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Dear Michelle

The Future of Financial Reporting in the UK and Republic of Ireland

The Association of Financial Mutuals (AFM) is pleased to respond to your request for comments on "The Future of Financial Reporting in the UK and Republic of Ireland".

Please feel free to contact me should you wish to discuss any of the points raised.

Yours sincerely

Martin Shaw
Chief Executive

Introduction

The AFM welcomes the opportunity to comment on the Financial Reporting Exposure Draft (FRED) “The Future of Financial Reporting in the UK and Republic of Ireland” published by the ASB on 30 January 2012.

Our response also refers as appropriate to the ASB Staff Paper “Insurance Accounting – Mind the UK GAAP” published on the same date.

Who we are

The Association of Financial Mutuals (AFM) has 57 members and represents mutual insurers and friendly societies in the UK. Between them, these organisations manage the savings, protection and healthcare needs of 20 million people, and have total funds under management of over £85 billion. Financial Mutuals are member-owned organisations, and the nature of their ownership, and the consequently lower prices, higher returns or better service that typically result, make mutuals accessible and attractive to consumers.

There is a wide range both of size of organisation, and of business model across AFM membership. For example, there are a number of very large composite insurers, as well as medium sized but growing providers. By contrast around one quarter of our members are so small as to fall below the threshold required for compliance with European Directives.

In developing this response we have consulted with a number of companies across our membership, and sought detailed input from their advisers. However it is important to reiterate that any regulation imposed on the sector will have a myriad of effects- and for that reason the Financial Services Bill requires the new regulators to take account of any significantly different effects of new rules on mutual organisations.

Major Points

General

We welcome the ASB’s decision to pull back from requiring all “publicly accountable” businesses (as defined) to apply EU-adopted IFRS; referring to the earlier proposals of October 2010. Under those proposals, mutual insurers fell within the definition of publicly accountable and would have had to apply full IFRS.

The vast majority of mutual insurers continue to report under UK GAAP at the present time although they have had the option to adopt IFRS since 2005. They are in the same position as the building societies and credit unions for which the ASB quotes feedback in Part Three of the FRED (Section II.4). The cost of producing full IFRS accounts outweighs the benefit to users. The primary users, the members of the mutual, are generally ordinary members of the public. It is likely that accounts produced under full IFRS would be more difficult to understand and therefore less transparent than UK GAAP.

A few mutual insurers do compare themselves to public companies and have the resources to produce similar financial reporting information and have adopted IFRS. One mutual has actually issued listed securities.

All mutual insurers in the UK are subject to regulation by the Financial Services Authority. Under the FSA's rules and powers, more detailed information may be demanded for regulatory purposes than is provided in the annual report and accounts. We consider that this is the appropriate channel for the more technical information of relevance to solvency, liquidity and security, rather than the annual accounts.

Insurance accounting

Whilst we applaud the ASB's efforts to produce a framework that will allow accounts under UK GAAP to be clear, concise and understandable, we are concerned about the general cross reference to IFRS 4, "Insurance Contracts".

In the context of mutual insurers undertaking long term or life insurance business, the direction of IFRS 4 Phase 2 is to produce information of very little value as far as the main users of the accounts (the members) are concerned. IFRS 4 Phase 2 is drafted primarily for proprietary and quoted company insurers. There is an overriding concern about how to breakdown and report the current profit performance of the entity and measure its change in wealth over the period. The perspective for mutuals is somewhat different. Members are concerned that the benefits promised by their policies are secure and that they are being treated fairly with respect to other classes of member and other commitments of the entity. For example, within IFRS 4 Phase 2, there has so far been no consideration of how a mutual's capital might be presented for financial reporting. Phase 2 also promises a technical margin analysis that attempts to explain "performance" in the period. The vast majority of mutual life offices see very limited value in producing such information for their members.

Given that IFRS 4 Phase 2 offers so little that could be construed as relevant to most mutual insurers, retaining insurance accounting within UK GAAP for the use of UK GAAP reporters, presents an opportunity to develop something more appropriate and meaningful. A number of mutuals write or manage with-profits business. This is considered by the IASB to be too much of a UK issue to merit serious attention as part of their standard setting, tending to reinforce the point that for entities not required to report under IFRS, a local solution would be preferable.

The current co-dependence of accounts and solvency information within UK GAAP for insurers is helpful in rationalising and inter-relating information requirements. When Solvency II replaces Solvency I, our preference would be to continue with this kind of approach and base accounting information on Solvency II rather than Phase 2. We would also like to avoid, if possible, having to produce out-of-date Solvency I information to cover any GAAP transition period.

