

# **Holistic Financial Reporting - Update 2003**

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**IAAust BIENNIAL CONVENTION 2003**



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# What Profit do you Want?

## *Alternative Reporting For Same Experience*

|  | Conservative <sup>#</sup><br>Bank<br>Unrealised<br>Gains | Conservative <sup>#</sup><br>Bank gains<br>realised <sup>*</sup> | Aggressive<br>Bank Defers<br>Expenditure | Life Company<br>Defers<br>Expenditure<br>Realised or<br>Unrealised<br>Gains |
|--|--|--|--|---|
| Income                                     | 100  | 100  | 100                                      | 100   |
| Less<br>Expenditure                        | (90)   | (90)   | (90)                                     | (90)  |
| Add back<br>Deferred Expenditure           | -  | -  | 20                                       | 20  |
| Reported Profit before<br>Investment Gains | 10   | 10   | 30                                       | 30  |
| Investment Gains                           | -  | 10   | -  | 10  |
| <b>Total Reported Profit</b>               | <b>10</b>  | <b>20</b>  | <b>30</b>                                | <b>40</b>   |

*\* gains realised to create a "profit".*

*# fully expends all costs.*

# Definition of Holistic Financial Reporting

**“A financial reporting system which covers the income, expenditure and changes in value of all aspects of an entity.”**

**Implies - Realistic and Informative**

# Definition of Profit

**OXFORD DICTIONARY: “FINANCIAL GAIN FROM THE USE OF CAPITAL”**

Capital = 1,000; used to purchase listed shares

| <u>Cash flow – sale</u> |         | <u>Cash flow – no sale</u>          |         |
|-------------------------|---------|-------------------------------------|---------|
| Purchase                | (1,000) | Purchase                            | (1,000) |
| Dividends               | 40      | Dividends                           | 40      |
| Sale                    | 1,100   | Value                               | 1,100   |
| Financial gain          | 140     | Financial gain<br>to reporting date | 140     |

**REPORTED PROFIT = “FINANCIAL GAIN UP TO REPORTING DATE”**

**NEED TO BE REALISTIC/INFORMATIVE DEMANDS “MARK TO MARKET” UNREALISED GAINS**

# Accounting for Goodwill

## INVESTMENT IN FINANCIAL SERVICES COMPANY

| BANK BUYS |                |  | 100 | BANK INVESTS<br>AND BUILDS UP BUSINESS |  |  | 10  | LIFE COMPANY INVESTS<br>AND BUILDS UP BUSINESS |  |  | 10  |
|-----------|----------------|--|-----|--|--|--|-----|--|--|--|-----|
| Y1        | NTA            |  | 10  | NTA                                    |  |  | 10  | NTA  |  |  | 10  |
|           | Goodwill       |  | 90  |  |  |  |     |  |  |  |     |
|           | Total          |  | 100 | Total                                  |  |  | 10  | Total  |  |  | 10  |
| Y5        | NTA            |  | 10  | NTA                                    |  |  | 10  | NTA  |  |  | 10  |
|           | Goodwill       |  | 90  |  |  |  |     | Excess of MV                                   |  |  | 90  |
|           | Total          |  | 100 | Total                                  |  |  | 10  | Total  |  |  | 100 |
| Y5        | Profit to date |  | 0   | Profit to date                         |  |  | 0   | Profit to date                                 |  |  | 90  |
|           | Sale for       |  | 105 | Sale for                               |  |  | 105 | Sale for                                       |  |  | 105 |
|           | Profit         |  | 5   | Profit                                 |  |  | 95  | Profit   |  |  | 5   |

# Accounting for Goodwill

## INVESTMENT IN FINANCIAL SERVICES COMPANY

|    |                     | BANK OWNS | LIFE COMPANY OWNS |
|----|---------------------|-----------|-------------------|
| Y1 | Cash profit         | 6         | 6                 |
|    | Revaluation profit  | -         | 4                 |
|    | <b>Total Profit</b> | <b>6</b>  | <b>10</b>         |
| Y2 | Cash profit         | 6         | 6                 |
|    | Revaluation loss    | -         | (4)               |
|    | <b>Total Profit</b> | <b>6</b>  | <b>2</b>          |

### *Management performance - How to reward?*

Achieving cash profit may have been “easy”

Revaluation profit/loss may have resulted from sharemarket movements.

Alignment with shareholders' interests? Life company numbers better base

Actual v budget results, but reduce impact of external influences?

