phase II Exposure Draft (Insurance Contracts)

2.1 The Chair introduced the paper which set out the draft FRC response to the IASB consultation on IFRS4 phase II Exposure Draft and invited the Council to provide additional input from an Actuarial perspective to the draft FRC response. The Council noted that the input of the Actuarial Council would be considered by the Accounting Council at its meeting on 17 October to assist finalisation of the response. The final response would then be presented to the Codes & Standards Committee (CSC) for approval before submission to the IASB. To support the CSC discussion of the final response and to ensure views put forward by the Actuarial Council are considered the Chair and Keith Barton would join the CSC meeting by teleconference.

2.2 The Council noted that a joint FRC/IASB out-reach event, hosted by the FRC, had taken place the previous week with presentations from the IASB, Aviva, a preparer, Deloitte, an auditor, and the FRC. The Council noted that over 60 stakeholders had attended but that the debate had been dominated by three of four attendees from the large insurance firms.

2.3 The Chair listed the five key issues raised in the IASB consultation document and asked the Council to comment on the proposed FRC response to each. The points and suggestions raised in discussion of each issue were as follows:

2.4 **Other Comprehensive Income (OCI**)

2.4.1 The Council noted that the OCI proposals are proving to be controversial, especially for insurers whose business model is to hold financial assets that allow them to match the value and incidence of cash flows arising from their insurance liabilities.

2.4.2 The Council considered and verified the fundamental concern set out in the draft response that recognising and presenting insurance liabilities in OCI will create extensive accounting mismatches and likely lead to asset liability measurement mismatch being hardcoded into accounting for insurance contracts, resulting in increased complexity in the financial statements rendering them less understandable for the users. The Council also noted the concern that the implication of this mismatch is to incentivise insurers to hold assets that can be held at FV-OCI (e.g. corporate debt) rather than those compulsorily required to be FV-PL (e.g. equities).

2.4.3 The Council recognised the widespread use of OCI throughout Europe and agreed that the IASB would have to recognise this in the proposals. Accordingly, the Council supported the alternative suggestion proposed by the FRC that there is a requirement for insurance liabilities to be classified as FV-PL with an option to recognise and present them in OCI based on business model and nature of the liability.

2.4.4 The Council noted that some of the issues created by the IASB proposals with regard to OCI are similar to the issues which arose in relation to the Solvency II regime, and that those issues faced in implementing Solvency II provide support for the argument put forward by the FRC that the IASB proposals regarding OCI are problematic. It was suggested that whilst the two Standards serve different purposes, conceptually, the same principles should apply with regard to reducing spurious volatility (whether referred to as matching adjustment under Solvency II or OCI under IFRS). The Council recognised that despite the similarities, it would not be appropriate, or practical, to artificially link the capital regime (e.g. Solvency II) to the accounting regime (IFRS); instead the Council requested that the FRC response include a suggestion that there be a requirement for reconciliations between the capital regime and accounting regime to be stated where relevant. The Council noted that the 'enhanced disclosures taskforce' had also recommended that there be reconciliation between the Accounting regime and Capital regime for banks, potentially adding support for this approach.

2.4.5 Melanie Mclaren (MM) informed the Council that there is a requirement within IAS1 for presentation of this reconciliation but that it is not always followed. Accordingly, MM suggested that the response might include a sentence encouraging the IASB to review this existing requirement.

2.5 **Mirroring**

2.5.1 With regards to the IASB proposals on mirroring John Instance (JI) clarified that the FRC does not support an exceptional reporting regime for contracts with links to underlying items.

2.5.2 Roger Marshall (RM) added that the FRC proposed approach to present at Fair Value through Profit & Loss, with an option for OCI depending on the business model, would provide a solution to the majority of issues linked to mirroring.

2.5.3 RM highlighted that a further problem with the proposals is that the proposals only allow mirroring if there is a legal requirement to hold those assets. The FRC view is that this rule is too restrictive. Similarly, Seema Jamil-O'Neill (SJON) informed the Council that the view from preparers is that decomposing insurance contract cash flows in to the elements which vary directly with the assets, those that are indirectly linked and those that independent of assets, is very difficult practically.

