



Accounting Alert

A Focus on Technical Accounting Issues - Issue Number 9

-
- [At last, a life insurance accounting standard](#)
 - [ED 85 - Financial reporting of insurance activities](#)

At last, a life insurance accounting standard

By Graeme Mitchell and Tom Davies

At last, as a result of a joint project between the Institutes in New Zealand and Australia, that has involved extensive industry consultation including both the actuarial and accounting professions, a life insurance accounting standard has emerged.

FRS-34: Life Insurance Business was approved by the Accounting Standards Review Board in November 1998 and applies to all accounting periods ending on or after 31 December 1999.

It is a culmination of many years' research and consultation on both sides of the Tasman, and is perhaps the first tangible product of the Financial Reporting Act's requirement for harmonisation of accounting standards between New Zealand and Australia.

The FRS-34 in New Zealand is identical to AASB-1038 in Australia, other than for some minor accommodation to allow for the impact of the different regulatory regimes.

Scope of the Standard

The standard applies to each life insurer and to each group which includes a life insurer. A life insurer is defined as an entity operating under the Life Insurance Act 1908 and similar entities operating outside New Zealand. As a result friendly societies are excluded from the scope of FRS-34. It is anticipated that friendly societies would be "financial institutions" and would therefore be required to comply with the requirements of FRS-33: Disclosure of Information by Financial Institutions.

The standard prescribes that all assets of life insurers must be measured at net market values, and that all their liabilities must be measured at net present values.

It also requires that life insurer entities recognise in their financial statements (and groups containing life insurers recognise in their consolidated financial statements), all assets, liabilities, revenues, expenses and equity regardless of whether they are regarded as relating to policyholders or to shareholders. This particular issue has been the subject of debate for some time. It revolves around whether it is appropriate to gross-up the figures in the financial statements on a line by line basis by including the assets, liabilities, revenues and expenses relating to the policyholder funds in which, it could be argued, the shareholders have no beneficial interest.

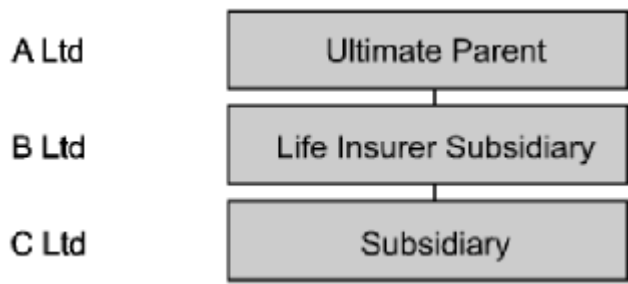
Value of Interests in Subsidiaries

Another feature of the standard is the requirement for a life insurer that is a parent entity of a group, to recognise and disclose in its consolidated financial statements as a separate asset, any excess of the net market values of interests in subsidiaries over the net assets of those subsidiaries. Note that this will include goodwill generated within the life insurer's subsidiaries, since the date of acquisition, in addition to the carrying value of purchased goodwill. (Where there is a deficiency of the net market values of interests in subsidiaries over the net assets of those subsidiaries, any change must be recognised and disclosed as revenue or expense.)

This requirement is consistent with the earlier-stated requirement for all assets to be measured at net market value. This effectively continues for life insurers the existing industry practice of allowing the recognition of internally generated goodwill to the extent this is recognised in the subsidiaries' market values. In this way the standard provides for inter-generational equity between policyholders in the life insurer parent.

Where the parent is not a life company, it must consolidate its life company subsidiaries, using normal consolidation procedures. Although it would not be able to recognise any internally generated goodwill in the life company itself, it would recognise goodwill revaluations made by the life company subsidiary in assessing the market values of its own subsidiaries. These gains or losses would flow through to the consolidated financial statements of the ultimate holding company.

This is demonstrated in the following diagram:



C Ltd's internally generated goodwill would be recognised in the consolidated financial statements of B Ltd and A Ltd.

