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Ref: AC/ASB

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Dear Ms Sansom

## INSURANCE ACCOUNTING - MIND THE UK GAAP

### Introduction

Ernst & Young LLP welcomes the opportunity to comment on the ASB staff paper concerning the potential short and long-term solutions for accounting for insurance contracts under draft FRS 102 and reduced disclosures in accordance with draft FRS 101 ('the staff paper').

We have commented on specific insurance contract matters in Draft FRS 101 and Draft FRS 102 in our separate response on *The Future of UK GAAP*.

### Overall comments and conclusion

We believe that the best long term solution for accounting for reporting entities in the UK is to adopt IFRS 4 Phase II. In our opinion, this will be a comprehensive model for accounting for insurance contracts and an improvement over existing UK GAAP which, for life insurers, is derived from a statutory solvency basis of accounting which is unsuitable for the decision-making needs of investors.

The major barrier to the adoption of IFRS 4 Phase II is its incompatibility, in certain aspects, with the Insurance Accounts Directive (IAD) and UK Company Law. This is acknowledged in the staff paper. We urge the ASB to address this issue as soon as possible and to make representations to have the IAD amended to permit IFRS 4 Phase II to be accepted into UK Company law.

There is a similar incompatibility between Solvency II and the IAD and UK Company Law. In addition, when Solvency II comes into force, s843 of the Companies Act will cease to be applicable and will have to be changed.

We believe that the best short-term solution to any 'gap' period for insurers reporting under UK GAAP (whether under draft FRS 101 or draft FRS 102) is to incorporate IFRS 4 into UK GAAP. IFRS 4 provides more flexibility than any of the other solutions. We note that draft FRS 102 already incorporates IFRS 4 and we welcome this,

Our detailed comments are included in Appendix A.

Yours sincerely



Tony Clifford  
Partner, Financial Reporting Group



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## Appendix 1 - Responses to ASB questions

We set out our responses to the specific questions raised by the ASB below.

### Long-term solution

Do you agree that the long-term solution for accounting for insurance by reporting entities in the UK (listed and unlisted) is to incorporate IFRS 4 Phase II into UK GAAP, when issued by the IASB and adopted for use in the EU?

We agree that the most appropriate long-term solution for accounting for insurance contracts by reporting entities in the UK is to incorporate IFRS 4 Phase II into UK GAAP. We do not believe that there is any feasible alternative. IFRS 4 Phase II is expected to be a comprehensive standard on accounting for insurance contracts. As such, we believe it to be an improvement on existing UK GAAP which, for life insurers, is derived from a prudent statutory solvency basis of accounting which is unsuitable for the decision-making needs of investors.

However, IFRS 4 Phase II, as currently drafted, is incompatible in certain aspects with the EU Insurance Accounts Directive (IAD) and, consequently, UK company law. This incompatibility is identified in paragraphs 4.7 to 4.9 of the staff paper. We understand that there is currently no intention by the EU to alter the IAD to permit IFRS 4 Phase II to be applied as GAAP in Europe. The ASB will need to address this issue as a matter of urgency.

### Short-term solution

Please comment on:

- (a) whether you agree that all aspects of the problem have been identified? If not, what is missing and how do you see it impacting the accounting for insurance contracts?
- (b) what is your preferred solution (whether one of those set out in section 6 of Insurance Accounting - Mind the UK GAAP issued by the ASB) for insurance accounting in the UK during the gap period?
- (c) what is your rationale for proposing that solution, including the balance of cost and benefits?
- (d) what is the likely impact of any changes in accounting for insurance contracts under UK GAAP on the entity you have in mind. It would be helpful if your response clarifies the current position of the reporting entity you have in mind (listed, unlisted, reporting in accordance with IFRS/grandfathering/own accounting policies/UK GAAP/other).

(a)

See below for specific comments.

(b)

Our preferred short term solution is for the current version of IFRS 4 to be incorporated into UK GAAP (as proposed in draft FRS 102), ie Option I.