2.5.4 Martin Bradley (MB) and the Chair agreed that unit-linked and with-profits posed particular issues. MB highlighted that the IASB proposals would also be complex for regular premium contracts are and guarantees and that further consideration would have to be given to this. The Council also noted insurers' concern that the proposals would make the performance of UK with-profits contracts very volatile. MB suggested that users might welcome a mechanism by which full with-profits estate volatility is spread over time and not brought in to the accounts each year.

2.5.5 The Council supported the FRC response and agreed that the IASB should review, with the aim of making the criteria in paragraph B85 regarding the decomposition of the cash flows that vary with underlying asset and insurance liability more helpful. MB suggested that it would also be beneficial for the order of decomposition for the varying cash flows to be clarified.

2.5.6 In response to a discussion considering the usefulness of the proposals for the investor MM highlighted that within the accounting arena the view of presentation of performance is very different to the view of ultimate distribution. MM continued to explain that in light of this disparity, there was an on-going debate in considering financial performance of banks This debate includes capital maintenance and the distribution of profits, highlighting that care needs to be taken when looking at performance in terms of what that means with regard to business sustainability and ultimate distribution, and that it could be proposed that a disclosure regarding distribution would make the financial statements more useful for investors.

2.6 **Revenue Recognition**

2.6.1 There was strong support from the Council that the IASB be encouraged to undertake more fieldwork to test the principles. RM informed the Council that the IASB would be unwilling to delay the publication of IFRS4 Phase II to allow for further field work but that the FRC would, in its response, encourage the IASB to issue the Standard as planned but continue field testing until the Standard is fully established. MM added that the FRC would also encourage the IASB to provide support systems to assist the consistent interpretation and implementation of the Standard as is being offered by the IASB to support implementation of the new Revenue Standard. The Council supported the proposal as set out by RM.

2.6.2 Through discussion the Council agreed that the proposals allow for less flexibility with regard to the allocation of expenses ‘up front’ and that the accounting treatment proposed is more conservative than Actuaries may currently be used too. The Council also debated the proposals with regard to revenue recognition and the move away from the use of margins. However, the Council broadly supported the FRC response but requested that the FRC highlight that further detail, and clarity over the definition of expenses, be provided.

2.7 **Transition**

2.7.1 The Council discussed whether the three year implementation period would be sufficient. To assist the discussion MB suggested that there are three reference points which must be considered, firstly, the time it would take to do the ‘wiring’ and make the numbers work, secondly, the time it will take to sync IFRS4 and IFRS9 and thirdly, to address any regulatory standards. The Council suggested that preference over whether the implementation date should be 2018 or whether implementation should be aligned with the issue of IFRS9 would be balanced across the industry and therefore did not offer a view; however, the Council did agree that early adoption should be allowed.

2.7.2 MM clarified that the reference to ‘retrospectively’ related to the application of the standard to the in force business at the effective date as if the standard had always applied and that the FRC thought this was appropriate.

2.7.2 In conclusion, the Council supported the statement set out the in the draft FRC response that the transition is appropriate and sensible.

2.8 **Unlocking the Contractual Service Margin (CSM)**

2.8.1 The Council discussed the purpose of the CSM and MB highlighted the importance of there being a shared understanding of what this purpose should be in considering the proposals. The Council were in broad support of the FRC response which accepts that the CSM should be unlocked to reflect changes in estimates of future profits but recognises that further thought is required on whether changes in other items, risk adjustment, asset value changes on with-profits business for example, should be absorbed in the CSM. The Council were concerned that the reporting should not create unnecessary noise and volatility in the reporting of financial performance.

2.8.2 The Council noted that some preparers in the UK and Europe have expressed concern with the proposals and believe a more effective approach would be to adjust the CSM for investment changes. The Council also noted that preparers are struggling to demonstrate the conceptual merit of this approach but that the FRC is continuing to work with preparers to attempt to reach a shared understanding.

2.8.3 David Hindley (DH) raised a concern with regard to the references to ‘individual contracts’ used throughout the ED; highlighting that it is very difficult to measure profit on individual contracts. DH understood that whilst the IASB intend this to cover groups of individual contracts it would be beneficial to review the language used and clarify this.

