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Shuffling the Deck Chairs

Exploring the impacts of Gross versus Net Margin on Services Reporting

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Disclaimers

The opinions expressed in this presentation are those of the authors and do not necessarily represent the views of our respective employers.

We have a life insurance focus and don’t cover participating business

We have removed names where possible

Why did we choose this subject?

- An issue that keeps on coming up but the actual technical detail isn't necessarily well understood
- To highlight some of the issues that need to be thought about when producing policy liability numbers for financial statements
- Because the authors enjoy playing around with things and trying to make them break

What this paper is about

- A short history of the standards driving policy liability reporting
- An exploration of issues in Margin on Services Reporting
- Particular focus on gross verses net valuation
- A starting point for people to think more deeply about some of the issues
- This paper is **not** about instructing anybody on what they should do

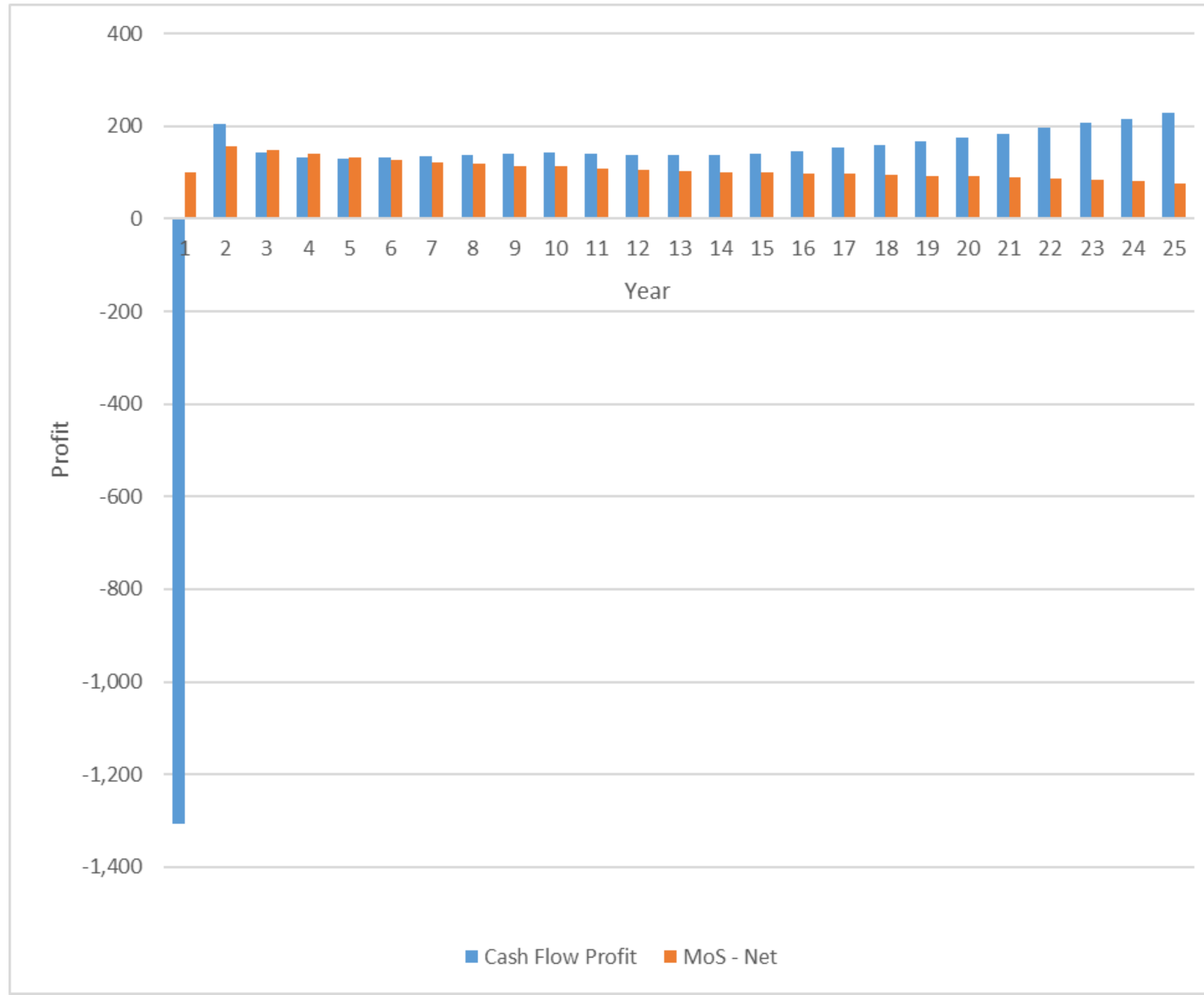
Background

- Margin on Services (MoS) Reporting
  - Introduced in Australia in 1995
  - In NZ FRS 34 applied from balance dates on or after 31 December 1999
  - An attempt to make financial statements more comparable
  - Relates profits to services and releases profits over the lifetime of a policy (smooths?) and removes new business strain (at least in the profit sense)
  - Priority was to get a realistic profit (P&L more important than B/S => NZSA had to introduce a "solvency standard" GN5 to cater for the adulterated B/S)
  - Interesting to note the primacy of the P&L may no longer be de rigueur – is the change in statutory solvency (distributable profit) all that matters now?
  - As the environment has evolved a number of issues have emerged with MoS

Background

- Base model
  - Male non-smoker aged 40 through to age 65
  - Death only with $750,000 SA
  - 80% NZ04
  - 4% after tax discount rate with 28% tax rate
  - $650 initial expenses, $150 renewal expenses and 2.5% inflation
  - 200% initial commission and 7.5% renewal is upfront model (20% level)
  - YRT premium rates from internet
  - Any capital (assets) assumed is just solvency capital of 1‰ catastrophe charge

