Institute of Actuaries of Australia – Convention 2003

HOLISTIC FINANCIAL REPORTING – UPDATE 2003

by Geoff Dunsford

SYNOPSIS

I have defined Holistic Financial Reporting (HFR) of an entity as "A financial reporting system which covers the income, expenditure and changes in value of all aspects of the entity".

This paper reviews the issues raised, and principles set out, in the author's 1999 paper on this subject, having regard to the reception received at the Darwin Convention and financial reporting developments since that time.

The paper notes the mixed responses to the thrust of the International Accounting Standards Board (IASB) towards "Fair Value Accounting". However, it notes the call for more realistic and transparent financial reporting following various financial disasters and "confessions" of doubtful accounting treatments. This must mean that "Fair Values" of assets and liabilities will continue to be the long term focus for future financial reporting development.

Issues arising from the development in Australia of life companies owning other life companies under the "Mark to Market" accounting requirements for assets under AASB 1023, are noted.

A reasonable extension of the principles of HFR is to include in the Balance Sheet a Value of the Business of the entity/company. This is arguably consistent with the developments above.

The IAAust's response to the IASB Exposure Draft on Expensing Executive Options and other share based instruments (ED 2), is noted. Some of the implications for expensing Executive Options in a "Fair Value" accounting environment are discussed.

An updated suggested format for the Statements of Financial Performance and Financial Position are presented. This incorporates distinctions between distributable profit and other changes in the amounts and values of assets and liabilities involving varying degrees of "quality" of profit, together with a focus on the capital requirements of the business of the company.

The paper notes the initiative of the IAAust to attempt to take leadership in those areas of financial reporting where actuarial approaches are likely to provide more realistic and informative results. Part of the discussion on the paper at the Convention will address suitable principles which should be adopted in pursuance of this initiative, and consider the extent to which these are consistent with the HFR principles in the paper.

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1 INTRODUCTION

1.1 Previous Paper

My paper "Holistic Financial Reporting" was presented to the Darwin Convention in June 1999.

At that time, I had concerns that financial reporting (both for life insurance companies and companies generally) presented highly misleading pictures of both their financial performance and their financial position. In particular, I drew attention to a range of possible life company profit results achievable, simply through varying business structures.

The development of the International Accounting Standard for Financial Instruments (IAS 39) flagged that some significant improvements were possible. In addition, the concepts of realistic (e.g. mark to market) valuations of assets were beginning to receive a degree of acceptability through Australian Accounting Standards AASB 1023 (for General Insurers) and AASB 1038 (for Life Insurers).

The paper attempted to anticipate likely developments, and to provide input to the thinking, on the general subject of realistic presentation of company results.

My recollections of the discussion sessions at that Convention, and re-reading of the summary, indicated a modicum of support for the general thrust of the paper. However, there was significant concern over the interpretation of the inevitable volatile profit outcomes, when these include changes to fair/market values of assets and liabilities.

1.2 Developments since 1999

Since that time there have been a number of significant developments.
These include:

- Commitment by the Australian Accounting Standards Board to adopt generally International Accounting Standards from 2005;

- A number of companies becoming financial disasters, both in Australia and overseas, where accounting techniques were found to be faulty, and /or the financial reporting was misleading.

- Issue of a draft accounting standard for the expensing of Executive Options and other share based instruments, which is unlikely to achieve the aims expected by shareholders and other observers.

These developments have spurred me to review the previous paper and write this update, as a further exercise towards the achievement of a clear picture of a company's financial performance and position – i.e. Holistic Financial Reporting.

1.3 Issues Previously Addressed

The previous paper addressed the following accounting issues and inconsistencies:

- the ability of a company to present different profit results depending on group structure, and through the realisation of gains from the sale of assets on a selective basis;

- the frequently ignored difference between Reported Profit and Distributable Profit;
- the need to recognise capital invested in the business of the company separately from other capital in the company itself;
- meaning of Return on Capital;
- problems with the "matching" (of revenues and costs) accounting concept;
- cost of Equity Capital, and economic value added (term registered by Stern Stuart);
- need for fair/ "mark to market" value accounting – for both assets and liabilities;
- value of "goodwill";
- concept of separation of "shareholders' fund" and "business fund" to accommodate the (goodwill) value of the company' own business and accounting for the cost of equity capital;
- measurement of management performance;
- elimination of need for deferral of recognition of costs under fair/market value environment;
- elimination of need for provisions against asset values under market value environment;
- elimination of need to make provision for future expenditure when it has been taken into account in determining the (goodwill) valuation of the business;
- breakdown of profit into "distributable" and "revaluation";
- volatility of total profit – and subjectivity in determining fair/market values;
- focus of tax authorities on accounting profit;
- fundamental lack of economic distinction between subscribed capital and retained profits – and between return of capital and dividends.

