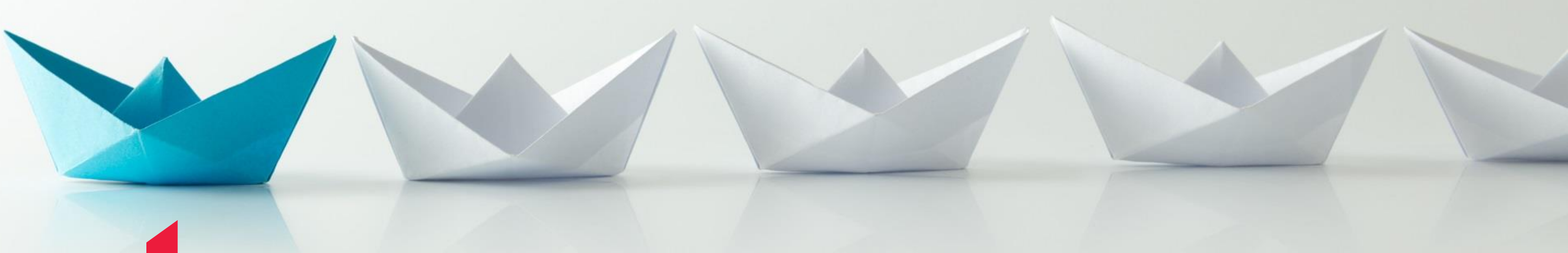
MUTUAL INSURANCE ACCOUNTING

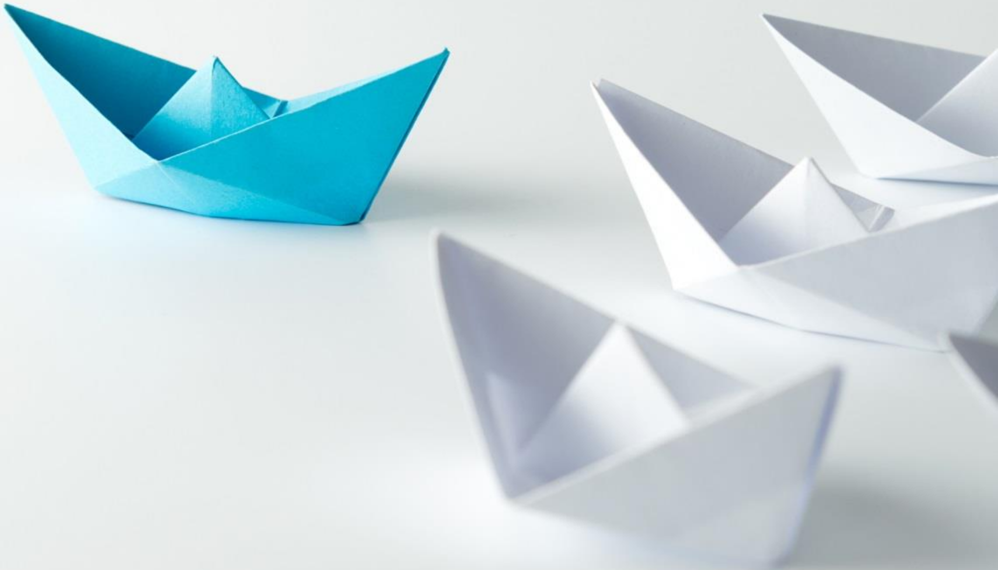
A consideration of best practice

20 July 2018



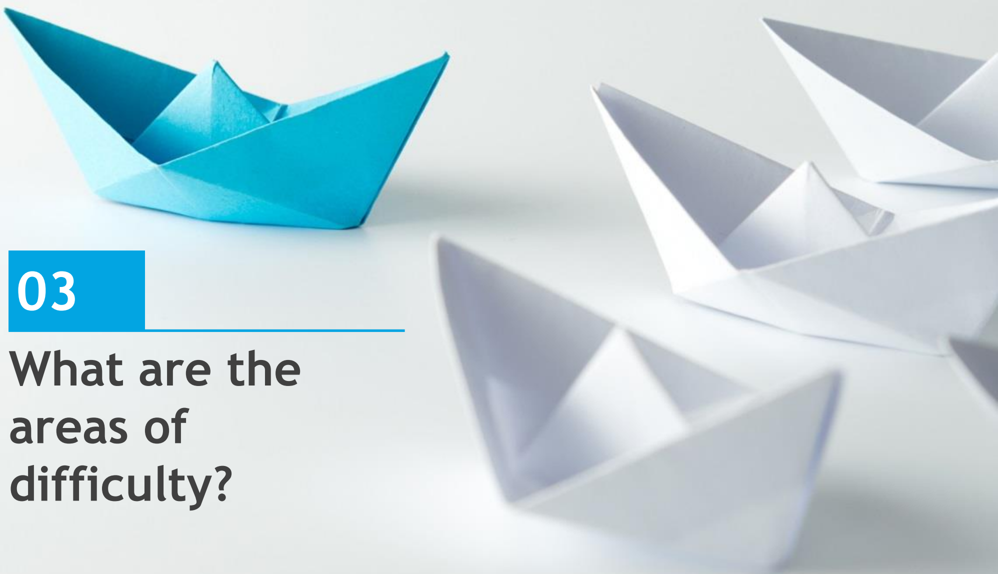
INSURANCE ACCOUNTING

INTRODUCTORY THOUGHTS & OVERVIEW



INSURANCE ACCOUNTING

AGENDA



01

Who is interested in insurance accounts?

02

Characteristics of good reporting

03

What are the areas of difficulty?