Premiums and Claims

The standard requires premiums and claims to be separated on a product basis into their revenue, expense and change in liability components unless the separation is not practicable or the components cannot be reliably measured. There is a transitional provision allowing the disclosure of premiums and claims as if they were all revenues and expenses, until the reporting period ending on or after 31 December 2001.

In the development of the standard there has been significant debate on this issue, the benefits to be gained from making the split being weighed against the costs of adjusting information systems and processes to make it possible. Time will tell the extent to which there is a significant shift in the extent of detail presently disclosed.

Investment Revenues

The standard requires returns on all investments controlled by a life insurer to be recognised as revenues. This is a continuation of existing practice.

Perhaps the most significant feature of the standard in terms of additional requirements is the requirement for all liabilities of a life insurer to be measured at net present values, with a description of key parameters for measuring policy liabilities. FRS-34 introduces greatly increased prescription regarding the manner in which such liabilities are to be measured and recorded.

In Australia and New Zealand the methodology most commonly used to meet the requirements for a more realistic measure of liabilities is the margin on services (MoS) method. This methodology impacts significantly on the recognition of profits.

Under MoS:

- Profits are recognised as the services underlying the insurance contracts are provided, and are released from measured income.
- Provisions (policy liabilities) are set up to cover payments to policyholders in future years.
- Profit over the life of the policy is the cash profit.
- MoS methodology does not change total profit, just the years in which the profit is recognised.

Cash Flow	Inc/(Dec) in MoS Liabilities	MoS Profit
-----------	---------------------------------	---------------

Profit				
Year 1	(100)	(150)	=	50
2	300	200	=	100
3	200	75	=	125
4	(100)	(125)	=	25
	\$300	\$0	=	\$300

Profit = Movements in Assets – Movements in Liabilities

= Premiums + Investment Income – Claims – Expenses – Movements in Liabilities

or Cash Flow – Movement in Liabilities.

= Best Estimate Liability + Value of Planned Profit Margin

Policy Liability

= bel + vpm.

bel

= Value of Future Claims + Value of Future Expenses - Value of Future Premiums

Previously the profits would have been recognised on a cash flow basis only. Under MoS, profit over the life of the policy is still the same, but timing in each year is different due to the recognition of movement in the liability under the policy each year.

The fundamental principles of MoS accounting are:

- Progressive profit recognition as services (risk, funds management, etc) are provided. (Expected or planned profit).
- In addition to the planned profits, MoS allows for the recognition of experience profits and losses. (ie difference between actual and assumed experience).
- Valuation of policy liabilities according to "best estimates assumptions" of expected future net cash flows and the net present value of future profit margins. These assumptions are reviewed at each reporting date. In most cases, changes in assumption will only affect future profits and not profit for the year (with the exception of capitalised losses).
- Valuation of invested assets at market with variations reflected in the statement of financial performance.

MoS profit reporting details a number of elements:

- Planned profits, being the expected profits from in force business at the beginning of the period, and new business written in the period.
- Experience profits or losses, being the difference between actual results and planned profits at the end of the period.
- The return on the net assets backing shareholder funds (ie return earned over the period on capital in excess of the MoS policy liabilities).
- Capitalised losses, being the net present value of expected future losses capitalised in the period.
- Capitalised loss reversals, being the write back of capitalised losses in the period in which it is recognised that the initial expectation was too conservative or operating performance has improved, and credited to the statement of financial performance in the current period.

As can be appreciated from the above, under MoS accounting there is a significant amount of work to be done by actuaries in not only designing products at the outset but each year comparing actual experience versus planned experience in terms of each of the areas of premiums, claims, expenses and profit.

Conclusion

Accountants and auditors now need to work even closer with actuaries in reporting the results of insurance business and it is perhaps not surprising that FRS-34 has taken so long to emerge from the long consultation between the professional bodies representing actuaries and accountants.

That there has been agreement thus far is an achievement in itself and the reporting of life insurance business is the better for it.

Graeme Mitchell and Tom Davies are partners of Deloitte Touche Tohmatsu and are based in the Wellington office.