Background



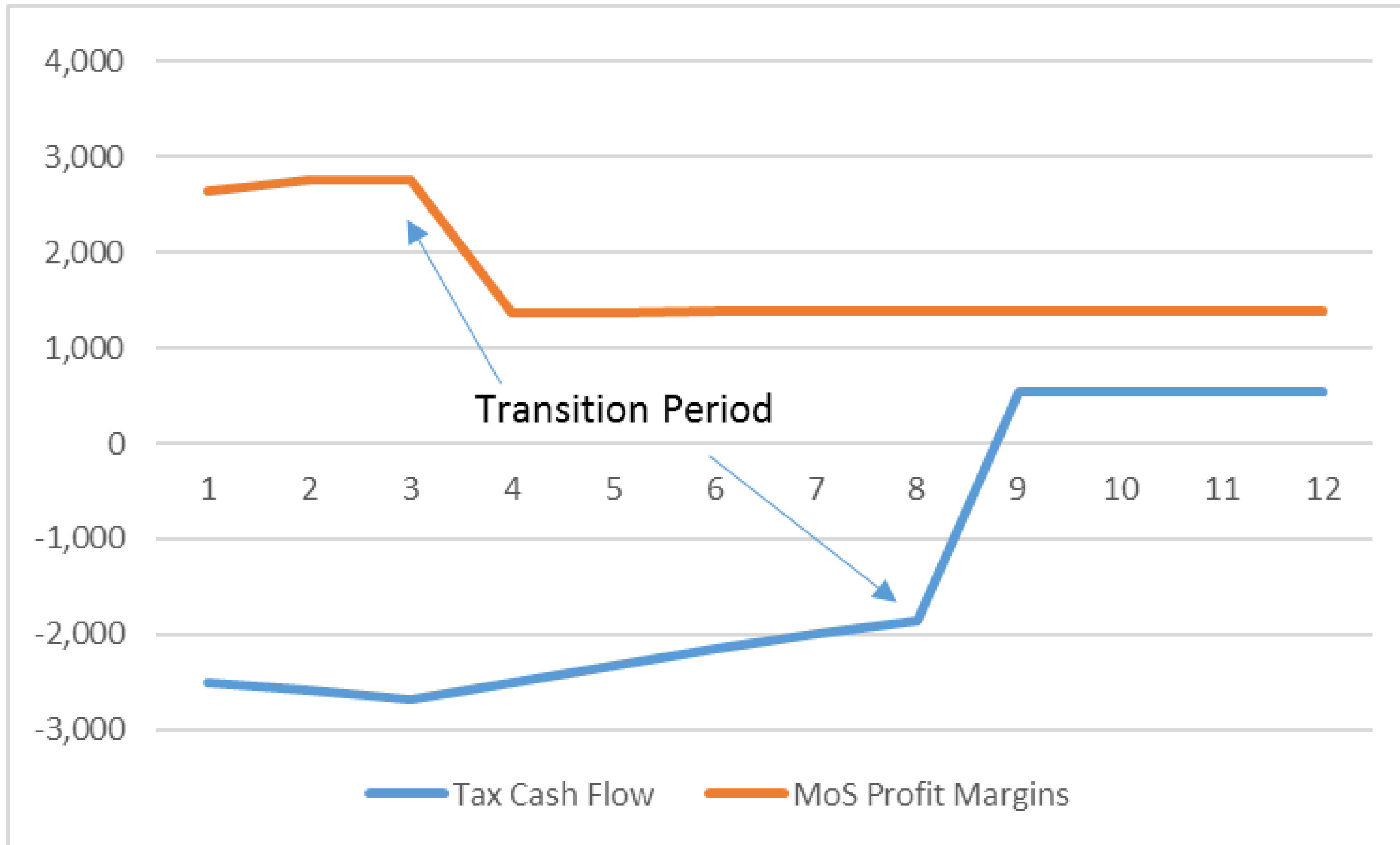
Background

- IFRS 4
  - Introduced in 2004
  - Not really an international approach as it let everybody keep doing what they had been doing
  - Improved disclosure but maybe not in the areas that mattered
  - Was only intended as a temporary measure until IFRS 4 Phase 2
- NZ IAS 12
  - Objective is to prescribe the accounting treatment for income taxes
  - Introduced in 2004 with many later amendments

Background

- ED113
  - Was to clarify the operation of NZ IAS 12
  - Never introduced
- Tax changes
  - Brought into force 1 July 2010
  - Included a transitional period to avoid a shock to the industry
  - But MoS on a net basis didn’t play well with the transitional period

