POLLYANNA PROFITS

WHY SOME MANAGERS FEAR AASB 1023

The financial reports of general insurance companies in Australia may provide profit numbers skewed by arbitrary accounting treatments. Some managers would prefer to cling to historical methods which have the potential to exaggerate their performance.

Accounting Standard AASB 1023 Financial Reporting of General Insurance Activities prevents this by requiring marking-to-market of assets and liabilities. FRANK ROBERTSON explains why he supports this principle and describes the sometimes hostile opposition to it.

In the “good old days”, which are not so long ago, general insurance companies sought to set their premium rates at levels that would achieve underwriting profits. The additional income earned from the investment of technical reserves and solvency reserves was considered a perquisite of the insurer, and rather incidental to the conduct of the insurance business.

Because of this management mind-set, premium rates were set and provisions for unpaid and unreported claims were made without any allowance for future investment earnings. Outstanding claims provisions were recorded at the full amount expected to be paid, with no discounting.

This approach works well enough in an environment where:
• insurance written is predominantly “short-tailed” (that is, classes such as motor damage insurance, where claims are usually settled quickly);
• nominal interest rates are reasonably low; and
• competitive forces allow premiums to be set at appropriate levels.

As inflation became endemic in developed economies in the 1960s and 1970s, so that nominal interest rates rose to very high levels, as more “long-tailed” insurance classes such as liability came to be written, and as competition increased, this traditional approach to insurance became progressively less sustainable.

Some insurers reacted scientifically to the changing environment, setting premium rates taking account of the timing as well as the expected amount of claims, and allowing for investment earnings on their technical reserves. Other companies reacted less scientifically, reducing premium rates to meet competition and saying to themselves that underwriting losses were acceptable so long as investment returns still produced a reasonable profit.

In either case, however, if premium rates are set at a level which makes allowance for expected investment earnings on outstanding claims provisions, but the provisions actually included in the company’s balance sheet are undiscounted, writing increasing volumes of business will cause reported profit to be reduced, and may even lead to losses being reported. Insurers began, logically, to allow for expected investment earnings in calculating their provisions for outstanding claims.

Claims provisions were inflated from the balance date to the expected date of payment, to allow for both:
• economic inflation (general changes in the purchasing power of money); and
• super-imposed inflation (changes in the general level of claim settlements due to changing social attitudes, increased court awards, etc).

They were then discounted back to the balance date to allow for future investment earnings.

This approach to insurance claims reserving is by no means universal. Only recently the chief executive of a large UK insurance-rating agency told me that his company rates down severely any general insurer which discounts its claims provisions. However, it is clearly a sensible approach to the business and had become usual in Australia for long-tailed classes of insurance before AASB 1023 made it mandatory.

Clearly, where liabilities are determined by discounting for inclusion in a balance sheet, there must be a nexus between the rate of discount used and the rate of investment earnings available.
from the corresponding assets on the other side of the balance sheet. The state of the insurer would be questionable if the rate of discount used were higher than the rate of investment return earned on the reported value of the assets.

However, if financial statements are to be useful to investors and analysts trying to compare one general insurer with another, it cannot be left to individual insurers to choose their own rates of discount and asset valuation techniques. The current chaotic state of life insurance reporting in Australia shows the inadequacies of this approach — it is impossible to make a sensible comparison, from published financial statements, of the profitability of different life insurers.

To make general insurance financial statements more comparable between companies, AASB 1023 takes the eminently sensible approach of requiring liabilities to be determined by use of a market-determined risk-adjusted rate of return, and of requiring assets to be valued in the same way as the liabilities — that is, at their market values. To have chosen any other approach would have rendered general insurers’ financial statements less useful.

SHAREHOLDERS’ FUNDS

There is another reason why it is appropriate for AASB 1023 to require assets to be reported at market values, rather than the traditional historic cost.

Unlike manufacturing or trading enterprises, general insurance companies do not need to invest their shareholders’ funds in tangible assets needed to conduct their business. General insurers take money from their policyholders in return for a promise to make future payments if insured events occur. The primary purpose of shareholders’ funds in general insurance is to provide assurance to policyholders that the insurer’s promise to pay will be honoured. It is only in the most extreme circumstances that the shareholders’ funds will actually be called upon.