04

Other observations

05

Concluding thoughts

06

Q&A

STAKEHOLDERS

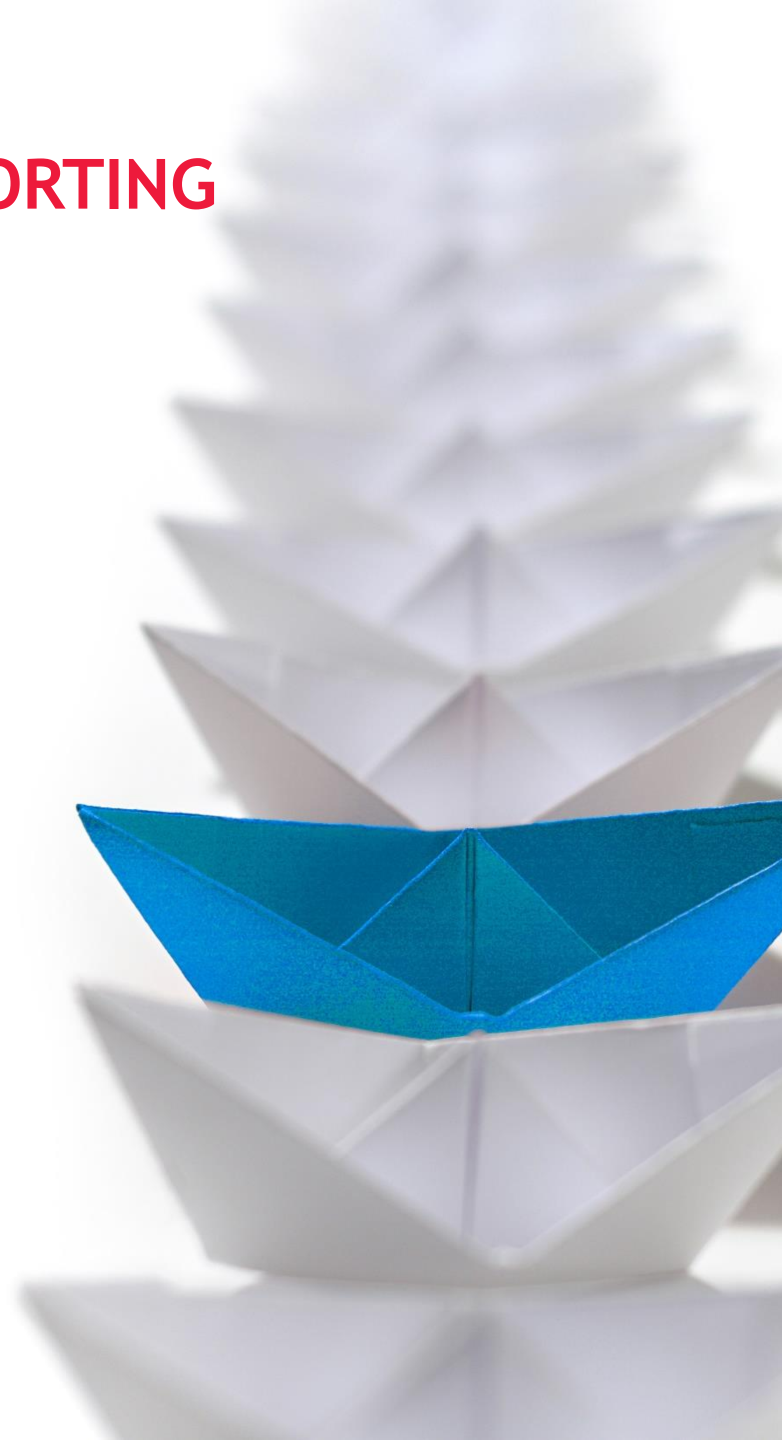
Who is interested in your accounts?

Members	Executive Directors	Non-executive directors	Reinsurers
Competitors	Financial reporting council	PRA	Professional services firms

CHARACTERISTICS OF GOOD REPORTING

- A single story
- How the "money is made"
- What worries the Board
- Consistency
- Cut the clutter
- Clarity
- Summarise
- Explain change
- True and fair

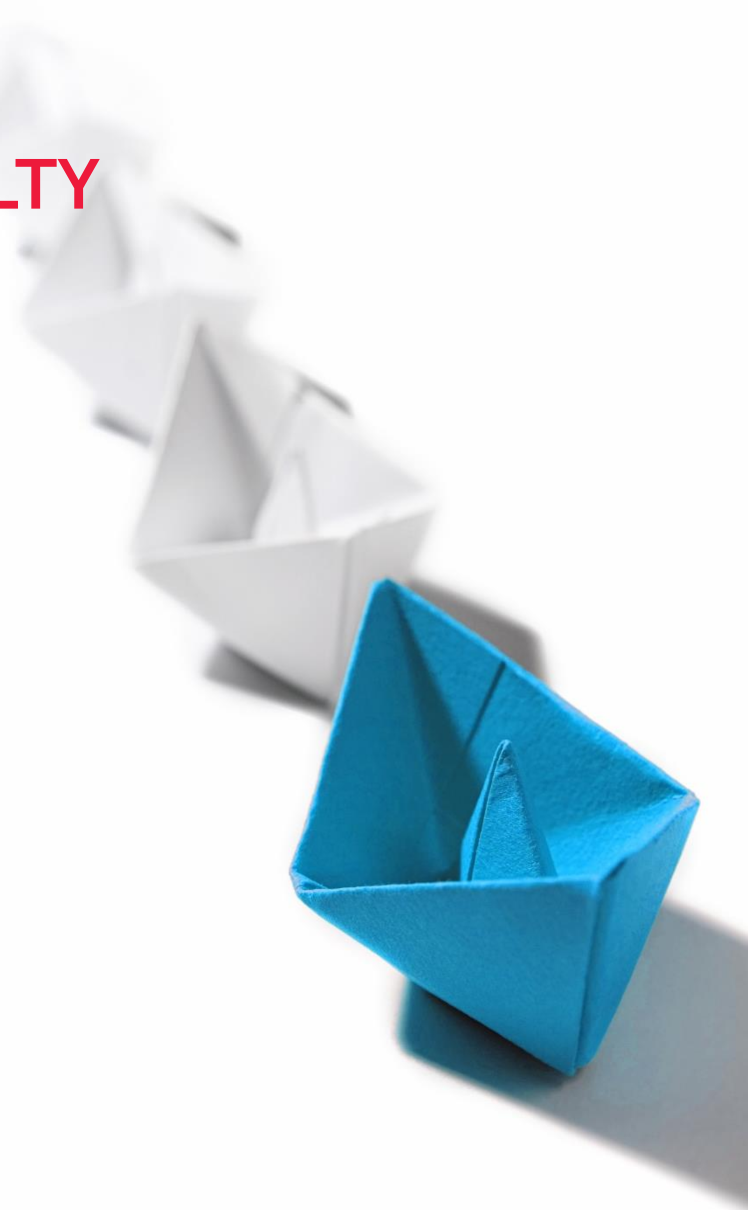
Source: Financial Reports Council "Annual Review of Corporate Reporting 2016/2017" (Oct 2017)



WHAT ARE THE AREAS OF DIFFICULTY

Impairment

- Discount rate(s) should reflect current market assessments of time value of money and asset-specific risks.
- A description is required of each key assumption driving the cash flow projection determining value in use. The discount & terminal growth rates were often incorrectly identified as the only key assumptions.
- Disclosures of wide ranging assumptions covering multiple cash generating units.
- A description is also required of the approach to determining the values attributed to assumptions, including how past experience or external sources of information have been used.



BDO

WHAT ARE THE AREAS OF DIFFICULTY

Impairment (continued)

- Observations noted in relation to disclosures where:
  - no explanation was provided of why the discount rate used was significantly changed from the prior year
  - sensitivity analysis did not include numerical disclosures
  - the assumptions used were unclear, for example:
    - Any volatility in assumptions was allowed for
    - the operational asset lives
    - Detail on key assumptions such as lapses or longevity.