It also anticipated:

- Further development of financial reporting; and
- Involvement of the actuarial profession in a variety of ways.

1.4 Current Activity

There does not appear to have been any Australian actuarial paper on the subject of general financial reporting in the last 4 years.

However, a number of actuaries are involved in dialogue:

(i) with the International Accounting Standards Board (IASB) with regard to the development of IAS 32 and 39 for Financial Instruments;

(ii) with the IASB and the International Actuarial Association with regard to the development of an International Accounting Standard for Insurance Contracts.

(iii) with the Australian Accounting Standards Board with regard to various matters relating to AASB 1023 and AASB 1038;

(iv) with accounting bodies through the Actuarial/ Accounting Liaison Group with regard to various accounting matters;

(v) with the HIH Royal Commission: the IAAust provided a submission in July 2002, in response to specific questions; and

(vi) with the IASB, through a submission in response to their ED 2 on the Expensing of Executive Options and other share based instruments.

In addition, some discussions on specific financial reporting issues have been conducted at seminars and other meetings organised by IAAust. These included particularly the presentation of, and discussion on, “Life Accounts – No Longer Standard”, a paper by Martin Hickling and Richard Lyon, in September last year.

1.5 Current Update

This update is structured by:

(a) reviewing Holistic Financial Reporting Principles

(b) briefly summarising the events, progress, and other inputs to financial reporting developments over the last 4 years, with personal commentary;

(c) reviewing each of the issues raised previously and suggesting a suitable position;

(d) introducing new relevant issues and suggesting a suitable position;

(e) providing updated suggested proforma Holistic Financial Statements; and

(f) noting areas where further development may be pursued, or ought to be.

2 HOLISTIC FINANCIAL REPORTING PRINCIPLES

2.1 Previous Paper

In my previous paper, I suggested that the first thing that needed to be done was to restore Profit to its proper meaning, ie "Financial gain from the use of Capital" (from the Oxford Dictionary). Since "financial gain" clearly includes increase in the value of the entity as a result of the use of capital, marking assets and liabilities to fair/market value must be an essential component.

I defined Holistic Financial Reporting as "A financial reporting system which covers the income, expenditure and changes in value of all aspects of the entity". (I did not include the adjective "realistic", as I considered that this applied automatically when the focus is all aspects of the entity).

It is probable that this definition could be better expressed. However, I did not want to constrain the definition by referring to "revenue accounts" and "balance sheet", as these concepts may change or be replaced by others. So I have not changed the definition, but would be happy to hear from others on this subject.

Certainly though, Holistic Financial Reporting should meet the objective of Financial Statements generally. According to the IASB's *Framework for the Preparation and Presentation of Financial Statements* "the objective of financial statements is:

"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".

It goes on to 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".

2.2 Need for Principles

What is needed now is a set of principles.

Accounting standards are being continuously developed and refined. These focus on the treatment of transactions and more generally on the valuation of assets and liabilities. There is a trend towards the idea of adoption by all countries of international accounting standards. The clear and desirable objective is consistency of accounting treatment around the world. This will have enormous benefits for trade and international understanding of commerce.

At the same time the standards are unlikely to address the central issue raised in this paper – clear financial reporting presentation – other than by more extensive disclosure.

This is not the preserve of the accounting standards boards only. A range of parties should have an interest in this. The IAAust should certainly be amongst these, particularly because of our training in the "value of the future" issues which are receiving an increasing focus.

In practice, the IAAust has taken a decision to attempt to take leadership in those areas of financial reporting where actuarial approaches are likely to provide more realistic and informative results. As part of this initiative, it is intended to develop a suitable set of principles. Those below could be considered as a first draft for discussion.

2.3 Suggested Principles

My suggested principles for achievement of an ideal Holistic Financial Reporting system (i.e. one which covers the income, expenditure and changes in the value of all aspects of the entity) are:

- 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;
- Apply a current fair value to all assets and liabilities of the entity;
- Recognise that fair value is always measurable, albeit that it is sometimes uncertain and 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 asset and liability, and report the components of Reported Profit generated by their changes in value;
- Facilitate an evaluation of the level and nature of future profits; and
- Disclose fully all assumptions made and calculation methodology adopted.

The remainder of the suggestions in this paper are simply a way of implementing the principles at the present time. It is expected that these would change periodically to accommodate changing language and views generally.

2.4 Fair Value

Both the concept and an appropriate definition of "fair value" have been the subjects of much debate.