The Institute of Chartered Accountants of New Zealand has issued an exposure draft dealing with insurance and reinsurance activities other than life insurance activities, namely ED-85: Financial Reporting of Insurance Activities.

ED 85 - Financial reporting of insurance activities

The exposure draft has been largely drafted from the Australian standard, AASB1023: Financial Reporting of General Insurance Activities, but with a few amendments to ensure that there is some consistency with FRS-34 and to adapt the document to New Zealand conditions and standard setting terminology.

The main purpose for issuing the exposure draft is to respond to the New Zealand Government's intention to introduce competition to the government operated Accident Compensation Corporation (ACC) Employer's Account insurance (accident insurance). The proposed legislation would deem entities registered to write accident insurance to be "issuers" in terms of the Financial Reporting Act 1993. Such entities will be required to file financial statements with the Registrar.

The proposed standard deals with 'insurance activities' rather than limiting its application to 'insurance entities'. Therefore any entities that are writing general insurance will need to comply with this standard with respect to the financial reporting of general insurance activities.

The proposed ED-85 is not applicable to life insurers who will need to comply with FRS-34.

Main Features of the proposed standard

Premiums

Premiums are to be recognised in the Statement of Financial Performance in accordance with the pattern of risk or if the result is not materially different, on an even basis over the period of the policy.

Claims

Liabilities for claims are to be recognised when the events giving rise to the claims occur. Until the event arises, no obligation exists and therefore no liability should be raised. This will mean that entities will not be allowed to create liabilities ("reserves") for catastrophes. Liabilities for claims will be measured as the present value of the expected future payments. The expected future payments will include amounts in relation to unpaid reported claims, claims incurred but not reported, adjustments in the light of the most recently available information for claims development and claims incurred but not enough reported, and costs that the insurer expects to incur in settling these claims.

Levies and Charges

Where an insurer is merely acting as agent for the government, any levies such as fire service levy which are collected from policyholders on behalf of the government as insurer will not be recognised as revenue and the amounts paid to the government would not be recognised as expenses. However, those levies and charges that are imposed on the insurer by government authorities represent a cost to the insurer of earning premium revenue, and should be recognised as expenses on the same basis as the recognition of premium revenue.

Reinsurance

Reinsurance premiums ceded are to be recognised as an expense of the ceding entity in accordance with the pattern of re-insurance service. Reinsurance premiums received are to be recognised by the accepting entity in the same manner the direct insurer recognises premium income.

Acquisition costs

Acquisition costs incurred in obtaining and recording insurance policies will be recognised as assets where it is probable that they will give rise to premium revenue that will be recognised in future reporting periods. These would be amortised over the period of expected benefits. Impairment rules will apply with regard to these deferred costs.

Investments and other assets

Investments integral to the entity's insurance business are to be measured at net market values as at the reporting date. Any changes in the net market values will be recognised in the statement of financial performance as revenues or expenses in the reporting period in which the changes occur. For investments without active and liquid markets, the methods used to determine their net market values must be disclosed. Land and buildings must be accounted for as investments, whether the buildings are partly or wholly owner-occupied or fully leased.

The rationale for this is that all property is normally regarded by an insurer as an investment. Owner-occupied property is therefore not to be accounted for as an operating asset. The exposure draft does not propose to permit the use of market value accounting for other assets. While this is not consistent with FRS-34 for life insurers, it is consistent with AASB-1023 on which the exposure draft is based.

Submissions on this exposure draft are to be sent to Ms April Mackenzie, Institute of Chartered Accountants of New Zealand, P O Box 11-342, Wellington by 31 January 1999.

| [Services](#) | [Industry Groups](#) | [Locations](#) | [Contact Us](#) | [Search](#) | [Hot Topics](#) | [Publications](#) | [Our Firm](#) | [Sponsorship](#) | [Global Firm](#) | [Careers](#) | [Home](#) |

© 2001 Deloitte Touche Tohmatsu
[Legal Disclaimer](#)