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LIFE PROFIT REPORTING—WHAT FUTURE?

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As part of its ongoing programme to provide a discussion forum on topics of interest to actuaries in the life assurance field, the Institute of Actuaries held a Seminar entitled 'Life Profit Reporting—What Future?' on 8 May 1991 at the St Ermin's Hotel, London. The format of the Seminar was that of workshops on the same subject with opening and closing plenary sessions. There were 106 attendees at the Seminar including 9 actuaries from the Faculty. Overseas members were welcomed from Jamaica, the Netherlands and South Africa.

The opening speaker provided a historical perspective of life profit reporting. From the traditional with-profits regime backed by predominantly fixed-interest investments, the industry has been through a period of great change since the last war. Changes have been equity growth and investment, unit-linked business development, statutory changes following insolvencies and mergers and acquisitions. These changes have led to the demand for a more realistic way of reporting life profits than the solvency driven statutory method.

The 1980s saw embedded value reporting developed, but this has not acquired universal support or adoption in published accounts. One reason has been its variance from generally accepted accounting principles as employed in other industries, making the 'true and fair' statement difficult for some auditors to provide. In more recent times the E.C. perspective and the AMP acquisition of Pearl have led to renewed interest in life profit reporting. The finance directors of large composite insurance companies have led the way for the ABI development of the proposed 'accruals method'.

The accruals method reflects the principles of relating profits to risks borne and work done, no initial loss on profitable contracts, earnings produced to which price earnings ratios can be applied, the time value of money is allowed for, in accounting language an activity rather than value driven method, compliance with legislation and the true and fair principles of the draft E.C. Accounts Directive. Following comments received, a refined version of the proposed accruals method is imminent.

The first concurrent workshop discussed why there was a need to put a value on the profits of a life assurance company and considered who might use such information. Current statutory reporting was considered of only limited use, providing a past-year statement of fact. Some view of the future is required, subjective though it might be. Whilst policyholders are primarily interested in future solvency, shareholders, analysts and predators are particularly interested in profit forecasts, dividend levels etc., to compare/assess companies. Managements need information to monitor performance on which their actions will be assessed.

In the second concurrent workshop, the basis to be used for profit reporting was discussed. It was agreed that the basis adopted should contain margins appropriate to the calculations, e.g. whether the reporting method was active or passive, realistic or conservative. The basis must satisfy the demands of directors and auditors, opening up dialogue with accountants on valuation bases. A basis imposed for consistency between companies was not considered appropriate in this subjective area, but a company needs to adopt a consistent basis from year to year, albeit changing elements of the basis from time to time. Experience data are normally available, particularly for large companies, but the aspect needing more attention was lapses. Should there be a Continuous Lapse Investigation developed by the profession?

In setting a basis, past experience may be adopted, but not without consideration of how the future relates thereto, and modification may be necessary. Sensitivity testing is needed, but over-provision of data needs to be avoided. Aspects specifically discussed were risk discount rate versus earned investment rate, expense over-runs and their temporary (or permanent!) nature and the treatment of options.

The mechanics of calculation of life profits brought up in the next workshop the question of materiality and the link with the auditors. Actuaries need to know what auditors mean by materiality. For the embedded value method and, in particular, the accruals method, computer modelling was seen as the most likely route to cope with the complexity. This again would lead to dialogue with auditors on the approach and the extent of modelling error and its acceptability. Either an existing model could be adjusted or a new model set up, dependent upon the reporting method. The accruals method was seen as requiring great cost and effort. There was also the need to model taxation, for which it was agreed a 'going concern' basis was appropriate. The introduction of a new method would require historical results—difficult to achieve for more than a year or two for the accruals method.

The value of the profit reporting exercise was assessed in the last workshop. Life profit reporting was adjudged necessary for shareholders and analysts to provide more information to support share prices and to directors and senior management who are likely to be assessed by such a performance measure. The E.C. and whatever Accounts Directive aspects are adopted by the U.K. may force companies down a different profit reporting route to the current method. Against the exercise was the effort and cost—particularly for the accruals method—for insufficient extra benefit. Amongst the attendees, there was support for both embedded values and the accruals method as being the most appropriate reporting method.

The closing speaker pulled together the day's discussions and then went on to describe another possible reporting method, which utilised realistic valuation reserves. Aspects of the method were debated, particularly the way in which surrender values were a foundation stone, and the implications thereof.

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