BDO

WHAT ARE THE AREAS OF DIFFICULTY

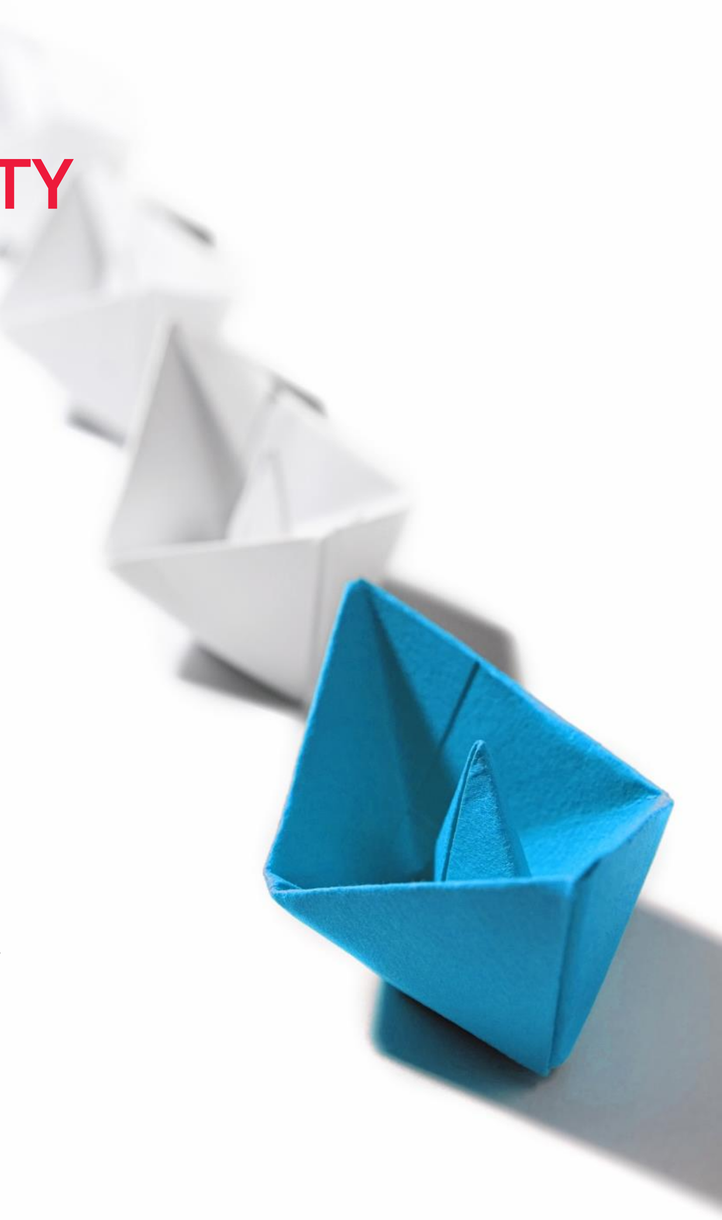
Financial and insurance risk disclosures

In the course of reviews instances have been noted where it is not immediately clear:

- why the selected sensitivities were selected (why 5% or 25 basis points)
- Usefulness of metric, for example a 5% increase in FV leads to a 5% increase in the balance sheet
- clear how tabular disclosures tie to the primary statements
- How the risks are actually managed

In addition, instances noted where balances have been aggregated and therefore arguably do not “hit the spirit of the standards in terms of depth and richness in relation to qualitative and quantitative disclosures”.

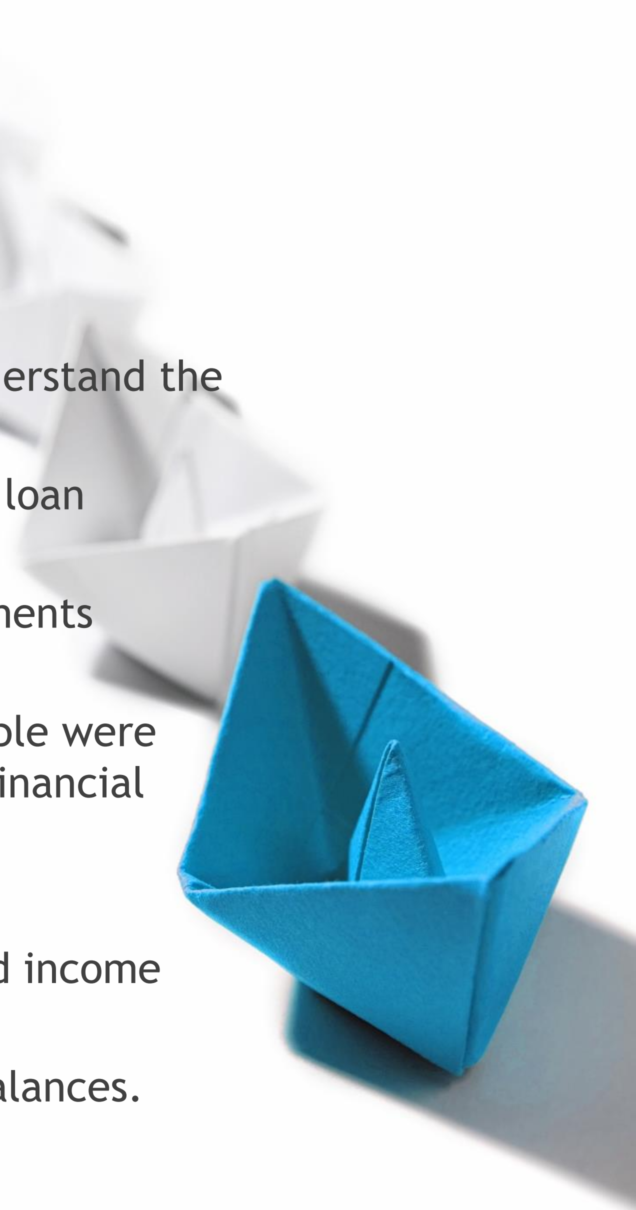
The qualitative disclosure should reflect internal risk management process that are reported, to a fair degree, internally



WHAT ARE THE AREAS OF DIFFICULTY

Financial instruments

- Financial instrument disclosures should be sufficient to understand the risks the company faces. We identified instances where:
  - the descriptions of the risk classes and disclosure of the loan impairment process were generic or unclear
  - Companies Act disclosures of off-balance sheet arrangements relating to ‘own use’ contracts were insufficient
  - there was insufficient explanation of why amounts payable were accounted for as a contingent liability rather than as a financial liability
  - the explanation of cash flow hedging was incorrect
  - no maturity analysis was provided for significant accrued income receivable considered to be a financial assets
  - assessment of credit risk not explained for short term balances.