It is not the purpose of this paper to pursue this debate. Accordingly, the suggested principles above refer specifically to "a current (lower case) fair value", rather than "(upper case) Fair Value" which may be defined in Accounting Standards.

My only comment is that the method(s) of determination of "a current fair value" need to be consistent with the Objectives of Financial Statements above and the Principles for Holistic Financial Reporting.

3 OBSERVATIONS OVER LAST 4 YEARS

3.1 International Accounting Standards

Revised Exposure Drafts for proposed amendments to IAS 32 – Financial Instruments, Disclosure and Presentation, and IAS 39 – Financial Instruments, Recognition and Measurement, were circulated in June 2002.

For the purposes of the Financial Statements, financial instruments are subdivided into a number of classes, focussing on those that are deemed tradeable and those that are not. An entity will be able to choose which category to place any financial instrument. Only those deemed tradeable will be valued at "Fair Value". The opportunity for choice will lead to a reduced capability to compare Financial Statements of entities, and objections have been submitted by the International Accounting Standards Committee of the IAAust, amongst others. It seems likely that objections will also be raised by regulators.

The revised Exposure Draft therefore represents, to some extent, a backward step from the thrust of earlier developments. It reflects a decision to defer consideration of the application of fair value to all assets (eg property) and liabilities, to 2009.

However, the revised Exposure Draft for amendments to IAS 32 proposes that fair values for all financial assets and liabilities be required to be disclosed in Notes to the Financial Statements "in a way that permits them to be compared with the corresponding carrying amounts in the balance sheet". Adoption of this should ensure that fair values will continue to grow in importance.

In this regard it is worth noting that the definition of "Fair Value" proposed is "the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arms length transaction".

This is close to the definition of Market Value adopted for AASB 1023 and AASB 1038.

Market Value in the International Accounting Standard is reserved for "amounts obtainable on the sale, or payable on the acquisition of, a financial instrument in an active market".

3.2 IAS Exposure Draft for Insurance Contracts

An Exposure Draft of an International Accounting Standard for Insurance Contracts is due to be released in the near future.

It is anticipated that this will introduce the concept of fair value of policy liabilities. This is expected to be based on that in the Draft Statement of Principles (DSOP) which has been developing over a number of years.

3.3 AASB 1038

This is the first accounting standard in Australia specifically for life insurers. It became effective from the first reporting date after 31 December 1999.

Amongst other things:

(i) it confirmed previous practice in the industry required by the regulator to adopt Market Values of all assets and include Revaluation Profits in its Operating Profit.

(ii) it abandoned the concepts of "matching" revenue and expenses in the revenue account – albeit that these are the basis for determining profit margins under the (Margin on Services) calculation of policy liabilities embraced by the Standard.

(iii) it adopted updated definitions of assets, liabilities, revenue and expenses. These are along the lines of the "Statements of Accounting Concepts", proposed for introduction about 10 years ago but abandoned at that time following discussion with interested parties. Having regard to the nature of this paper it is worth restating them here :

assets	means future economic benefits *controll*ed by the *entity* as a result of past transactions or other past events
liabilities	means future sacrifices of economic benefits that the entity is presently obliged to make to other entities as a result of past transactions or other past events
revenues	means inflows or other enhancements, or savings in outflows, of future economic benefits in the form of increases in assets or reductions in liabilities of the entity, other than those relating to contributions by owners, that result in an increase in equity during the financial year
expenses	means consumptions or losses of future economic benefits in the form of reductions in assets or increases in liabilities of the entity, other than those relating to distributions to owners, that result in a decrease in equity during the financial year.

3.4 Life Company owning another Life Company

A structure of a "holding" life company owning the main operating life company (and other subsidiaries) in a financial services group, has been adopted by a number of such groups. Under this structure the Revaluation Profit arising from the increase in the market/ appraisal value of the subsidiary life company is included in the parent life company's Operating Profit.

This makes it clear that recognising Revaluation Profits is considered by some as a desirable development. One assumes this is the ability to present greater realism in the results, rather than cynically simply to increase Reported Profit!

In practice, a major reason for the development of this structure was to ensure that the reporting provided a suitable reflection of the purchase of a major business with a significant goodwill component. Traditional accounting demands an annual write-off of the goodwill element over up to 20 years. Life Insurance accounting offers the opportunity for the financial statements to reflect greater realism.

However, the size, impact and volatility of the Revaluation Profits arising from this development have caused some concern to analysts and other observers. This is partly due to the concept only being included in life company results, rather than those of the whole of a banking/ financial services group. Also, different groups have adopted different structures which has led to inconsistency and confusion. It is worth noting also that the increase in the *parent* life company's market/appraisal value of its *own business* is not recognised in the determination of Revaluation Profit under the Standard.