Background

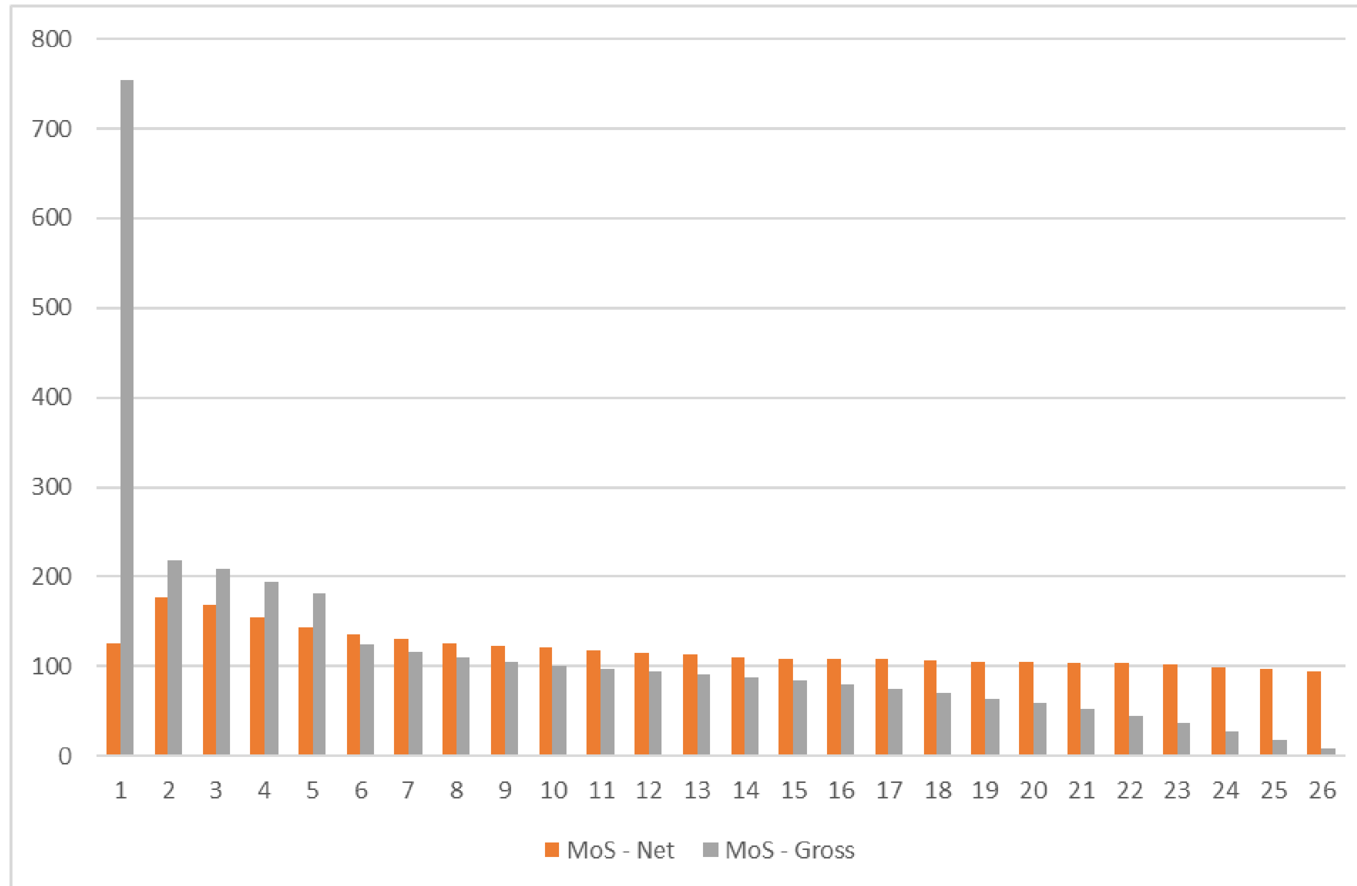


What we found

- Issues with MoS
  - Distorts understanding of issues due to smoothing
  - Starting Amounts were never likely to be accurate
  - Not symmetric
  - Not a measure of profitability
  - Profit emergence is impacted by choice of profit carrier
  - Modelling of cash flows isn't perfect
  - There are many more issues