# Company owns Another Company

## - Consolidation of Profit

|                               | BANK OWNS LIFE<br>COMPANY | LIFE COMPANY<br>OWNS LIFE<br>COMPANY | HOLDING LIFE COMPANY<br>TRANSFERS BUSINESS<br>TO SUBSIDIARY LIFE<br>COMPANY |
|-------------------------------|---------------------------|--------------------------------------|---|
| Parent Company                |                           |                                      |   |
| - Cash Profit                 | 20                        | 20                                   | -   |
| - Revaluation                 | -                         | -                                    | -   |
| Subsidiary Company            |                           |                                      |   |
| - Cash Profit                 | 6                         | 6                                    | 26  |
| - Revaluation                 | -                         | 4                                    | 11  |
| <b>Reported Profit</b>        | <b>26</b>                 | <b>30</b>                            | <b>37</b>   |
| <b><i>Holistic Profit</i></b> | <b><i>37</i></b>          | <b><i>37</i></b>                     | <b><i>37</i></b>  |



# Fair Values

**Market Values; Current Listed Share Price; Current Share Price if Listed.**

**Use of Option Pricing in Market.**

**Stochastic Methods where no market and Assets/Liabilities asymmetric (Guarantees, Options).**

**Liabilities: Immediate Option Value (e.g. Surrender Value); Separate offsetting Asset = Fair Value of effect of other options (e.g. Value of expected Future Distributable Profits)**

**Measurable? - Every thing of perceived value must have a financial value.**

**Measurement methodology - will be developed, if need arises.**

# Financial Reporting - Current Issues

- Executive Options
- General Insurance Accounting
- Reinsurance Accounting
- Accounting for Goodwill
- Accounting for Leases
- Solvency/Capital Adequacy
- Superannuation Liabilities
- Life Company Owning Another Life Company
- IAAust Initiative

# Holistic Financial Reporting - Principles

- Objective
- Primary Principles
- Secondary Principles

# **Holistic Financial Reporting - Objective of Financial Statements**

## **IASB's Objective:**

**“To provide information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions.”**

## **IASB's Further Note:**

**“The economic decisions that are taken by users of financial statements require an evaluation of the ability of an enterprise to generate cash and cash equivalents and of the timing and certainty of their generation.”**

# **Holistic Financial Reporting - Suggested Primary Principles**

- **Ensure that Profit Reported realistically represents “Financial Gain from the use of Capital”;**
- **Encompass all aspects of the entity’s business;**
- **Be capable of universal and consistent application across entities and businesses;**
- **Demonstrate the strength of an entity’s ability to continue to trade.**

# Holistic Financial Reporting - Suggested Secondary Principles

- Apply a fair value to all assets and liabilities of the entity;
- Recognise that “fair value” is always measurable, albeit that probabilities may need to be applied to a range of future outcomes, and that stochastic methods will need to be employed where the range of future outcomes is asymmetrical;
- Distinguish between the nature of the different forms of assets and liability, and report the components of Reported Profit generated by their changes in value;
- Facilitate an evaluation of the level of nature of future profits.

# Quality of Profit

- **Distributable - Now/Future**
- **Financial Statements Information**
- **Other Historical Information**
- **Forecasts**

# Holistic Profit Between Time<sub>0</sub> and Time<sub>1</sub>

ASSETS minus LIABILITIES at TIME<sub>1</sub>

less

ASSETS minus LIABILITIES at TIME<sub>0</sub>

equals

INCREASE IN NET ASSETS

All Fair Values. Amounts adjusted for Capital Movements and Dividends.

Assets include Value of Entity's Own Business



# Holistic Profit - Suggested Breakdown

| <u>ASSETS</u>   | <u>LIABILITIES</u> | <u>ASSETS – LIABILITIES</u><br><u>(NET ASSETS)</u> |
|---|--------------------|--|
| Cash  | -                  | Cash   |
| Other current   | Current            | Other Net Current Assets before Provisions         |
|   | Provisions         | less Provisions                                    |
| Non Current Tangible  | Non Current        | Net Non Current Tangible Assets                    |
| Intangible  | -                  | Intangible Assets                                  |
| <b>PROFIT BETWEEN TIME<sub>0</sub> AND TIME<sub>1</sub></b> |                    | <b>= INCREASE IN ABOVE NET ASSETS</b>              |

# Quality of Profit - Suggested Breakdown

| SOURCE/COMPONENT   | GENERAL COMMENTS  |
|--|---|
| Increase in Cash   | Distributable   |
| Increase in Other Net Current Assets, before Provisions          | Likely to be distributable at a later date;<br>Subject to reasonable provisioning   |
| (Increase in Provisions)   | Is level sufficient; or is it too conservative?   |
| Increase in Net Non Current Tangible Assets, before Revaluations | May be distributable at a later date;<br>Depends on liquidity and need in Business  |
| Revaluations   | Unrealised Gains – Ultimately distributable;<br>Subject to market movements   |
| Increase in Intangible Assets                                    | Non Distributable; will become distributable if/when converted to cash the future; Value may be volatile; Subject to market movements |

# Financial Reporting - Future Aims

## IAAust

- **Comment on Accounting Standard Drafts**
- **Comment on Current Issues**
- **Refine Principles**
- **Develop Strategy**

## Other

- **Refine Presentation**
- **Refine Fair Value Methodology**
- **Develop Concepts of Capital and Capital Adequacy**
- **Research dividing line between Tangible and Intangible Assets**