One approach would be for *all* financial services businesses, including banking, to be valued each year, and the Revaluation Profit included in the Operating Profit for *all* such businesses. While education would still be required, at least there would be greater consistency of reporting.

3.5 Statements of Financial Performance and Financial Position

Following International Accounting Standard developments, these statements have replaced the Revenue/Profit and Loss Account and Balance Sheet, for the purpose of returns under the Corporations Law. Prescribed formats apply.

Perhaps, subtley, by introducing the clearer and more direct expressions - "Statement of Financial Performance" and "Statement of Financial Position" - this is an attempt at encouraging more realism in the results, as well as consistency.

I have adopted these expressions in this paper.

3.6 Financial Disasters

Over the last year or so there have been a number of companies becoming financial disasters – for example, Enron, WorldCom in the USA, HIH and OneTel here in Australia.

In each of these cases there was a focus on the financial reporting – particularly just before the disaster became manifest.

Arguably, a major issue was the "quality" of Reported Profit. At Enron, expenses were "capitalised", with significant doubt as regards their recoverability from future profits. In the case of HIH, amounts received or expected to be received from reinsurers were included in profit without proper recognition of the impact of the related future payments to the reinsurer.

Observers can rightly be circumspect if major components of Reported Profit are increases in intangible assets (like deferred costs) or reinsurance receipts without corresponding liabilities.

It is not suggested that greater disclosure would have prevented the disasters, as it is alleged that fraudulent activity was a major contributor in each case. However, it is possible that the extent of each disaster would have been less if observers and regulators had been more informed with regard to the components of Reported Profit.

The disasters also exposed another significant area of weakness – a lack of demonstration of the ability to continue in business. Accounting Standards generally are weak in this regard, with the focus simply on Assets exceeding Liabilities – regardless of their nature. In the case of HIH, lack of an up-to-date General Insurance Solvency Standard at the time of reporting also contributed.

One move which would have enormous benefit would be to introduce a reasonable minimum test for the ability to continue in business – say a Capital Adequacy test. This need not demand the same margins as for guaranteed financial services products. However, there could be a simple focus on the level of liquidity, as well as the ability to cover liabilities with tangible assets.

Including this information in the Balance Sheet (Statement of Financial Position) would appropriately focus both observers and industry participants.

It is unfortunate that this paper and general moves towards realism in accounting should be occurring against the backdrop of these disasters. There are likely to be more calls for greater conservatism in financial reporting, than realism.

Yet shareholders will not be well served with greater conservatism. In the past this has simply allowed takeovers by experts who have better (or inside) knowledge.

We must continue the move towards greater realism. This demands greater disclosure and a genuine attempt to present the financial picture of the company as clearly as possible.

3.7 Quality of Profit

The value of any equity is related to the expectation of future profits.

One guide to future profits is the most recently reported Operating Profit. Indeed, because of the importance of the profit number for this purpose, accounting standards have attempted (through the matching of revenue and expenses principle) to make the published profit a good guide to future profits.

This in turn has been developed further by management, taking advantage of flexible provisioning, as well as cost deferral, to the extent that many observers consider that reported Operating Profit has become a managed number.

Analysts have carried out their work from the extensive Notes to the Financial Statements. However, in many instances the issues regarding the quality of profit numbers remain obscure.

The analysts have frequently asked for more information. These calls have become louder following recent financial disasters.

Quality relates to both the likely maintainability of the current level of profits into the future, and the amount that is distributable. In this regard, the degree of maintainability will be affected by the extent to which the profit arises from business operations and the extent to which it arises from other shareholder activity – like investment income.

Quality also relates to the extent to which the profit is distributable. In my previous paper, I suggested a breakdown of profit into "distributable" and "revaluation".

"Revaluation" was used as a catchall expression to cover all aspects of profit arising from changes in the value of tangible assets and the amounts of intangible assets. The demand for the ability to be able to assess the "quality" of profit requires a breakdown of this item.

3.8 Fair Value of Insurance Policy Liabilities

The latest draft of the DSOP (Draft Statement of Principles) focuses on a "single view" of the value of life policy liabilities.

The suggested approach is broadly equivalent to:

	Current Termination Value
plus	Capital Adequacy Margins
less	Embedded Value, with adjusted net worth = 0
	i.e. Value of Future Distributable Profits (from business in force)

While the overall result may be acceptable, it hides the existence of the intangible asset:

"Value of Future Distributable Profits"

A more transparent presentation is to show these items explicitly:

	Current Termination Value	matched to
plus	Capital Adequacy Margins	Tangible Assets
	Shareholder Equity	matched to
		Value of Future Distributable Profits

It is understood that this "dual view" approach had hitherto been rejected, as this would place an internally generated goodwill item on the Balance Sheet. This is anathema to many accountants.