BDO

WHAT ARE THE AREAS OF DIFFICULTY

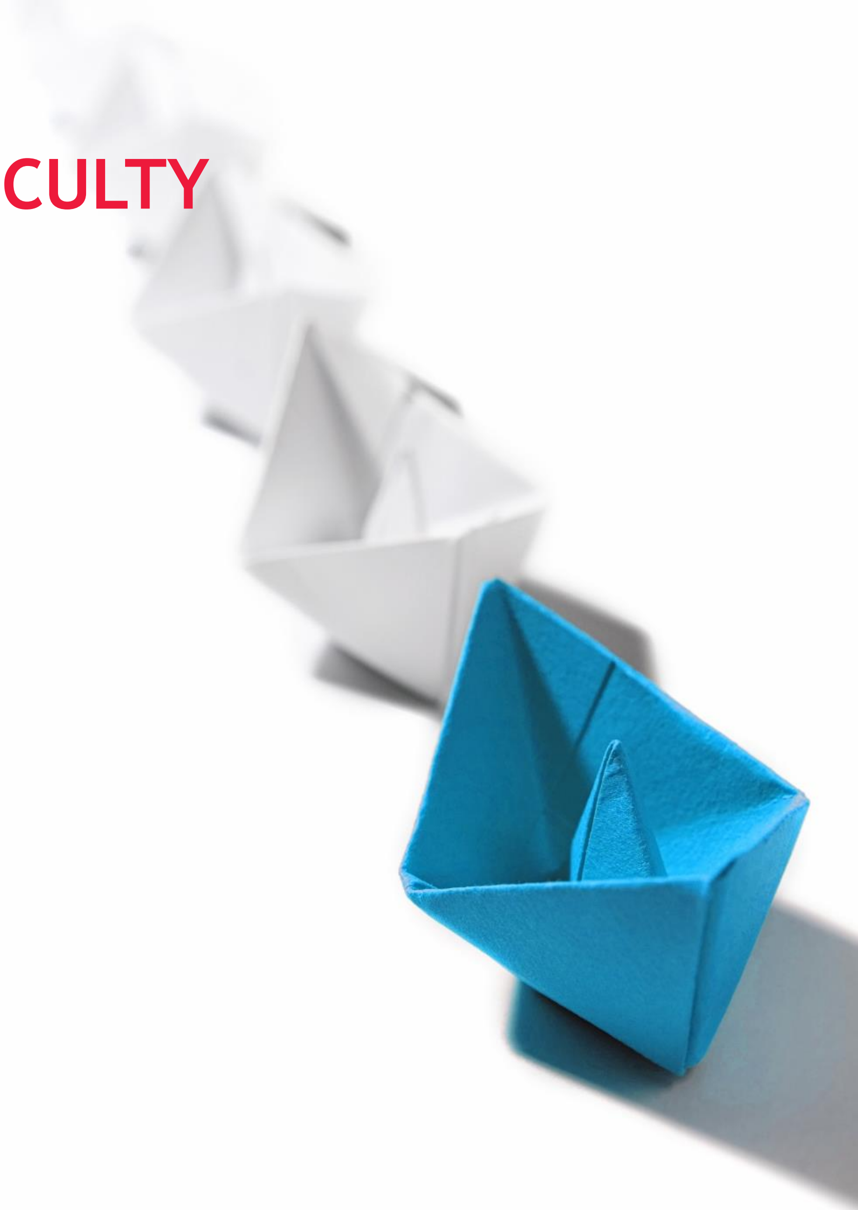
Fair value measurement

- Instances noted where :
  - It was not clear whether the valuation techniques were used
  - there was incomplete or missing disclosure of significant unobservable inputs or sensitivities
  - the basis for the categorisation of investments into the three levels of the fair value hierarchy, e.g. where the categorisation appeared inconsistent with the description of the investments

WHAT ARE THE AREAS OF DIFFICULTY

Cash flow statements

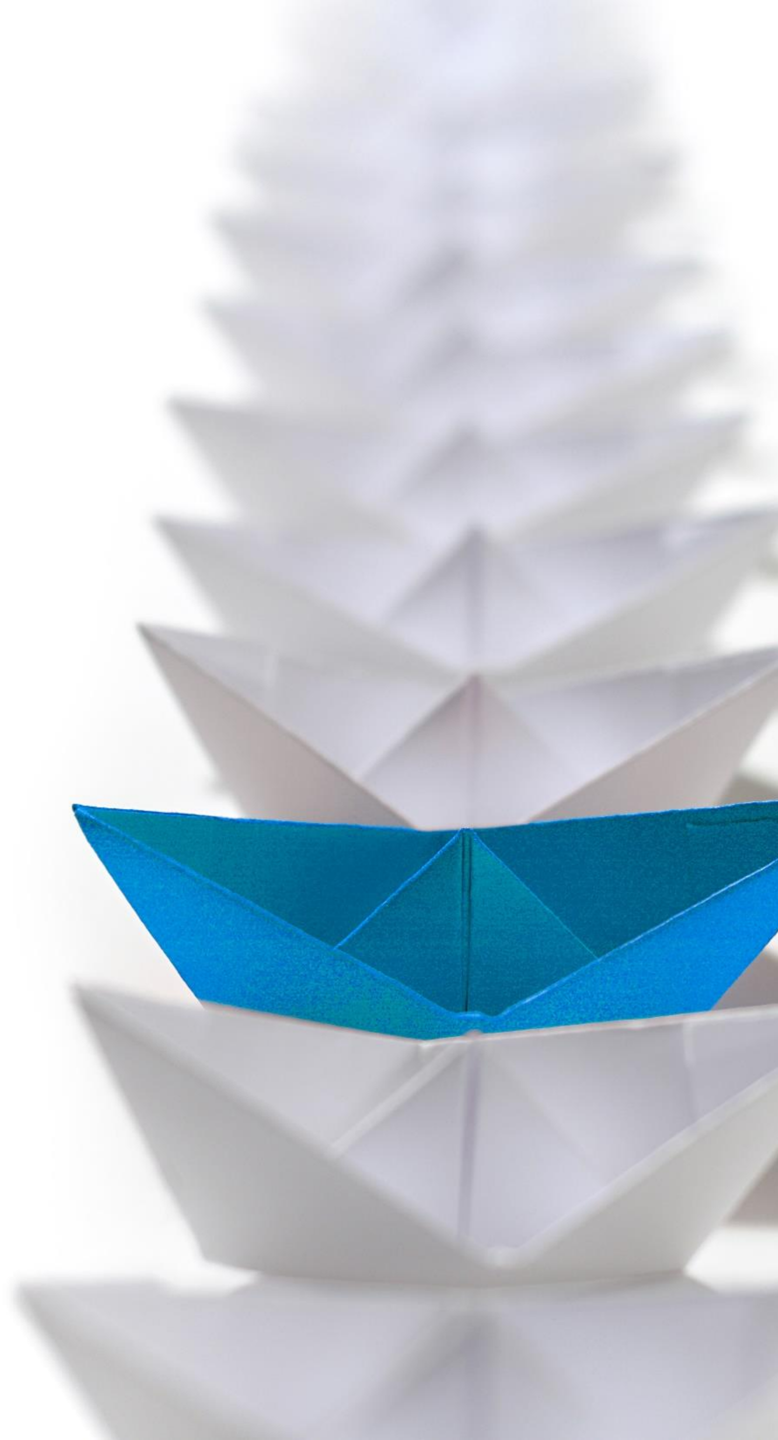
- Good news for mutual life assurers – exemption available from preparing a cash flow statement!
  - For non-life mutuals, in our reviews we have noted:
  - Issues relating to the classification as 'operating' (rather than 'financing') movements in factoring balances included as borrowings on the balance sheet.
  - In the event there are any restrictions over cash should be clearly explained.



