The Meaning of Composite Insurers' Results

All the quoted UK composite insurers spend considerable time and effort communicating their results to their shareholders. Attention tends to focus on pre-tax profits. But what precisely is this supposed to mean, and what conclusions should shareholders draw from it?

Consider the following results from Commerical Union (for example) over the past five years. (results as originally reported).

	1980	1981	1982	1983	1984
Underwriting loss	(57.3)	(131.9)	(271.5)	(314.2)	(439.4)
Investment income	142.8	191.7	243.5	255.4	275.9
Life profits	15.2	17.3	40.7	55.8	77.9
Other income	2.5	4.6	8.8	12.3	12.8
Pre-tax profit	103.2	81.7	21.5	9.3	(72.8)
Earnings per share	18.6p	16.5p	3.3p	(2.0)p	(21.4)p
Net dividend	10.8p	11.8p	11.8p	11.8p	11.8p

These figures present a picture of a company in severe decline. But how accurate is that picture? And why has the dividend been maintained (after an increase in 1981) despite mounting losses? Try looking at the company another way:

	1980	1981	1982	1983	1984
Shareholders' funds at 1st Jan	715.3	767.5	822.0	1045.4	1046.5
Net operating income	76.5	68.0	13.8	(8.1)	(88.3)
Realised capital gains (net)	2.1	27.1	70.8	30.1	53.4
Foreign Exchange gains	(48.6)	76.2	77.0	44.1	127.9
Change in unrealised gains etc	66.6	(68.3)	110.5	(16.3)	(19.2)
	811.9	870.5	1094.1	1095.2	1120.3
Net dividends paid	(44.4)	(48.5)	(48.7)	(48.7)	(48.7)
Shareholders' funds at 31st Dec	767.5	822.0	1045.4	1046.5	1071.6
Net return on funds	+13.5%	+13.4%	+33.1%	+4.8%	+7.1%

It is clear from this presentation that CU has not made much profit out of insurance over the period (£61.9m net in total), but has made a great deal of money out of capital appreciation in its assets (£256.8m, of which £73.3m is unrealised), and out of currency movements (£276.6m). These 'non-insurance' earnings have produced an average return on capital employed of 14.0% p.a. after tax, and enabled the company to maintain its dividend over the period. This is despite the fact that the dividend has been uncovered by insurance earnings since 1982 (and since then the company has paid out 55p per share more than it has 'scored' - a quarter of its market capitalisation.).

This analysis raises many interesting questions:
What is the purpose of reporting results? Is it to enable shareholders to judge the performance of their directors (Stewardship)? Or to demonstrate dividend paying potential? To compare the company's performance with offers in the industry? Or in other industries? Does the traditional earnings presentation accomplish any of these purposes? Or any other purpose? Is the second presentation an improvement? Is it right to judge management's performance in managing currencies, investments and tax as well as insurance earnings? If so, what standards should be applied? If not, how should these earn ings be treated? Is it right to pay dividends from these earnings? Should just some of these earnings be used (eg the Eagle Star five-year smoothing approach for capital gains)?

If companies just had to report a single figure which represented their results, what figure would be most appropriate? Pre-tax profits? Earnings per share? Dividend? Increase in net worth of the company? Return on capital employed? Would the figure change depending on the purpose for which it was to be used? To what extent should the management decide what figures to report? Is there a case for a standardised reporting basis? If so, how standardised? If not, how should different companies be compared?