My view is that there should be no problem with such an item, provided its impact on both the statements of financial performance and financial position is shown clearly. Certainly, development of a fair value structure should ultimately lead to placing a value on internally generated goodwill.

In any case, it seems unlikely that the value of bank deposits would be shown at other than their face value (or current termination value in the case of fixed interest rate deposits). Logically therefore, realism in the balance sheet demands a (goodwill) Value of Future Distributable Profits to be shown.

Accordingly, it should be seen as necessary to allow for "Value of Future Profits" from banking products as well as life insurance products, for consistency under the "Fair Value of Liabilities" principles.

3.9 Expensing Share Options

3.9.1 Principles

Granting of options to buy a company's own shares in the future at a current (or discounted) price has been a popular method of rewarding senior management.

As with the direct issue of shares as bonuses, the granting of options is (currently) not treated as an expense – merely noted as a (small) dilution of (other) shareholders' interests.

Clearly, the granting of options to purchase a company's own shares at a price that is likely to be lower than the then market price is a cost to existing shareholders.

At the time of writing my previous paper this was not considered to be a major issue. However, more recently, their use has increased in Australia. In the USA the use of options is extensive – partly because of tax benefits, as well as avoiding a bottom line impact.

Various papers have been written to establish the value of share options. An agreed suitable basis must be reasonably close to determination.

It has been suggested that, for a number of companies in the USA, allowing for the cost of options granted would have converted a healthy reported profit into a healthy reported loss.

In the USA, Europe and Australia, regulators and other parties consider that there is a need to expense share options.

3.9.2 Accounting

The G4+1 Position Paper prepared for the International Accounting Standards Committee in October 2000 concluded that expensing options should occur on the Vesting Date.

This was modified in the IASB Exposure Draft (ED 2), issued in November 2002. The conclusion reached was that the valuation of the options should occur at the Grant Date, and that the amount should be expensed over the period up to the Vesting Date.

To actuaries, both of these approaches are inadequate.

A liability is established at the Grant Date, and a provision should be made in the accounts based on an appropriate valuation. This would allow for the probability of:

(a) any performance hurdles being met, and

(b) survivorship of the executive to the vesting date.

At each balance date after the Grant Date the provision would need to be adjusted to take account of a revaluation based on the then share price, other updated facts and revised expectations. This would be carried out at all balance dates up to the one prior to the Exercise Date.

On the Exercise Date the shares would be bought by a trust on the open market or created via a new issue, with the exercise price value paid by the executive and the excess funded by the company as an expense of management. The cost would be offset against the provision so that only the difference will represent an expense in the "Exercise" year. However, over the period from the Grant Date up to the Exercise Date, the correct total cost will have been expensed – which is surely what shareholders and analysts would expect.

To my mind, despite the need for revaluations each year - likely to be a non-trivial exercise with a large range of Options with different Grant, Vesting and Exercise Dates and pricing, in force at any time - this procedure is the only realistic accounting approach where shares are not bought until the Exercise Date.

Of course the company may wish to immunise itself against the potential rise in the share price prior to the Exercise Date. It can do this by arranging for the trust to buy shares in advance.

The IAAust made a submission to the IASB with an accompanying press release in April 2003, commenting on the proposals and making most of the above points.

3.10 Property Leases

When a company takes a lease on a property, it creates a liability in respect of the future rents it has agreed to pay.

Historical cost accounting does not cope well with leasing contracts. Reporting Profit on a current income less current expenses basis results in a rationalisation that future income will cover future costs. Hence the leasing liability can be ignored. (Alternatively, the company may rationalise that if it didn't want the accommodation at a future date, it could always re-let it).

Mere disclosing of a lease contract as involving expected future expenditure, sits uncomfortably with auditors and analysts. (Arguably, it is also a problem for lessees who have "guaranteed" income matched to uncertain future expenses). If the market for the company's business is difficult, it may be that the lease will become an important issue. In a market downturn sub-letting may be a problem.

It would be so much better if specific future income could be incorporated in the disclosure note, to match the specific future expenditure.

Better still though, is simply to place a value on all future expected income less outgoings from the business in the Balance Sheet (Statement of Financial Position) – ie the Value of the Business.

Since the rents payable are included in this calculation, leases then cease to be an issue – both for the lessor and the lessee.

For capital adequacy purposes it would seem desirable that provision should be made for sufficient tangible assets to be available to cover any run-off of leases.