So the return which shareholders receive for investing in a general insurance company is made up of two parts:

1. the earnings achieved by investment of the shareholders’ funds; and
2. the earnings achieved by the conduct of the insurance business.

For a proper understanding of the operations of a general insurer, it is essential that analysts consider the insurer’s earnings in these two parts. (GIO Australia always reports its earnings in this way; investors and analysts should insist that all general insurers do the same.)

It is because of this two-part structure of general insurers’ earnings that one often hears the comment from insurance company analysts that a general insurance company can be regarded as a combination of a closed-end investment trust and an insurance business.

Adequate reporting period-by-period of the return achieved by investment of shareholders’ funds requires that changes in market value must be reported. If an insurer’s investment manager buys equities to give a lower immediate dividend yield than is available from fixed-interest securities, then expected or hoped-for increases in market value must be a part of the justification for doing so. If information on subsequent changes in market value is withheld, the manager’s performance cannot be properly assessed.

INSURERS’ OPPOSITION

If there are these two good reasons for the “mark-to-market” requirements of AASB 1023, why is there such vocal opposition to it from a section of the insurance industry?

The reason is not hard to understand. Historic cost reporting gives management control over the timing of profit recognition.

## PROFIT REPORTING

The profitability of a general insurance operation is conveniently expressed in the following way:

- **Gross written premiums**
- **less** Change in unearned premiums
- **less** Gross earned premiums
- **less** Reinsurance expense
- **equals** Net earned premiums (1)
- **less** Reinsurance recoveries
- **equals** Net claims incurred (2)
- **equals** Underwriting profit/(loss) (3)
- **plus** Investment income
- **less** Other management expenses
- **equals** Operating profit before tax (4)
- **less** Income tax expense
- **equals** Operating profit after tax

“Claims incurred” in this profit statement include not only claims paid during the period, but also changes in the provisions for claims incurred but not reported (IBNR) and claims incurred but not enough reported (IBNER).
Any investment portfolio at any time will include some securities with market values higher than their acquisition cost, and some showing unrealised capital appreciation. Where profit reporting is based on historic cost, if profit for a reporting period is disappointing it is very easy to sell a few winners and realise the profit. In the rather less likely situation where business profits are running too well, the insurer has only to sell some losers and reduce the reported profit.

Who would willingly give up such flexibility?

The dangers of this "cherry-picking" approach to profit reporting are very apparent. When business conditions are difficult, several periods of selling winners can leave the insurer over-burdened with losers. Can anyone believe that, if US savings and loan institutions had been required to report their assets regularly at market values, to show their drift towards negative aggregate net worth in the 1970s, they would have expanded so recklessly in the 1980s? Full and prompt disclosure of the effect of risk-taking can affect the behaviour of those who take risks. A financial reporting policy which obscures the risks must be questioned.

Insurance company managers who do not want to give up their ability to manage (or "massage") profit have invented many reasons to defend a system which has served them well in the past. Their arguments include:

- **AASB 1023 can produce sharp fluctuations in insurers' profitability.**
- **Even a marked-to-market balance sheet is out-of-date by the time it is prepared.**
- **Many of an insurer's fixed-interest securities are intended to be held to maturity, so changes in market value are irrelevant to investments which will not be sold.**
- **Security prices fluctuate both up and down; AASB 1023 requires insurers to report losses in one period which might well be reversed in the next period.**
- **AASB 1023 has the potential to influence investment managers by, for example, leading them to avoid investments which could be badly affected by value fluctuations, such as long-term bonds.**
- **Professional investors might understand the AASB 1023 presentation of insurers' financial statements, but that presentation is confusing to individual investors.**
- **Other countries do not require general insurers to report in the way required by AASB 1023.**
- **Compliance with AASB 1023 is too costly.**
- **AASB 1023 earnings, which take unrealised gains on investment into account, are of lower quality than if only realised gains were included.**
- **Mark-to-market accounting has the potential to distort investors' analysis of trends.**

All of these arguments can be countered.

FLUCTUATIONS IN PROFITABILITY

Insurance companies hold substantial amounts of long-term debt securities. When interest rates fluctuate, so do the market values of those securities. If changes in market values are reflected in financial statements, both reported profit and the net worth of the insurer fluctuate.

It is argued that such volatility could give the impression that the company is taking risks, and might reduce investor confidence.