OTHER OBSERVATIONS

Critical judgments and estimates

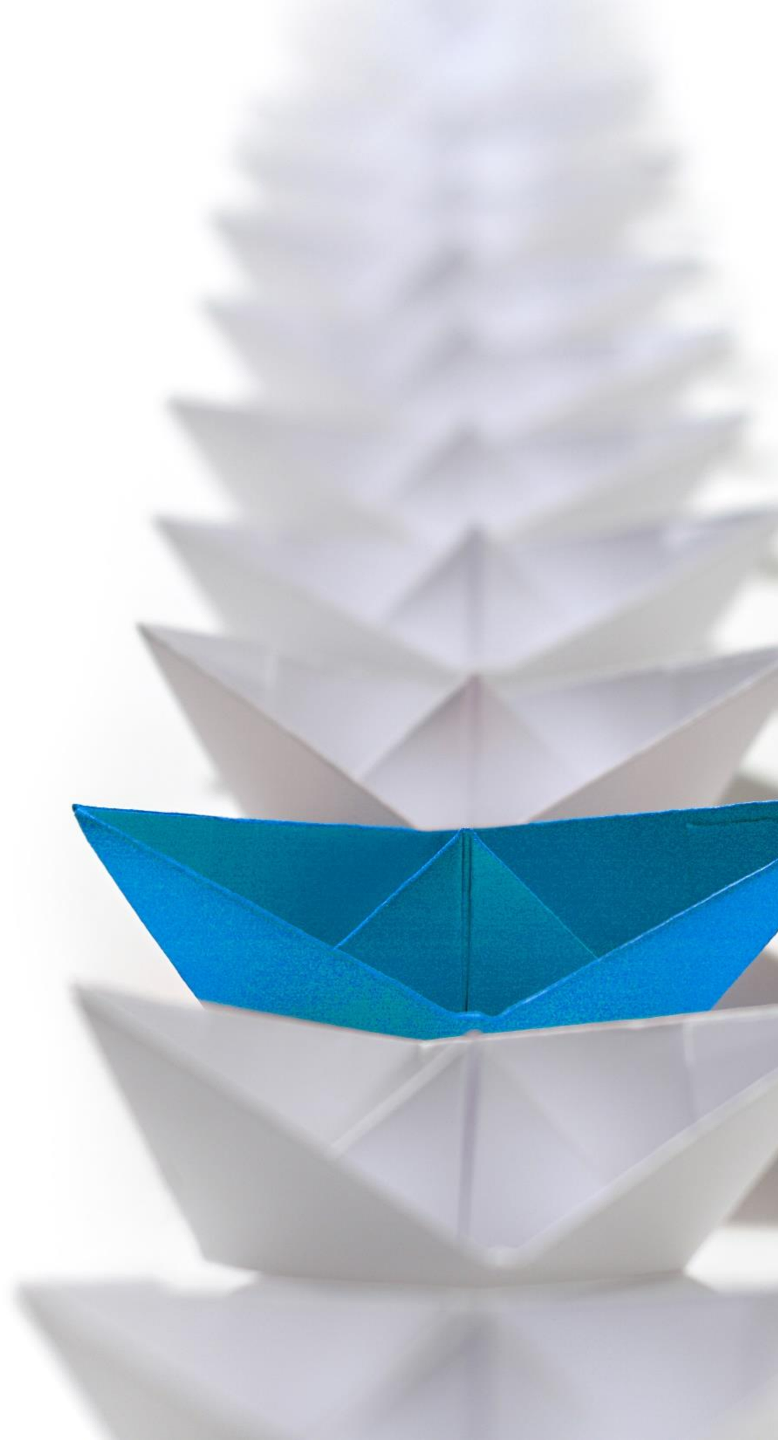
- Boilerplate and generic disclosures should be avoided. Information value can be improved by providing more granular information about a smaller set of judgements and estimates that had a significant impact on results and explaining why certain assets were subject to significant risk of material change.
- Make sure they are relevant to the organisation
- The FRC carried out a thematic review on this topic was published in November 2017



OTHER OBSERVATIONS

Reinsurance

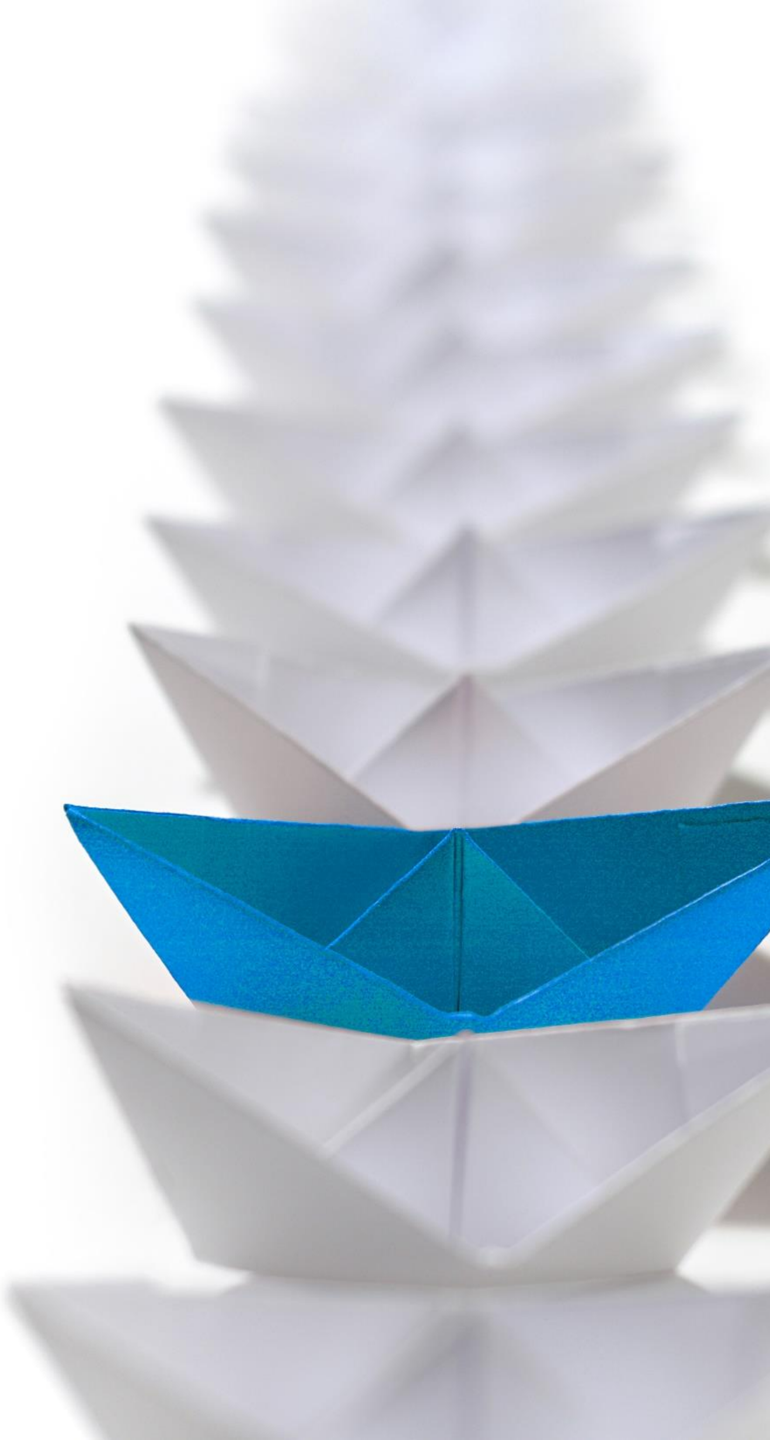
- Cedants are required to disclose the gains and losses recognised in profit or loss on buying reinsurance, we see a number of disclosures where this is omitted or accounts simply state that “this is presented in the income statement” – this is not really in the spirit of the standards requirements
- Instances noted where the required reconciliation of reinsurance assets is not presented