This is not currently addressed in either the solvency or capital adequacy standard for life insurers. It could possibly be considered covered in the case of the Shareholders' Fund Management Capital Standard; this refers to the "best estimate" valuation of liabilities. Such a valuation could be simply the present value of the future rents until the first break/ expiry date.

3.11 Superannuation/ Pension Fund Liabilities

At a reporting date, a company's obligation to its employees' superannuation/ pension fund will fall into a number of categories, eg:

(i) statutory, i.e. minimum benefits arising from Superannuation Guarantee requirements;

(ii) other accrued commitments – eg. contribution undertakings up to the reporting date;

(iii) special guarantees of benefits; and

(iv) statement of intention with regard to future contributions to cover both past and future benefits.

Commitments in respect of (i) and (ii) above are clearly current liabilities of the company at the reporting date.

Commitments in respect of (iii) may also generate the need for a provision at the reporting date. They could for example, apply to a select group of individuals treated as special cases, and/or to pensions in payment.

Under US Accounting Standard FASB 87, a deficit in the fund of "accrued" liabilities against assets, is required to be recognised over a suitable period as a liability of the company. An International Accounting Standard (IAS 19) is being developed along these lines, (but with faster recognition of funding deficiencies). This could be in place by 2005, and at this stage it is expected that Australia will adopt International Accounting Standards by that date.

It is possible that, under the accounting standards, a deficit in the fund and a liability of the company could exist as a result of accommodating (i), (ii) and (iii).

However, fundamentally, this should not apply to (iv). The purpose of the company making a statement under (iv) would simply be to provide some comfort to superannuation fund members. Though the accounting standards take the view that the company is liable for benefit liabilities accrued for service to date, this is arguable from a legal viewpoint. If the company is not in a position to fund accrued benefit liabilities, and terminates its participation in the fund, then there may be little practical alternative for the trustee but to reduce accrued benefits. In reality therefore, there should be no liability shown on the company's balance sheet.

Under Holistic Financial Reporting, expected future payments to the fund would be included in the future expenses component when determining the value of the company's business – i.e. the value of the future distributable profits. To the extent that an accounting standard had required reporting of an amount as a liability which was covered by such payments, then, to avoid double counting, this amount would be added to the "Value of Business" asset in a "Holistic Financial Reporting Balance Sheet".

Consequently it would be unusual for changes in superannuation/ pension fund liabilities to be a specific factor in determining "Holistic" Profit for the year. However, they may influence the breakdown of its components.

3.12 General Insurance Accounting

The HIH Royal Commission has questioned whether better accounting processes would have resulted in at least an early warning of potential problems.

The Institute of Actuaries of Australia's submission (July 2002) answering specific questions in this regard, indicated clearly that the General Insurance Accounting Standard AASB 1023 in conjunction with normal accounting principles failed to reflect a realistic position in a number of ways.

In general, application of the "net present value of cash flows/ market value" approach to the valuation of assets and liabilities, incorporated in APRA prudential standards, would have assisted. However, these were only introduced in 2002.

A major issue for the Accounting Standards is the obligation to recognise the value of the liability created by the payment of a premium over the period of cover. This is required by the "Matching" principle where revenue should be recognised as the service is performed.

Where an inadequate premium is collected on the last day of a financial year, virtually the full amount of the premium is equated to unexpired risk and has no net effect on the Balance Sheet.

Realistically, the liability created by the contract for which the premium was paid should be calculated and included in the Balance Sheet. Then, if the premium is inadequate, the immediate loss can be correctly reported.

The inadequacies of the accounting concepts of “Matching”, “Recognition” and “Measurement” when applied to General Insurance are explained in the submission. Commentary on these concepts is included in this Paper in Section 4.8.

3.13 Reinsurance Accounting

Fundamentally, reinsurance exists to reduce an underwriter’s risk. The corollary of this is that it reduces expected rewards.

Where the reinsurer simply accepts a share of the risk, normal accounting simply records reverse cash flow items and reports net premium income, together with net expenses and claims, ie after deduction of reinsurance recoveries.

Two main issues have arisen:

1. The uncertainty of outcomes and the spanning of the one year risk period over two financial years have led to the development of reinsurance structures which can recognise a company’s net profit or loss over the two years in different ways. In the case of losses, deferring the main pain to the second year can (appear to) be advantageous.

2. The opportunity for manipulation of results arising from (1) above has led to the development of reinsurance contracts where there is <u>no risk transfer</u> at all. They are designed simply to transfer an amount of profit or loss in the ceding company, from one year to another.

There is nothing illegal in the design of these products. (At worst, contracts where there is no transfer of risk should perhaps not be called “reinsurance” if that term is understood to mean “transfer of risk”).

The problem is with the accounting. It is essential that the impact of reinsurance contracts on future cash flows is taken into account in determining the company’s financial position.