Recall my earlier observation that a general insurance company is properly considered in two parts - the investment of shareholders' funds and the conduct of insurance operations - and consider this feared volatility in this context.

First, as to their insurance operations, general insurance companies are a significant sub-set of the financial services industry. It is a characteristic of this industry that the success or failure of a company is often dependent on how well its management matches, from one side of the balance sheet to the other, maturities, yields, liquidity and other characteristics of its asset and liability positions. A basic principle of managing a financial services organisation is to minimise interest rate and currency risks by matching financial asset investment with financial instrument liabilities.

This "cherry-picking" of assets and liabilities is fundamental to the sound operation of a general insurer. It is possible to forecast with some reliability the timing of payment of outstanding claims. It is then possible to match the outstanding claims liabilities with fixed-interest investments having the same maturity profile. If that is done accurately, then external changes in market interest rates can have no effect on the profitability of the run-off of outstanding claims, because changes in the market values of the assets are precisely offset by changes in the value of liabilities discounted at market-related rates. In that way, the profitability of the insurance operations can be "immunised" against the effect of market value changes.

So, as far as insurance operations are concerned, the volatility of profitability is substantially in the hands of management. The success or failure of insurance company management in controlling volatility by managing financial risks can only be measured by valuing both assets and liabilities at market, as required by AASB 1023. If management is free to alter the value of liabilities, by altering rates of discount, without similarly re-valuing the assets, then financial reporting gives no valid assessment of management's success or failure.

As for the investment return on shareholders' funds, we all know that invest-
ment returns are volatile from one period to the next. Stability of reported earnings is desirable, all else being equal, but if the underlying earnings are indeed volatile, whom does it help to report stability?

Naturally, like all company managers, the management of an insurer seeks to minimise their cost of capital by reporting smooth and growing earnings.

It is no wonder that some directors "prefer" to report earnings on a smoothed basis. But the fundamental question remains: is the function of financial reporting to make life comfortable for management, or is it to report accurately to the users of financial statements? In any view, truth wins over management comfort every time.

In any case, I suspect that investors generally are more concerned that companies should pay smooth and growing dividends than they are to see smooth and growing earnings.

**AASB 1023 BALANCE SHEETS ARE OUT-OF-DATE**

Obviously, even a marked-to-market balance sheet is out-of-date by the time it is prepared and read. Historic cost accounting is a record of market transactions at some time in the past. It is argued that, if balance sheets are bound to be out-of-date in any case, we are better off with old but transaction-related historic cost financial reporting than with the AASB 1023 approach which does not relate to any specific transactions of the insurer.

There are two answers to that:

- many historic cost values are far out-of-date, but we have no way of knowing how far, so proper analysis of financial statements is made more difficult by historic cost accounting; and
- all balance sheets prepared on a market-value basis at a common date are out-of-date to the same extent, and so are comparable for different companies, whereas historic-cost data are never comparable between companies.

**FIXED-INTEREST SECURITIES HELD TO MATURITY**

Many fixed-interest investments made by insurers are intended to be held to maturity, so it is argued that changes in market value in the interim are irrelevant. This argument is not sound. When interest rates rise, the real value of a fixed-interest investment falls, because the economic cost of holding it and receiving a lower-than-market rate of interest, rises. That fall in value is relevant, whether or not the investment is held to maturity.

Those who oppose AASB 1023 must defend the unjustifiable assertion that if they buy a bond to yield 7%, and later find that interest rates have risen so they can buy another bond to yield 8%, the two bonds are worth the same.

Under historic cost accounting, if one insurer buys securities that rise in market value, and another buys securities that fall, both can report the same results so long as neither sells. Indeed, the same security may have several different values in historic cost accounts, if parcels were bought at different times.

Accountants believe in reporting like things as alike. Managers who resist this apparently believe that the purpose of financial reporting is to make management look good. This is financial reporting for the benefit of the reporters, not of those reported to.

**SECURITY PRICES FLUCTUATE**

It is argued that since security prices fluctuate both up and down, insurers should not be required to report a loss in one period which might well be reversed in the next period.

However, security price movements cannot be relied upon to reverse according to any predictable pattern. If they could, we would all be rich.

Those who argue this way show a preference for old prices rather than current prices. But current prices include more information about the value of a security than any old price. To deprive users of financial statements of that information is to use financial reporting to deceive rather than to inform.