(c)

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

We believe that incorporating IFRS 4 Phase I into UK GAAP is the most suitable proposal until IFRS 4 Phase II can be incorporated into UK GAAP. As IFRS 4 Phase I does not prescribe a valuation methodology for insurance contracts, its incorporation means that insurers would be able to either maintain their existing accounting practices for insurance contracts in the gap period or, if they wish, incorporate part of the Solvency II or IFRS 4 Phase II proposals (to the extent that these do not conflict with UK law and satisfy the criteria in IFRS 4 paragraph 22).

We do not believe that the cost of incorporating IFRS 4 Phase I into UK GAAP will be onerous or require considerable implementation time (as implied by paragraph 6.9 of the staff paper). Many UK life insurers have already adopted FRS 26 and FRS 29. FRS 29 contains the same definition of an insurance contract as IFRS 4. Although many general insurers have not adopted FRS 29, it is our experience from IFRS conversions that the impact of moving to the IFRS 4 definition of an insurance contract for general insurers is limited and primarily affects a small number of financing-type reinsurance arrangements.

We acknowledge that selecting this solution will potentially result in diversity in accounting practice. However, listed insurers have had to live with such diversity since the introduction of EU adopted IFRS in 2005. Such diversity in the short-term is inevitable due to the non-coterminous dates of Solvency II, the proposed introduction of draft FRS 102 and the introduction of IFRS 4 Phase II.

There is a conflict with UK Company Law and IFRS 4 in respect of equalisation provisions which are prohibited by the latter if they relate to claims under insurance contracts that do not exist at the end of the reporting period. However, this is a conflict that already exists under existing UK GAAP and we believe that it can be addressed in the same way (ie by the additional disclosures already required by paragraphs 125 to 126 of the ABI SORP).

*Option II - Embed the relevant rules of FSA's Realistic Capital regime into UK GAAP*

We do not believe that retaining the ABI SORP and FRS 27 in their current format is a feasible solution for the gap period. This would require insurers to maintain two regulatory systems concurrently (both Solvency I and Solvency II). This would result in a significant cost to preparers. We believe that some insurers would wish to "switch off" their Solvency I reporting systems once Solvency II is implemented.

If the gap period proves significantly longer than anticipated (eg because IFRS 4 Phase II is delayed) this option leaves UK insurers with an accounting system that is no longer supported and cannot be changed.

If insurers wish to continue to report UK GAAP results under Solvency I in the gap period they will be allowed to do so under Option I above.

*Option III - Update FRS 27 and the ABI SORP for Solvency II Requirements*

We do not believe that updating FRS 27 and the ABI SORP for Solvency II during the gap period is feasible or even possible.

Solvency II is a solvency basis of accounting and we do not believe that a regulatory basis of accounting is suitable for meeting the needs of investors in comparing and understanding the financial performance of insurers.

Various aspects of Solvency II are also incompatible with the EU Insurance Accounts Directive (IAD) and UK Company Law as they are with IFRS 4 Phase II (see answer to Long-term Solution question above). Therefore, this 'gap' solution could not be applied unless there was a change to the IAD.

As noted in paragraph 6.16 of the staff paper, additional work will be required by the ASB and the ABI to address the various income recognition issues for insurance contracts that Solvency II does not deal with. This work will be onerous and will require considerable time and consultation.

Option I would permit Insurers who wished to incorporate certain aspects of Solvency II to do so by changing their accounting policy for insurance contracts provided the change satisfied the criteria in paragraph 22 of IFRS 4 and was not incompatible with the IAD.

*Option V(sic) - Incorporate IFRS 4 Phase II into UK GAAP*

As discussed under Long-term Solution above, we believe that the long term solution to accounting for insurers is to incorporate IFRS 4 Phase II into UK GAAP.

We believe that this should be adopted as UK GAAP when feasible but not before the application date for IFRS reporters. Applying the new standard before its IFRS application date would unfairly burden UK GAAP reporters.

As noted under Long Term Solution above, the IAD will need to be changed in order for IFRS 4 Phase II to be able to be used as UK GAAP.

(d)

No comments.