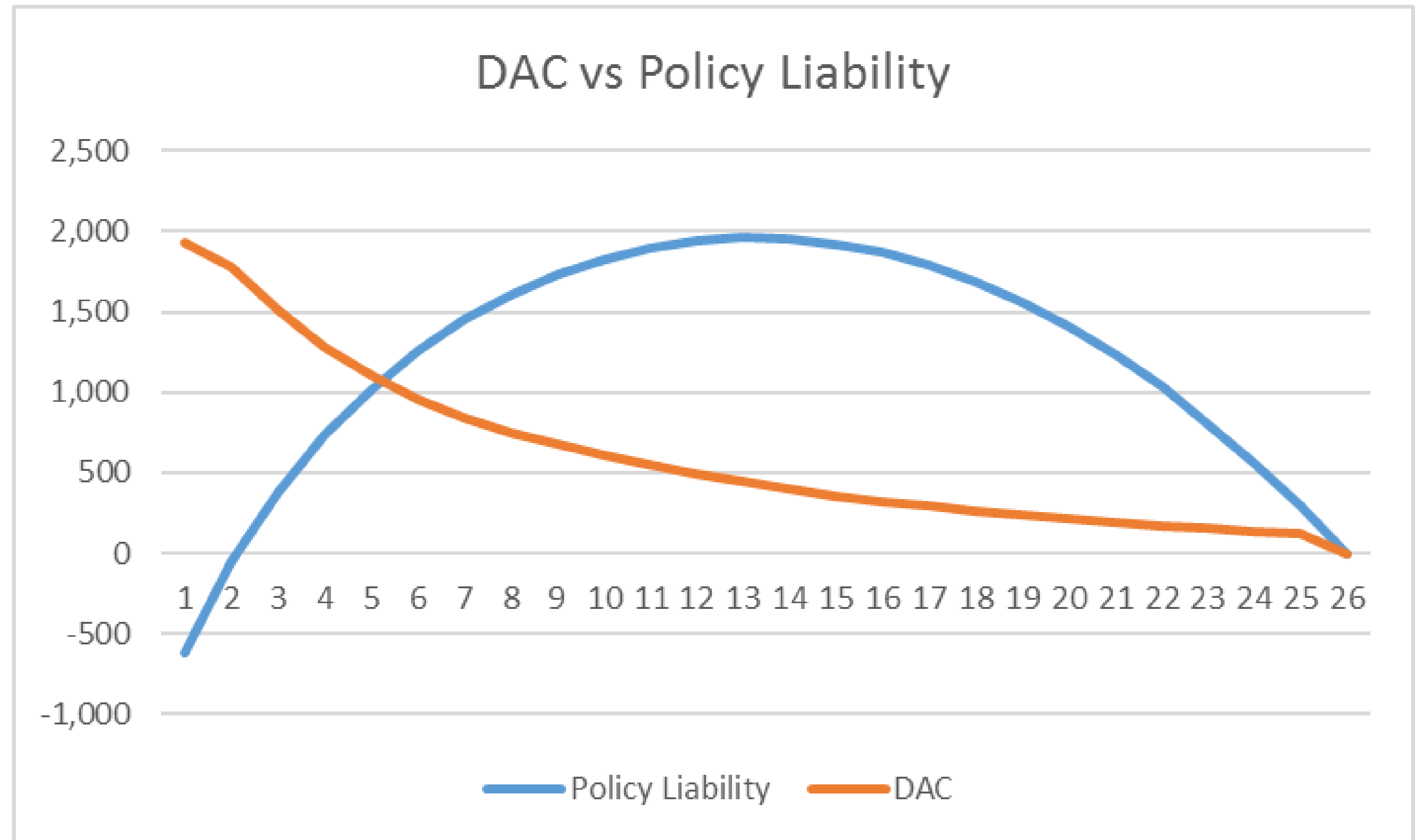
What we found

- Gross of tax on cash flows, net discount rate

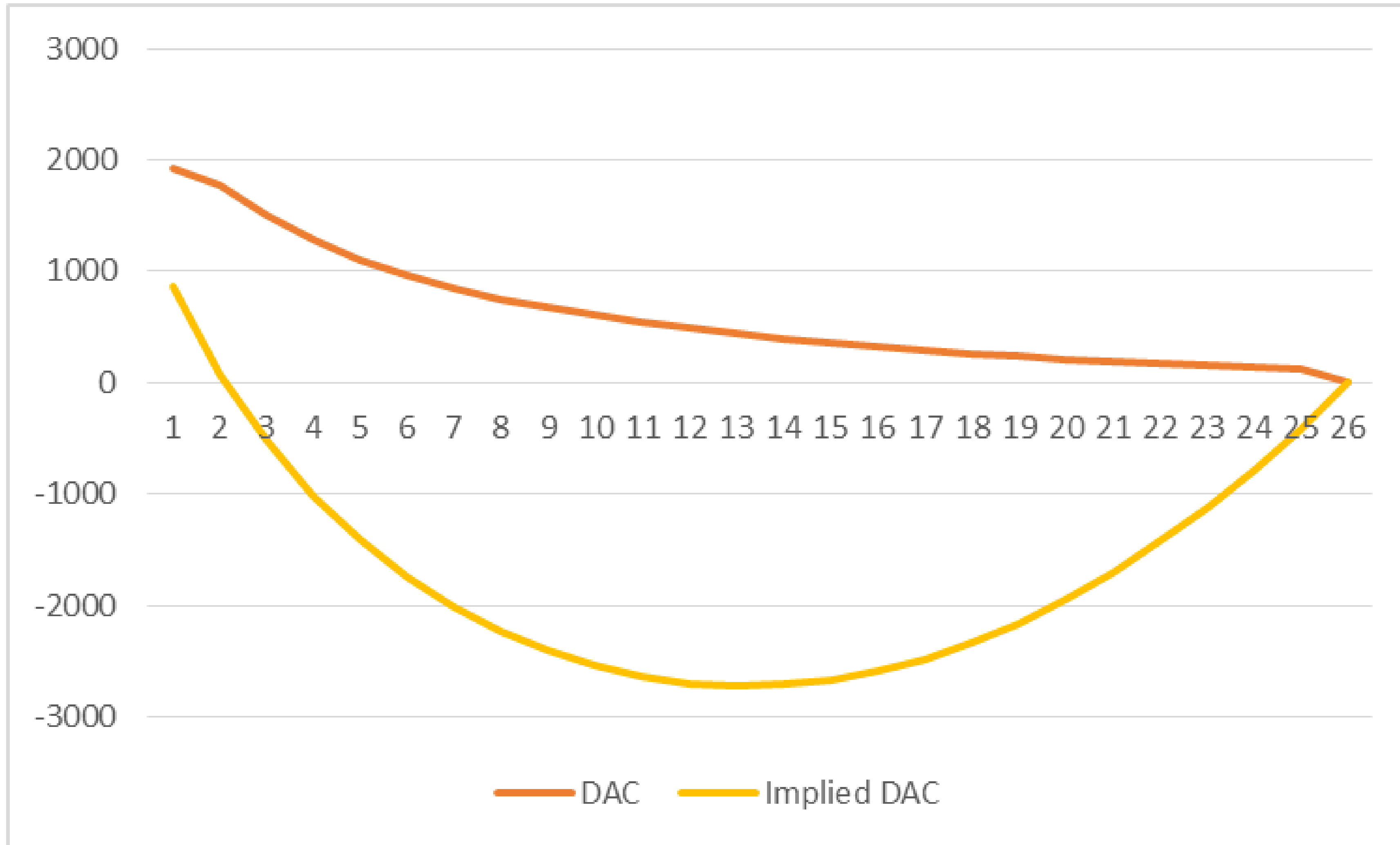


What we found

- Things to consider with implementation (DAC run-off)
- Level premium policy