Non-directive friendly societies have a different capital regime and FSA is due to review this in light of Solvency II, though it is not due to consult on any proposals until at least 2013. Again we would like to see an accounting regime that is consistent with the capital regime for non-directives.

In considering how insurance accounting should be developed under UK GAAP, we would encourage the ASB to reflect on its stated objectives in the FRED proposals (Part One, 1.11) to:

> "…balance consistent principles for accounting … with pragmatic solutions, based on size, complexity, public interest and users' information needs…" and
>
> "…provide succinct financial reporting standards that are cost effective to apply."

Responses to Specific Questions

QUESTION 1:
The ASB is setting out the proposals in this revised FRED following a prolonged period of consultation. The ASB considers that the proposals in FREDs 46 to FRED 48 achieve its project objective:

> To enable users of accounts to receive high-quality, understandable financial reporting proportionate to the size and complexity of the entity and users' information needs.

Do you agree?

We refer to our comments under "Major points."

Most mutual insurers still report under UK GAAP and welcome the relief now offered from having to move to full IFRS which, in many cases, would call for information out of proportion to the needs of users of their accounts.

We do not believe that IFRS 4 Phase 2, as it is currently being shaped, will provide a suitable approach to insurance accounting in the context of mutual life offices except for the few that actively compare themselves with listed companies or that may themselves issue listed securities as a source of capital. In most cases, the costs of producing IFRS 4 information for the accounts will outweigh the benefits.

Members of mutuals are "protected" by prudential regulation, which calls for financial information on a different basis to IFRS. To satisfy the ASB's objectives for UK GAAP, the best solution, in our view, for insurance accounting is to minimise the differences between the regulatory information insurers are required to produce and the annual accounts. This, of course, is similar in principle to the existing solution under UK GAAP for insurance reporting and it may require maintaining an Insurance SORP going forward. As Solvency II replaces Solvency I for regulatory purposes, so the basis for accounting will change and accounting rules for the transition will need to be laid down.

In a broader context than mutual insurers, requiring two sets of distinct technical information, one for regulatory purposes and one for financial reporting would add to the costs of starting up or running an insurance business in the UK, i.e., adding to undesirable "red tape." It should be noted that producing the information in question requires highly trained and costly professional specialists and data processing applications.

The proposed UK GAAP solution for insurers of applying IFRS Phase 2 might be compared and contrasted with the proposed solution for defined benefit 'retirement benefit plans' (pension schemes), the latter being arguably another form of "mutual" long term insurance business. The pensions solution (FRED 48, Section 34) is merely to require disclosure of information regarding the actuarial present value of promised retirement benefits, a less burdensome requirement than confronts insurers with not dissimilar business.

QUESTION 2:
The ASB has decided to seek views on whether: As proposed in FRED 47

A qualifying entity that is a financial institution should not be exempt from any of the disclosure requirements in either IFRS 7 or IFRS 13; or alternatively

A qualifying entity that is a financial institution should be exempt in its individual accounts from all of IFRS 7 except for paragraphs 6, 7, 9(b), 16, 27A, 31, 33, 36, 37, 38, 39, 40 and 41 and from paragraphs 92-99 of IFRS 13 (all disclosure requirements except the disclosure objectives).

Which alternative do you prefer and why?

FRED 47 relates to the reduced disclosure regime from full IFRS that may be applied by subsidiaries in groups that apply full IFRS. As mutual insurers are not by their nature likely to be subsidiaries, this Question may be of limited import for our members. We note however that the specified paragraphs in 'the alternative' broadly align with the proposals for mainstream UK GAAP (FRED 48) that would apply for most mutuals.

Turning the Question around as to whether mutuals, as financial institutions, should apply IFRS 7 or IFRS 13 in full, we consider this, in general, would not be appropriate. The relatively succinct requirements set out in FRED 48 appear to capture the important features of the standards and to be preferable. Requiring mutuals to capture and report voluminous disclosures would be at odds with the needs of the members and primary users of accounts being, as noted elsewhere, ordinary members of the public. Again, referring back to our Major Points above, the regulator may call for more information and analysis in the areas covered by IFRS 7 and IFRS 13. This, in our view, is the appropriate channel for it.

Our preference on this Question for 'the alternative' (i.e., specified paragraphs only) is unchanged in respect of the extent of disclosures to require for a subsidiary of a mutual insurer that applies full IFRS in its group accounts, where the subsidiary also qualifies as a financial institution in its own right under the FRED.