In its attempt to attribute “profit” to particular years in a fair way, the current accounting standards appear to fail. No doubt some improvements could be made.

However, as indicated in the Institute’s HIH submission, measures needed are:

(a) require all reinsurance transactions to be treated in the same way as the corresponding direct insurance transaction; and

(b) require all assets and liabilities to be determined on a “net present value of cash flows basis”.

The suggestion under (b) above is equivalent to a fair/market valuation of the assets and liabilities.

This will ensure a more realistic balance sheet.

It is accepted though, that “profit” measured as the difference between two balance sheets will be volatile and often difficult to explain.

This issue is discussed in general terms in Section 4.10.

4 REVIEW OF ISSUES

4.1 Market Values

The previous paper drew attention to a number of accounting issues and consistencies which could be resolved simply by introducing:

(1) marking assets and liabilities to fair/market values, and

(2) including a value of the company's own business on its balance sheet

These issues and inconsistencies included:

- the ability of a company to present different profit results depending on group structure, and through the realisation of gains from the sale of assets on a selective basis;
- meaning of Return on Capital;
- problems with "matching" (of revenues and costs) accounting concept;
- cost of Equity Capital and economic value added;
- value of "goodwill";
- measurement of management performance; and
- elimination of need for

  (a) deferral of recognition of costs;

  (b) provisions against asset values; and

  (c) provisions for future expenditure.

  All can be eliminated under a fair/market value environment.

Events over the last 4 years have led to a, perhaps reluctant (by some parties), acceptance that some "mark to market" valuation activity is required. In particular, a more diligent approach to ensuring that the value of all intangible items can be supported has become necessary – to reduce the incidence and size of disasters.

In any case, the gradual move of International Accounting Standards towards "fair values" of assets and liabilities will inevitably result ultimately in the relegation of the matching of revenues and expenses concept to history.

4.2 Meaning of Profit

While the desirability of fair/market valuation support for getting the balance sheet right has been accepted, this has not extended to profit and loss account impacts.

The focus is still on reporting a profit number which is intended to have some "maintainable" medium term significance.

The volatility of the bottom line profit from accommodating fair/market value changes is considered to be a major problem for many observers. In particular these include analysts whose job involves attempting to place a value on company shares. The traditional methodology of applying a (traditional) price earnings ratio to Reported Profit, cannot be applied when the latter includes a "Revaluation Profit".

It is worthwhile noting that "Distributable" Profit continues to receive minimal focus in the press – despite its importance to shareholders. In addition, the various items contributing to Reported Profit vary in their "quality" – i.e. soundness in the numbers as well as likely maintainability. My suggestion in relation to this position is to ensure that public reporting gives strong focus to the breakdown of the Reported Profit into the contribution from each of the main areas as follows:

Contribution to Profit from :	**Quality**
Cash flow from Operations	Top
less	
Cash required to be retained in the business	
equals	
Distributable Profit	Top
Increases in Other Net Current Assets	
less	High, but note Provisions can be "managed"
Increases in Provisions	
Increases in Net Non-Current Assets, before Revaluations	High, but deferred.
Revaluations	If Revaluations only on sale, or writedown, could be conservative
Increases in Intangible Assets	Can be "managed"
Total Revaluation Profit	Uncertain

In particular, by separating out increases (decreases) in provisions and intangible assets, this could assist in assessing how much Reported Profit has been "managed". The observer may not appreciate the level of strength or weakness in these items, but at least they can receive separate focus from the "real money" profits. Desirably also, the amounts of intangible assets are broken down into the different types.

It would, of course, help if all tangible assets were marked to market value. However, at least the separation of this item from cash profits from operations assists appreciation of the breakdown between "normal" business profits and one-off profits.

In recognition of the demand for analysis of quality of profit, I have included the above breakdown in my updated "Holistic Financial Statements" proformas in section 5 of this paper.

4.3 Value of Business

As was seen in section 3.4 (Life Company owning another Life Company), realistic (as well as Holistic) financial reporting demands an assessment of the Value of the Company's own Business. This is clearly an asset and should therefore be included in the Financial Statements, and would avoid the inconsistency that arises if the business is, or is not, a subsidiary.

4.4 Separation of Shareholders' and Business Accounting

One of the ways inclusion of the Value of the Business can be accommodated in a clear manner is to separate the accounting for "Business" transactions from the accounting for matters of purely "Shareholders' interest, into separate Funds.

The Shareholders' Fund can then focus only on Shareholder accounting elements:

- money invested in the Business (as opposed to being retained for other/ future activity);
- assets held in respect of Shareholders' money not invested in the Business;
- Profit/ Return of Capital distributable from the Business;
- the Value of the Business eg, the value of future distributable profits.