What we found

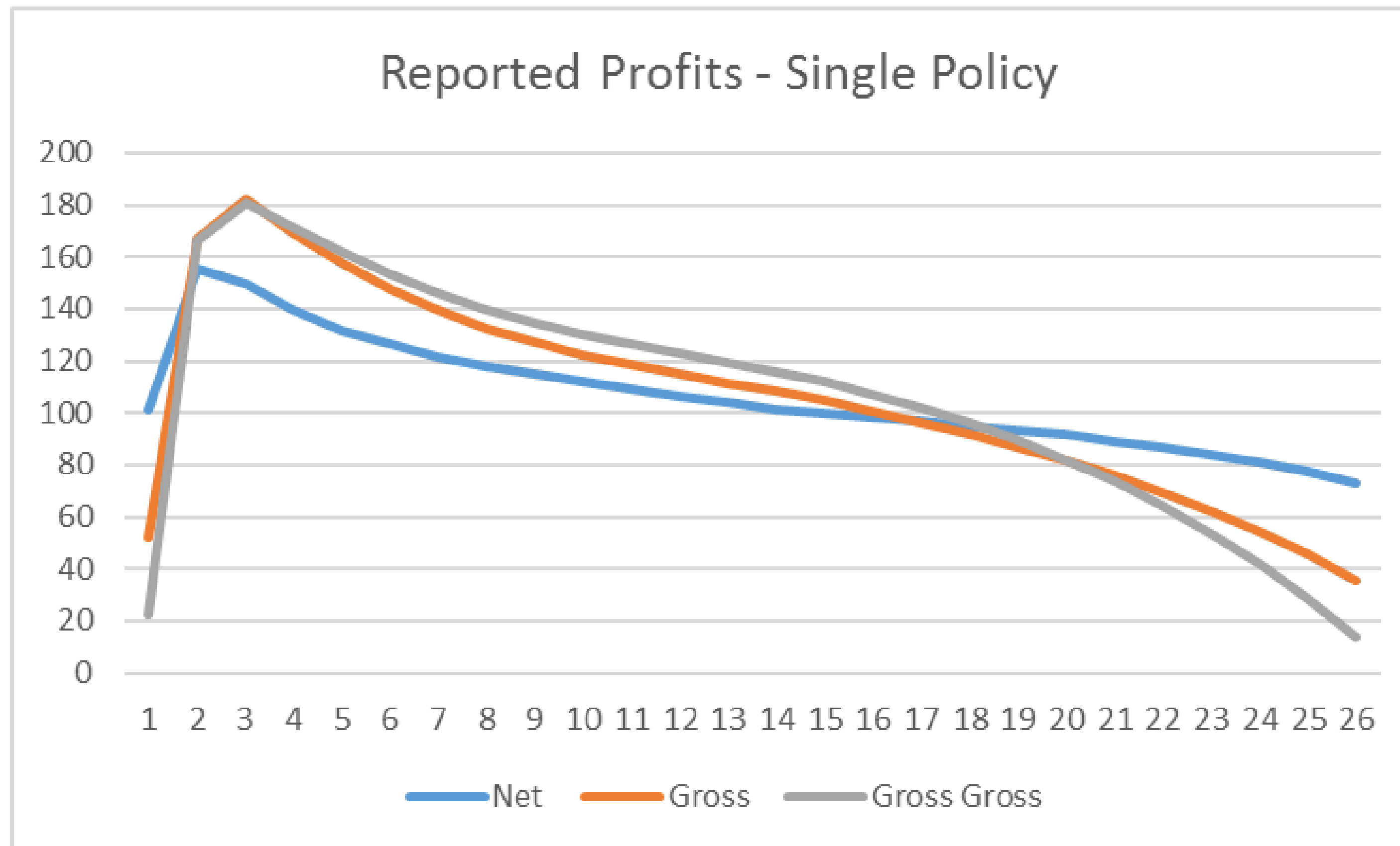


What we found

- NZ IAS 12 doesn’t allow discounted deferred tax
- You can’t infer Deferred Acquisition Costs from the Policy liability
- Need to track DAC explicitly and run-off in a fashion that isn’t discounted
- One possibility is to use the non-discounted profit carrier
- However very few companies have DAC calculated from inception
- If everything else is equal then this DTL would be the same number under both gross and net valuations