QUESTION 3:
Do you agree with the proposed scope for the areas cross-referenced to EU adopted IFRS as set out in section 1 of FRED 48? If not, please state what changes you prefer and why.

Significantly for mutual insurers, most of which still apply UK GAAP, there is a cross-reference to IFRS 4, "insurance contracts," which would bring IFRS 4 into mainstream UK GAAP.

As set out under our Major Points above and under Question 1, we do not believe this to be an appropriate solution for insurance accounting in the UK. As IFRS 4 Phase 2 is currently shaped, it would change the calculation of long-term business provisions, in particular, and more importantly, is likely to diverge from the regulatory basis used for technical provisions. Indicators are that IFRS 4 Phase 2 may have a lesser impact for general insurance technical provisions but nonetheless there are still likely to be differences in the detail from the regulatory basis.

As stated earlier, we would prefer a solution for insurance accounting that dovetails with the regulatory basis. This would satisfy the ASB's objectives for a pragmatic solution based on user information needs, which is cost-effective to apply.

We reiterate that the nature, perspective and information needs of the members of mutual insurers, being the primary users of accounts, differs from that of investors in proprietary or quoted companies for which IFRS 4 is primarily drafted.

Imposing costly and unnecessary information demands on mutuals could make the mutual business model no longer workable in some instances. It is unhelpful to sustaining diversity in the forms of business enterprise available in the UK.

QUESTION 4:
Do you agree with the definition of a financial institution? If not, please provide your reasons and suggest how the definition might be improved.

We note that the definition of financial institution captures:

> "… an entity that undertakes the business of effecting or carrying out insurance contracts, including general and life assurance entities…" and
>
> "… an incorporated friendly society or a registered friendly society…"

All mutual insurers are therefore caught by the definition.

The implication is that disclosures enabling the users of accounts to evaluate the significance of financial instruments to financial position and performance have to be made (FRED 48, 34.17 seq).

In principle, we do not take issue with this and note that the requirements are less than full IFRS; which we consider to be appropriate. Some small mutuals and friendly societies are nonetheless uncomplicated savings or investment vehicles with relatively few members and we would call for common sense and proportionality in interpreting and applying the requirements.

QUESTION 5:
In relation to the proposals for specialist activities, the ASB would welcome views on:
(a) Whether and, if so, why the proposals for agriculture activities are considered unduly arduous? What alternatives should be proposed?
(b) Whether the proposals for service concession arrangements are sufficient to meet the needs of preparers?

Not of particular concern to mutual insurers.

QUESTION 6:
The ASB is requesting comment on the proposals for the financial statements of retirement benefit plans, including:
(a) Do you consider that the proposals provide sufficient guidance?
(b) Do you agree with the proposed disclosures about the liability to pay pension benefits?

Whilst not directly applicable to mutual insurers, please note the parallel between defined benefit pension schemes and mutuals writing long term business discussed under Question 1. For two ostensibly similar business models, the information requirements for mutual insurers under the proposals appear more onerous than those for pension schemes. The difference will be accentuated if IFRS 4 is brought into UK GAAP and mutual life offices are required to produce more than one set of actuarial calculations each year (one for accounts and one for the regulator).

QUESTION 7:
Do you consider that the related party disclosure requirements in section 33 of FRED 48 are sufficient to meet the needs of preparers and users?

The disclosures on related party transactions that are suggested appear sufficient. It might be noted that many mutual insurers (including all AFM members) subscribe to the annotated UK Corporate Governance Code which itself has related party disclosure implications particularly in respect of directors' remuneration and interests. Statutory and regulatory requirements dictate that interests of actuarial function holders and with-profits actuaries (where applicable) be disclosed.

QUESTION 8:
Do you agree with the effective date? If not, what alternative date would you prefer and why?

The vast majority of mutuals (including all friendly societies) have December year-end reporting dates. This means they will need to publish accounts on the new basis as at 31 December 2015. In preparation for this, given the need for comparative information, balance sheets will need to be prepared for 31 December 2013 and 2014, and income statement information for 2014.

In itself the foregoing timing does not seem unreasonable and does tie in with the current implementation date for Solvency II (1 January 2014) should this become the basis for insurance accounting in the UK. There is always a danger that slippage in related developments, be it Solvency II or IFRS 4 Phase 2, will make implementation less practical. We would encourage the ASB to be conscious of this and flexible and pragmatic in terms of transition as circumstances develop. Making more than one change in consecutive, or near consecutive periods, will serve the interests of neither preparers nor users of accounts.