2.9 In conclusion the Council considered that the proposals set out were unduly complex and unless reviewed, the aims, to achieve comparability for global investors and encourage investment, may not be achieved. The Council was broadly supportive of the draft FRC response and the suggested alternatives set out in that response. A final, additional point, identified by the Council for inclusion in the response to the IASB, was that the IASB should advocate disclosures on free cash flows that support the ability of entities to make distributions to investors.

3. FRS 103 Exposure Draft (Insurance Contracts)

3.1 The Chair introduced the paper and highlighted the difficulty in responding with confidence to the questions posed in the exposure draft whilst IFRS 4 Phase II is still being developed.

3.2 The Council noted that an extensive outreach project had been undertaken to assist the development of FRS 103 and that informal feedback received suggested that the proposals set out in the current ED are workable and offer a suitable solution.

3.3 The Council noted that the Chair of the Codes & Standards Committee had expressed concern with regards to the use of IFRS 4 language in the ED which sets out a rebuttable presumption that an insurer's financial statements will become less relevant and reliable if an accounting policy is introduced that reflects future investment margins in the measurement of insurance contracts (unless those margins affect contractual payments). In considering this concern the Council noted that a) this presumption would only apply where a user wishes to adopt a new accounting practice, which would be uncommon and that b) despite this concern raised by the Chair of CSC the FRC Executive remains satisfied that the proposals will allow users to continue with current practice. The Council identified that the consultation would highlight whether the concern raised by the Chair of the CSC is shared amongst the industry and that this would determine whether that specific proposal within the ED requires further consideration.

3.4 The Council debated whether or not greater clarity should be provided on whether liabilities should be insured at or above best estimate, however, in noting that the FRC would like to leave in a level of flexibility understood that the current guidance was suitable.

3.4 DH highlighted that there may be specific, separate issues, within the proposals for the ED for P&I (Protection and Indemnity) Clubs and suggested the FRC look in to this.

3.5 In conclusion the Council were supportive of the ED but suggested that the Standard should be reviewed in three years when the status of IFRS4 is known.

4. IASB Conceptual Framework

4.1 SJON talked the Council through a presentation which provided background to the development of the Framework, a description of the Framework and highlighted the areas in which the FRC had expressed concern. The Council noted that the purpose of the Framework is to assist the IASB in the development and review of accounting standards and to provide continuity of thinking despite changes in membership of the IASB Board.

4.2 MM highlighted that the as a Global Standard the terminology and language used in the Framework varied from the language used in the UK and within Europe, however, despite the differing terms, the definitions and meanings of those terms were broadly similar.

4.3 The Council noted that the FRC had identified a number of areas for further consideration by the IASB, these included:

4.3.1 **Prudence, Stewardship and Reliability**

- The Council noted that reference to each of those concepts had been either deleted, or downplayed from the 2010 revisions.
- The Council noted that the FRC had written to the Chairman of the IASB in December 2012 highlighting the importance of including each of the concepts.
- With regard to Stewardship SJON highlighted that investors had emphasised a need for reference to Stewardship in the Framework.

4.3.2 **Definitions and recognition**

- The Council noted that the IASB propose to change the definitions of assets and liabilities so that there is no requirement for a minimum probability of inflow or outflow to be classified as an asset or liability, it must just be capable of resulting in an inflow / outflow of benefit.
- The Council verified the concern set out by the FRC that this proposal will create complexity and potentially affect the reliability of measurement.

4.3.3 **Measurement**

- The Council noted the concern that the proposals in relation to measurement do not adequately describe the criteria for using different techniques for measuring assets and therefore, will not provide useful guidance.
- The Council agreed that it would be useful for the IASB to produce principles in relation to measurement rather than the ad hoc rules which are currently proposed.

4.3.4 Profit & Loss and OCI

- The Council noted that the P&L and OCI will not be defined in the Framework and that the IASB may use OCI for bridging items, mismatched measurements and transitory re-measurements.
- The Council highlighted the importance of P&L for investors and expressed concern that there will be no framework for P&L.

4.4 In summary, the Council verified the concerns of the FRC.