**INFLUENCE ON INVESTMENT MANAGEMENT**

Another argument raised against AASB 1023 is that by requiring marking-to-market it influences insurers' investment decisions. It leads investment managers to shun those investments which might be badly affected by market-value fluctuations, such as long-term bonds.

That is a threadbare argument. If the old accounting approach obscures the risks, then it fails to serve its purpose and should be changed. It takes a rather cynical view of the intelligence of users of financial statements to argue that they are better served by reporting out-of-date values of riskier investments than by reporting current values of less-risky investments.

In any case, the argument has no validity in a general insurance company, where proper matching can immobilise a company against fluctuating interest rates.

**PRESENTATION CONFUSING TO INDIVIDUAL INVESTORS**

Around the world, there has been a dramatic increase in recent decades of the share of national stockmarkets held by institutional investors and financial intermediaries. A notable effect of this rise of institutional investors is the growing need for financial reports written for and directed at the professionals who recommend investments to institutions. They are a major primary audience of financial statements.

The needs of individual investors are often cited as a justification for retaining
traditional forms of reporting, such as historic cost. This argument has been used against AASB 1023 in Australia.

It is rather patronising of insurance company management to assume that individual investors are incapable of understanding market-value information. There must be some onus on those who use financial statements to educate themselves in how to read and interpret them.

But even if it were so, it would be scandalous to deprive professional investment advisers, portfolio managers and financial analysts of accurate information on the grounds that this might mislead some unsophisticated investor.

OTHER COUNTRIES HAVE DIFFERENT REQUIREMENTS

One of the most remarkable trends of recent decades has been the globalisation of business and investment, and it is apparent that this trend will continue.

Globalisation introduces the need for common accounting standards in different countries, so that companies may be compared and investment decisions made across national boundaries. The IASC has done a great deal in this area, but much remains to be done.

The desirability of international consistency in financial reporting standards has led opponents of AASB 1023 to argue that, since the accounting standards applying to general insurers in the US and UK do not require marking-to-market, Australia should not be the first to introduce such a standard.

In life it is always easier to lower standards than to raise them, to make the easy choices and avoid conflict by accepting the lowest common denominator.

We who are concerned about the validity of financial reporting and financial analysis should support those who make the hard choices, as the AASB has in regard to reporting of general insurance activities. Let us not say that because the US does not yet have the same standards as Australia, then Australia should change. Rather, let us recognise that in this area we are showing the right way and the highest standards to the rest of the world.

In financial reporting for general insurance activities, “world’s best practice” is to be found in Australia.

COMPLIANCE COSTS ARE TOO HIGH

It should be axiomatic that the benefits of financial disclosures must exceed the cost of their production, although this expectation does not always seem to be met in Australia.

It is sometimes argued by managers of general insurance companies that AASB 1023 fails this test.

It is obvious that it is the owners of a general insurance company who bear the cost of reporting, and who reap its benefits. Managers and directors are the servants of the owners, and the financial reporting process is not intended for the benefit of management.

So the opinions of company management on this matter should be rejected. It is the current and prospective shareholders of an insurer and their professional advisers, not the managers, who should advise the AASB of the proper balance of costs and benefits in the financial reporting of general insurance companies.

LOW QUALITY EARNINGS

Some analysts say that AASB 1023 earnings, which take unrealised gains on investment into account, are of lower quality than if only realised gains were included. In particular, it has been said that dividends should not be paid out which represent profits derived from unrealised appreciation.

I am still waiting for those who argue in this way to explain to me why, if a company holds shares bought long ago at low prices, it can be said to have enhanced the quality of its earnings and the security of its dividends by selling those shares and repurchasing them at current prices.

DISTORTION OF TREND ANALYSIS

Some financial analysts criticise mark-to-market accounting in general because of its potential to distort their analysis of trends.

Trend analysis requires comparable numbers period-by-period. It is argued that historic cost reporting allows analysts to assess changes in an insurer’s position over time, without their having first to remove the effect of market-value changes.

I quite understand why analysts want to be able to examine changes in the insurer’s business which result from transactions, excluding the effects of exogenous changes in market values. Information to permit this should be available.

However, I find it difficult to make the conceptual leap from this legitimate desire for information to the position that general insurance accounts should be prepared on historic cost, when it is known how readily historic cost data can be distorted by management manipulation such as “cherry-picking”.