QUESTION 9:
Do you support the alternative view, or any individual aspect of it?

There are aspects of the alternative view that we consider the ASB could give weight to, particularly in considering reporting by unlisted entities (such as mutual insurers) and where international comparisons are less significant.

In the UK mutual insurer sector, it would be helpful to deal with users' information needs more sympathetically. This means eliminating unnecessary complexity, reducing "clutter" and preparing and presenting accounts in a way that is understandable to most ordinary people. These appear to be important principles in the alternative view.

We recognise that the problem for the ASB and IASB in producing accounting standards for "SMEs" is that they have already started financial reporting development at the relatively large sophisticated publicly-owned company end of the spectrum, as this has potentially the most economic impact. The problem then is to relate this to other entities without losing consistency and comparability in financial reporting altogether. We appreciate this is a challenging task.

Other Points

Referring to FRED 46, A2.18, "Entities not subject to Company Law," the tables should include under Legislation - "The Friendly Societies Act 1992" to which attaching statutes (notably "The Friendly Societies (Accounts and Related Provisions) Regulations 1994") determine the form and content of friendly society accounts. It might be noted that there are different accounting formats for directive and non-directive friendly societies in the legislation.

ASB Staff Paper: Insurance Accounting – Mind the UK GAAP

In the foregoing comments on the FRED, our views on the proposals in the ASB Staff Paper on Insurance Accounting (issued for comment at the same time as the FRED) will be evident. For ease of reference, we summarise our views below against the questions raised in the Staff Paper.

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 do not believe that IFRS 4 Phase 2 as currently drafted offers a meaningful basis for annual reporting by mutual insurers to their members; at least in respect of those writing long term business that will be most affected by Phase 2.

Members of mutual insurers tend to be ordinary members of the public requiring financial information to be presented in a way that is relevant to them and easy to understand. They are concerned that the promises under their insurance policies will be met and about whether they are being treated fairly versus other members and other commitments of the entity. They are unlikely to value (or more likely will be confused by) an actuarially-derived "performance" statement which departs from a straightforward presentation of contributions they have paid-in and the benefits they have taken-out. Their interests in performance tend to be long term. More confusion is likely to arise and require explanation as the financial position under IFRS 4 departs from the regulatory solvency basis. Members of mutuals are not prejudiced by the absence of sophisticated technical detail in the accounts. Their interests are protected by the financial regulator (currently the FSA), which has its own information demands on the entity.

For certain mutual insurers – those which value comparisons with listed competitors or those which themselves have issued listed securities or those which operate in international markets – IFRS in general, and IFRS 4 in particular, will be the appropriate accounting basis.

Short-term solution
When providing comments on the short-term solutions 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 above or not) 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).

We note that current accounting in the UK, for insurers writing long term business, cross-refers to Solvency I which is due to be replaced by Solvency II on 1 January 2014. The ASB considers IFRS 4 Phase 2 as the long-term solution for UK GAAP (possibly from 2016 or 2018) and therefore is asking for comments on alternative "short term" solutions.

In brief:

(a) As discussed above, we do not consider IFRS Phase 2 as currently drafted as an appropriate UK GAAP solution for mutual insurers.
(b) Our preferred solution is for the UK accounting framework for insurance to continue to dovetail with the regulatory basis (Solvency I, Solvency II or other basis as applies at the relevant time). It might be noted that non-directive friendly societies may not be subject to Solvency II. Minimising the differences between accounting and regulatory basis will most benefit members of mutual insurers (being the primary users of the accounts) in terms of relevance, clarity and being understandable. It will benefit the mutual insurers themselves (the preparers) in containing the extent of different analyses required of the business for different purposes – in this sense it would be a cost effective and pragmatic solution. In the ASB Paper (Section 6), Option III updating FRS 27 and the ABI SORP for Solvency II, would be the closest proposal to this. There is a question as to whether FRS 27 and a SORP is still required or whether this can be incorporated into the standard (FRS 102) based on the FRED itself in due course.
(c) Our rationale is strongly based on the costs and benefits as discussed in the foregoing.
(d) The impact on insurance entities reporting under UK GAAP is that their financial position in the annual accounts will change only based on changes in the regulatory basis. There has been precedent for this in the past, for example, with the ability to allow for surrenders in statutory long-term business valuations from 2007/8.