OTHER OBSERVATIONS

Accounting policy disclosures

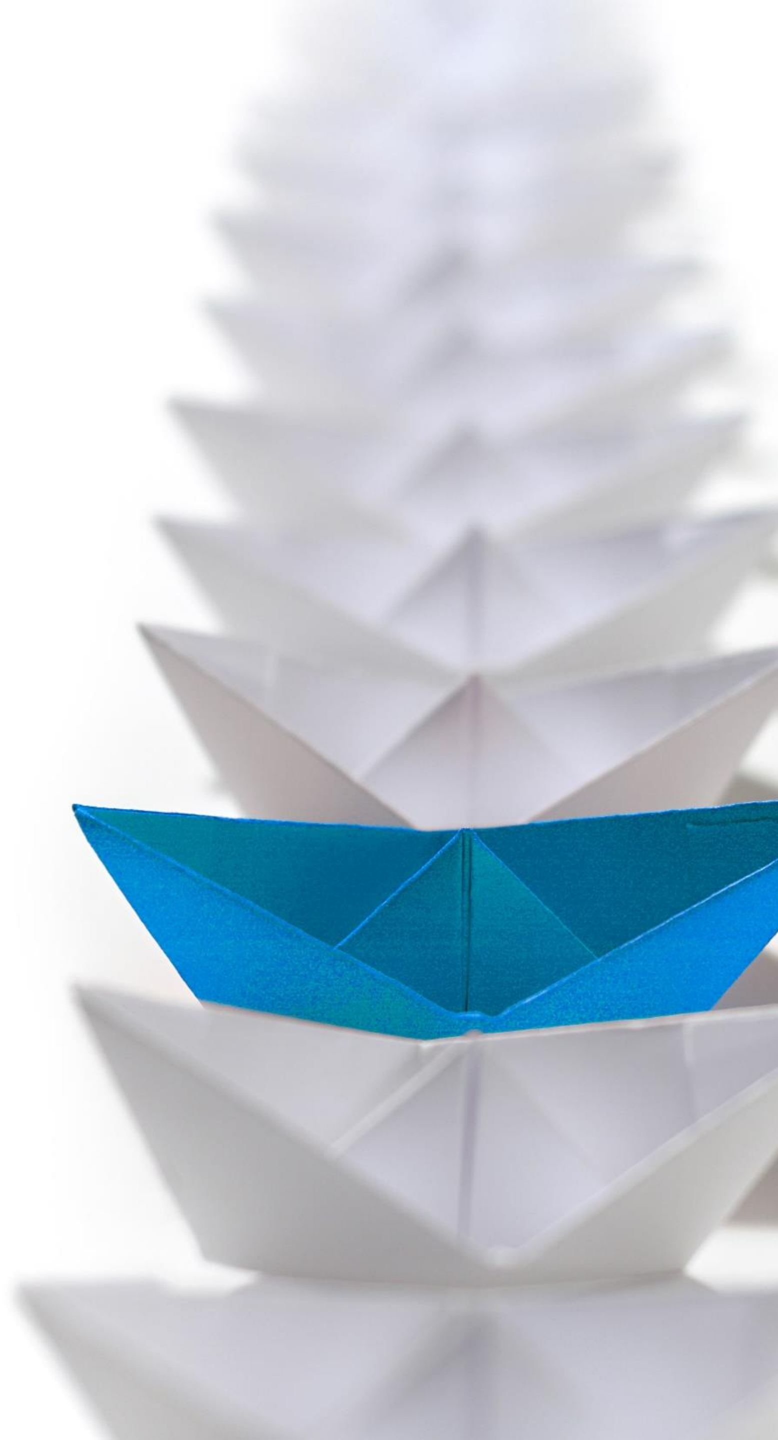
- Accounting policy disclosures that appear to be out of date, irrelevant, immaterial or based on boilerplate text taken from the standard.
- Recommendation that you critically review your disclosures to ensure that they are sufficiently tailored to your circumstances. For example, revenue accounting policy disclosures should cover each significant business stream.
- Inclusion of other financial information in the policy narrative (as opposed to in the notes)
- Statements of the nature of items and what account captions are comprised of rather than describing the actual accounting



OTHER OBSERVATIONS

Adjusting / one off / exceptional items

- Instances where it was not immediately clear why items were separately identified.
- Observations noted :
  - where the items identified appeared inconsistent with the accounting
  - the policy referred to non recurring items but the items were recurring