LOSS RATIOS

Mention of trend analysis brings me to a consideration of loss ratios, which are sometimes thought to show important trends.

To report and compare insurance results in summary form, ratios are often used such as:

- **the loss ratio**, the ratio of net claims incurred to net earned premiums;
- **the expense ratio**, often (but not always) defined as the ratio of acquisition costs and other underwriting expenses to net earned premiums; and
the combined ratio, which is the sum of the loss ratio and the expense ratio.

I have serious reservations about the value of loss ratios for assessing the performance of an insurer taken as a whole, or for comparing different insurers.

In short-tailed classes such as most personal lines of insurance, where there is on average only a fairly short time (typically one year or less) between the receipt of premiums and the payment of claims, premium income and claims payments will be dominant considerations. Interest income on technical reserves will be relatively much larger, because the reserves will be invested for a much longer time. Outstanding claims reserves are typically discounted in Australia (and were so calculated before AASB 1023 was introduced, although the rates of discount used were not always market-related). Hence reported claims incurred for a portfolio of long-tailed insurances will vary over time, depending upon the rate of discount, even if the underlying experience does not alter.

When viewed at the whole-company level, loss ratios are essentially meaningless. A loss ratio of 80 per cent might be unprofitable in a portfolio of short-tailed business, whereas a loss ratio of 110 per cent might be quite profitable in a long-tailed portfolio. Aggregate loss ratios for a whole company will vary from period to period as the relative proportions of short-tailed and long-tailed business alter, and as rates of discount for long-tailed outstanding claims provisions alter.

Loss ratios are also useless for comparing one insurer with another, as they are so much affected by different business mixes between companies.

Consider GIO Australia's overall direct-insurance loss ratios, derived from its reported half-yearly results since its privatisation:

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<th>2H93</th>
<th>1H94</th>
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</thead>
<tbody>
<tr>
<td>Net earned premiums</td>
<td>279.2</td>
<td>291.1</td>
<td>299.5</td>
<td>293.5</td>
</tr>
<tr>
<td>Net claims incurred</td>
<td>188.0</td>
<td>284.3</td>
<td>239.0</td>
<td>187.4</td>
</tr>
<tr>
<td>Loss ratio</td>
<td>67.3%</td>
<td>97.7%</td>
<td>79.8%</td>
<td>63.9%</td>
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These aggregate figures disclose no useful information about the progress of the company's insurance business, because of:

- the inclusion of the run-off of closed classes of business which are no longer transacted, and which affect the periods differently;
- changes in the mix of business in open classes; and
- changes in the rates of discount used for the calculation of outstanding claims provisions.

For meaningful information, investment earnings on technical reserves must also be considered. In the second half of 1993/94, we saw interest rates in Australia increase by almost unprecedented amounts. This was reflected in a negative investment return earned on technical reserves. However, the effect of this negative investment return on the reported profit was almost entirely mitigated by the corresponding increase in the discount rate used to calculate outstanding claims provisions.

This applied to all Australian general insurers to the degree that they match their assets and liabilities. And yet many commentators on insurance results for that period failed to appreciate the nexus between the two sides of the balance sheet.

One heard comments such as: "XYZ Insurance suffered from low investment returns reported during the half-year, due to the reporting requirements of the controversial accounting standard AASB 1023. However, the company reported a very strong underwriting result, which bodes well for future profitability when investment returns are more stable."

Such comments indicate a total failure to understand the profit drivers of the general insurance business.

CONCLUSION

The validity of the efficient market hypothesis is still subject to debate. There are voluminous academic studies supporting the hypothesis, and there is abundant literature pointing out anomalies in the theory.

Wherever we stand on that issue, we can all agree that information affects share prices eventually, and it follows that investment markets cannot be efficient without accurate information. Further, those who lack information, or who cannot understand it, are clearly at a disadvantage in dealing in investment markets.

Information is the lifeblood of financial markets, whether they are efficient or not. So we who are interested in the proper working of financial markets should support any initiative which improves information, and oppose any proposal which inhibits or restricts it.

AASB 1023 provides better information about the operation and profitability of general insurance companies than historic cost reporting, and deserves to be supported against those who find its disclosures inconvenient, uncomfortable or embarrassing.