What we found

- If the DTL is the same under all methodologies then what differences arise



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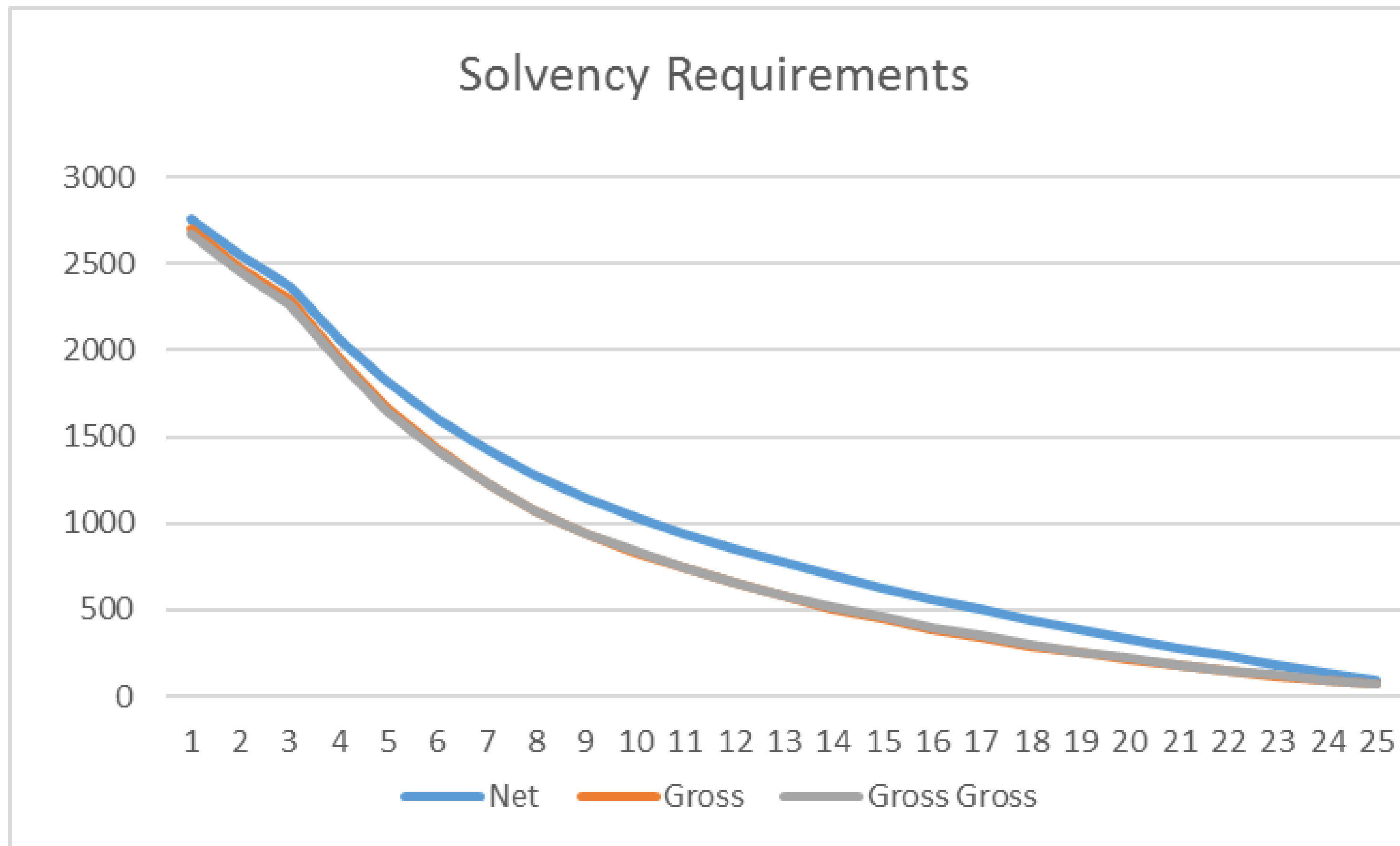

What we found

- Separating out the DTL increases solvency requirements under a strict interpretation of the Solvency Standard
- This is because the IRCC will increase due to the increase in Other Liabilities but the total accounting liabilities haven't changed
- Should a format change in the financial statements result in a changed solvency requirement?
- Could argue that this part of the DTL is really part of the policy liability
- Harder to argue in the case of a gross valuation and calls into question the accounting treatment anyway

Conclusions

- Do accountants understand enough about what actuaries do?
- Do actuaries understand enough about what accounting standards are trying to do?
- Accounting standards are conflicted
- Need to explore these issues more deeply
- The impact of how you treat deferred tax in financial statements isn't really going to materially impact the comprehension of them as there are much bigger problems
- Is all we care about anyway just the "distributable profit" ???

Conclusions