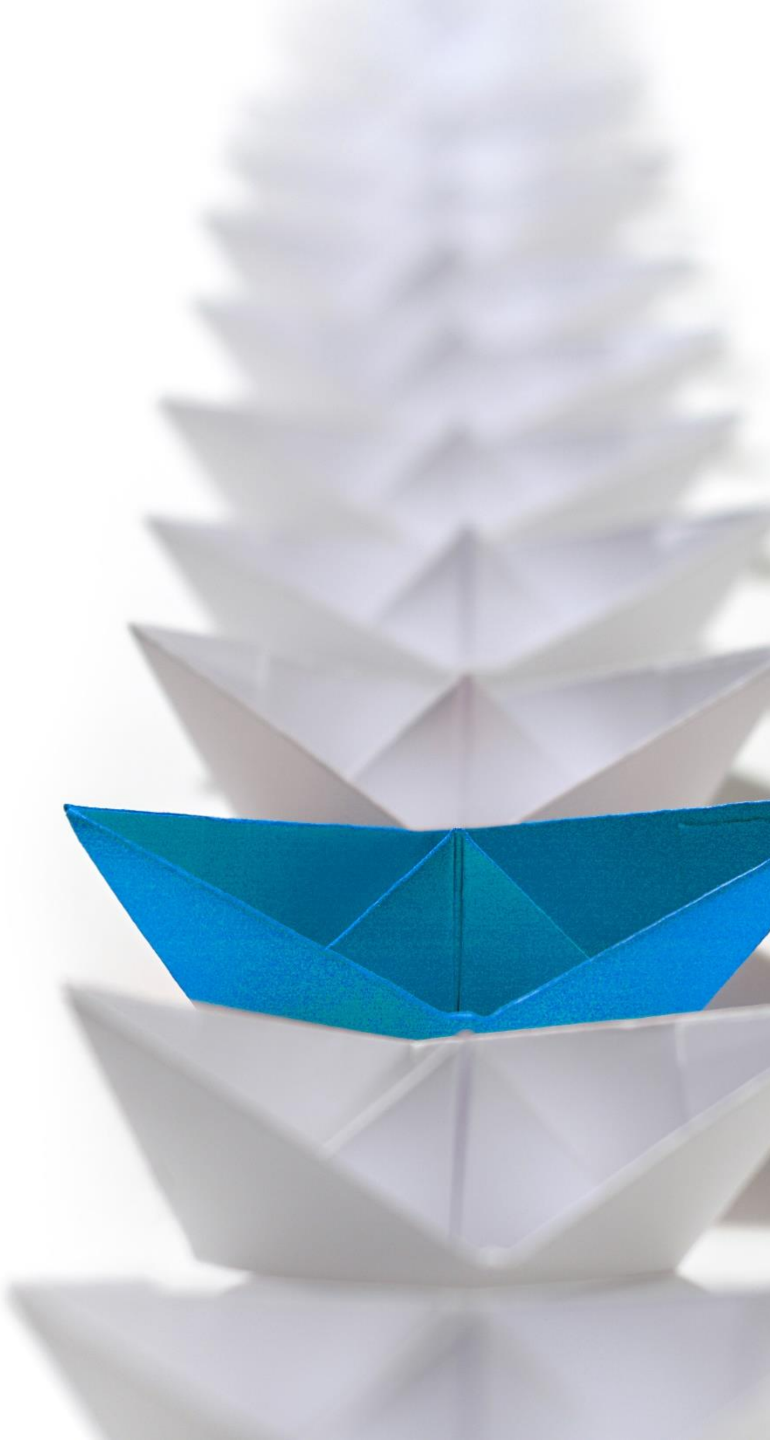


OTHER OBSERVATIONS

Capital management

Use of boilerplate capital management policies or unclear explanations, e.g.:

- incomplete disclosures of objectives, policies and processes for managing capital
- the strategic report indicated that the entity was subject to regulation in various jurisdictions but did not refer to any capital requirements.

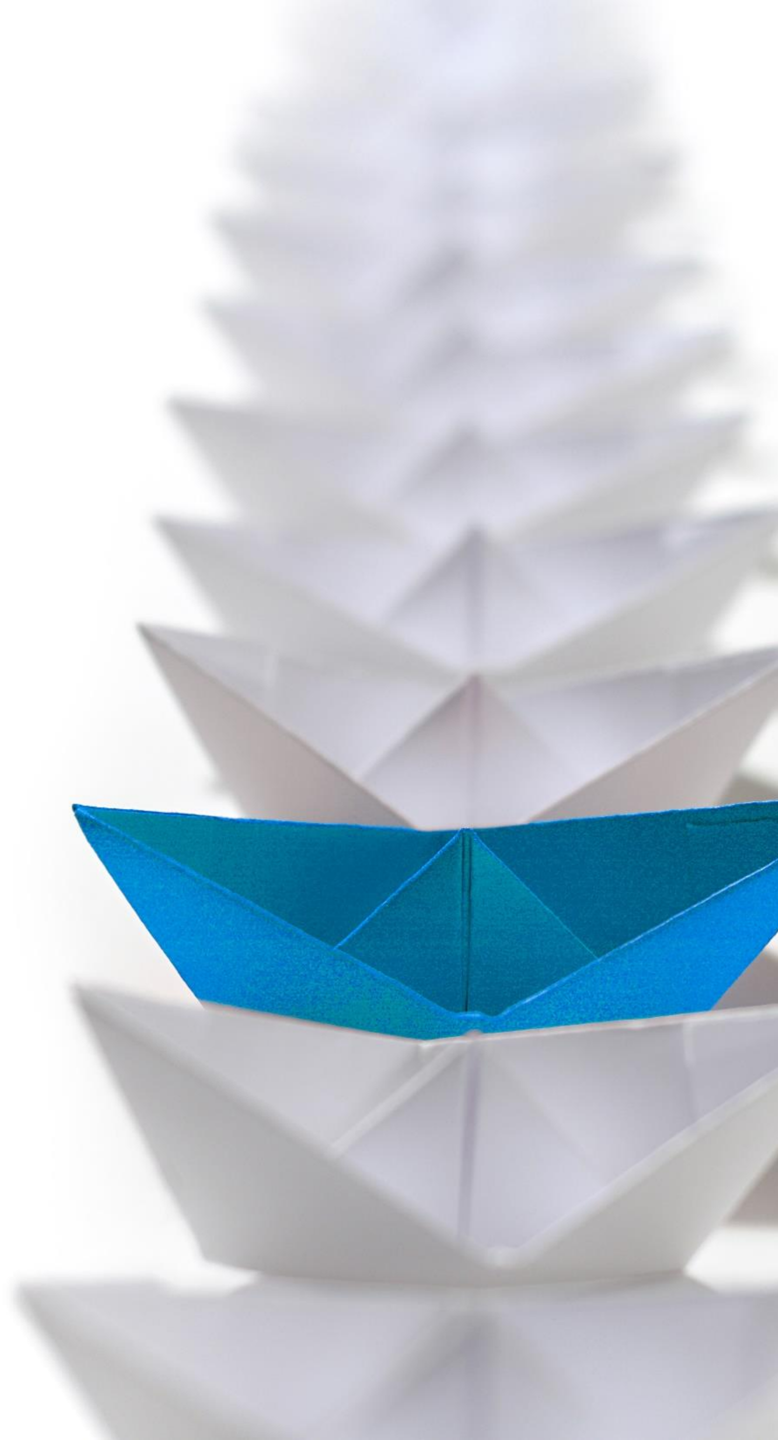


OTHER OBSERVATIONS

Related parties

Observations relating to the lack of, or unclear, disclosures of transactions or balances required:

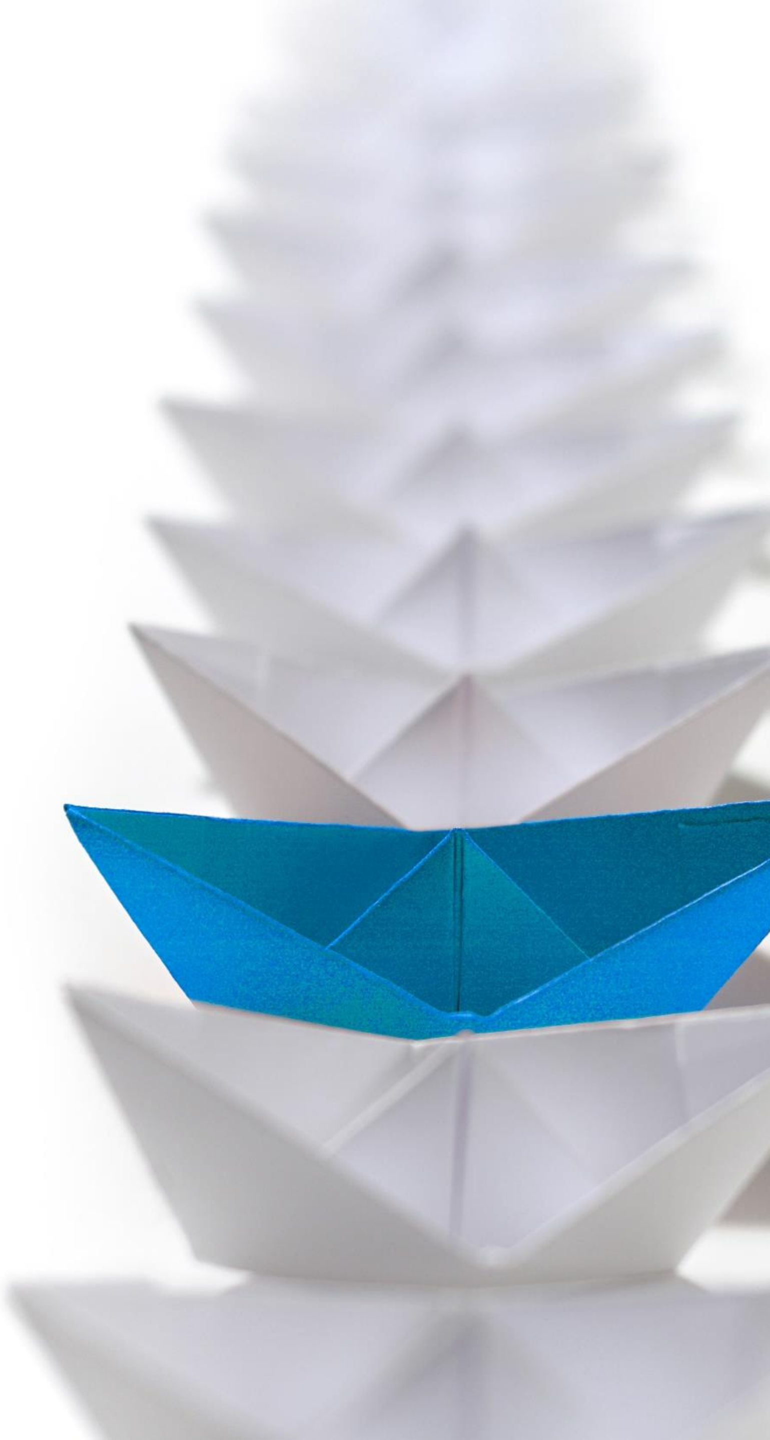
- incomplete disclosure of loan balances, impairment provisions, rental and other service agreements with joint venture companies;
- unclear how the parties referred to in the disclosure are related to the entity; and
- members of the executive management team who were not directors should also have been included as Key Management Personnel.



OTHER OBSERVATIONS

Monetary items – don't forget!

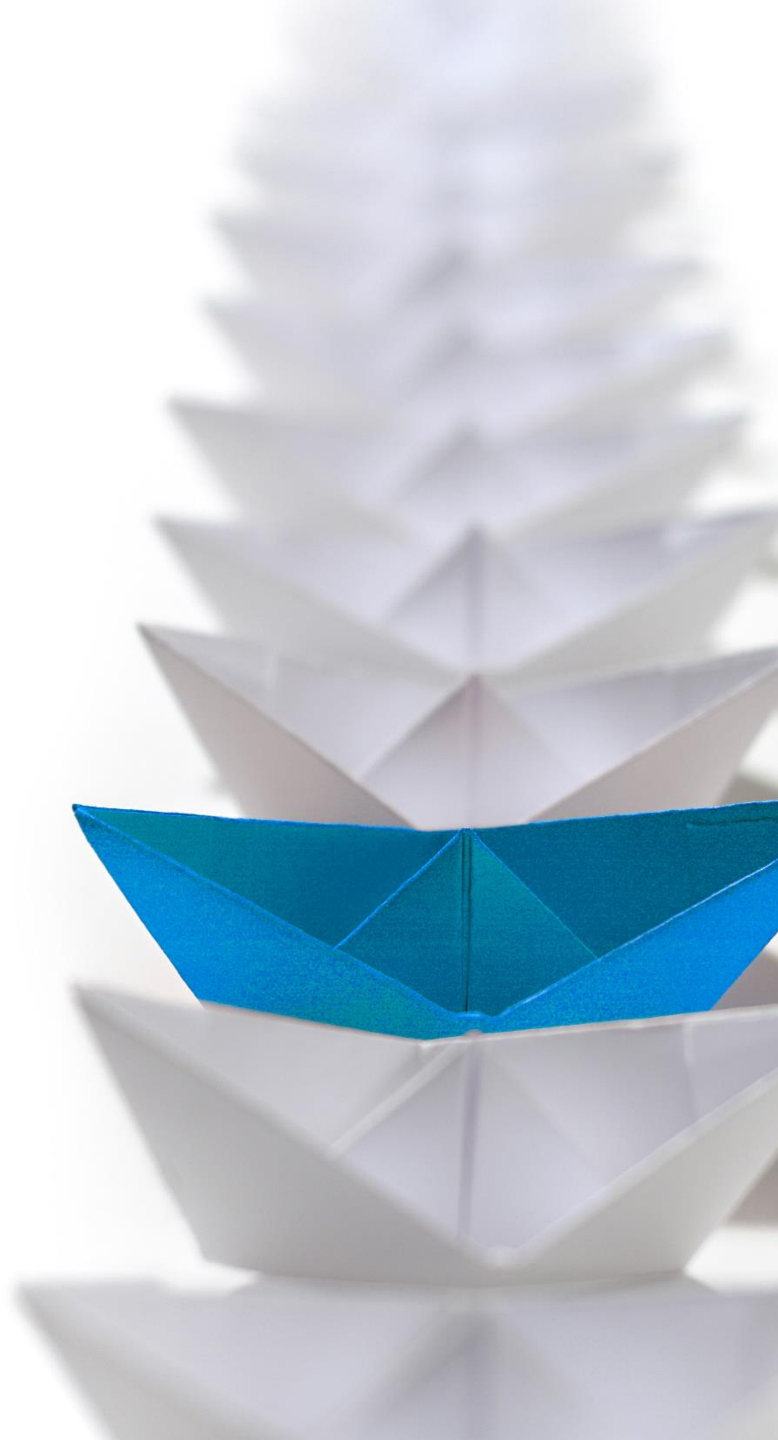
- Unlike IFRS and FRS 23 The Effects of Changes in Foreign Exchange Rates, FRS 103 states that all assets and liabilities in a foreign currency arising from an insurance contract must be recorded as monetary items for the purpose of applying FRS 102.
- Therefore unearned premium reserve (UPR) and DAC are re-translated at the closing rate.
- This removes foreign exchange volatility where the assets held to back insurance liabilities are also monetary items.



CLOSING THOUGHTS

- Requirement to present a true and fair view
- Present information that is meaningful and understandable to users
- Compliance with the requirements of FRS102/103
- Try to avoid “boiler plating”

Litmus test – will a reader find the disclosure useful and informative about the organisation?



Q&A

Contact details

John Perry
Insurance Partner
BDO LLP

+44 (0)20 3219 4528
john.perry@bdo.co.uk

HB010472