This approach was advocated in my previous paper and still appears to have merit – for the same reasons.

4.5 Management Performance

In absolute terms this is simply:

Increase in Value of Business (excluding Capital movements)

Plus

Distributed Profit.

Sometimes this is referred to as "Value Added", but it is simply equal to "Profit" under Holistic Financial Reporting.

Economic Value Added (as defined by Stern Stuart) is the excess of (Adjusted) Profit over the Cost of Capital.

Under Holistic Financial Reporting, a new form of Economic Value Added could be considered, ie (HFR) Profit less the Cost of Capital.

For management performance measurement purposes, it is the "Value Added" or "Economic Value Added" in excess of Budget/ Business Plan that is probably most relevant.

4.6 Taxation

In my previous paper I drew attention to the penchant of the tax authorities to tax accounting profit. This proved to be borne out in practice under the new life insurance tax regime introduced in July 2000. This included (for the first time) taxing the accounting profit of Risk/ Protection Business – despite the fact that the distributable profit was well short of this in most cases.

In moving to profit reporting within a "mark to market" environment, there is a danger that the tax authorities will want to tax unrealised gains (ie revaluation profits), where these are included in Reported Profit. This is clearly unreasonable as there may be no cash available.

It is possible, however, that the "up front" breakdown of Reported Profit into distributable and other elements may assist the process of persuading the tax authorities that they should only tax cash flows.

4.7 Subscribed Capital and Retained Profits

Fundamentally, there is no economic distinction between these items. Within a class of shares each shareholder has an entitlement to the same specified share of each.

However, distributions out of Retained Profits are called dividends and distributions of capital are called "Returns of Capital". For as long as these are taxed differently there can not be any attempt to eliminate the difference in accounting for these items.

4.8 Matching, Recognition, Probable and Reliable Measure

The Accounting concept of "matching" requires, inter alia, recognition of revenue as the service for which it is received, is provided.

"Recognition" of a transaction requires "reliable" measurement. In the case of a future transaction the requirement is that it should be "probable" and be reliably measured. Probable is effectively defined as at least a 50% chance.

If a transaction is not "recognised" it must be ignored – ie assumed that the probability of its occurrence is less than 50%! (In practice for insurance contracts this requirement is usually ignored for practical reasons. There is a concern however, that in special circumstances it could be invoked in order to provide a misleading picture).

At their heart these concepts are the result of the whole basis of accounting as providing a historical record of transactions.

Over the years this has (been) broken down. But the breakdown has been piecemeal - which is where problems of inconsistency are created, and exploitation of inconsistencies is considered to be "financial engineering".

At a balance date, internally generated goodwill has a value, but is ignored – largely because it represents a future benefit – and in any case it cannot be measured reliably. But if the company is sold, the purchaser will include the goodwill component in the price paid as an asset in the Balance Sheet.

To stop companies within a group creating goodwill through inter-group sales, such transactions are ignored on consolidation at group level. However, there is nothing to stop companies arranging for third party purchases and sales to crystallise goodwill items – and indeed to recognise realised capital gains.

Fundamentally, these Accounting Concepts are now inappropriate to meet shareholder needs in the modern world, and need to be revisited

The "fair value" accounting approach under the draft International Accounting Standards provides such an opportunity, and the ability to eliminate these inconsistencies. However, it cannot just be "grafted" on to existing concepts. It has to replace some of them.

Focussing on the Balance Sheet, with all assets and liabilities marked to market (or at least fair) value, facilitates production of a "realistic" picture of the position of the company.

However, this needs to extend to internally generated goodwill items in order to obtain holistic consistency, and there are indications that some accounting bodies are baulking at this development. This is the basis for the argument that Fair Value of Policy Liabilities should be a single number, "hiding" the deduction of the embedded value "goodwill" item from the Current Termination Value. (Refer subsection 3.8).

4.9 Maintainable Profit

There will be those who will continue to yearn for a profit analysis which enables them to produce a "maintainable" profit number, to apply a P/E ratio to, to determine a current valuation of the company.

The fact that the profit number may not be equal to the distributable profit doesn't faze them. The fact that the likely pattern of future distributable profits will vary between lines of business and over time doesn't faze them.

They may even try to take the new numbers and convert them to old style profits with appropriate growth rates!

But they miss the point.

Reported Profit is only a means to an end. The end is the current valuation of the company. Use of Reported Profit could only ever provide a crude basis for determination of this. Under fair value/ market value accounting, the focus is on distributable profit both in the past and in the future. Arguably, this is what was always wanted.

4.10 Volatility and Interpretation

The breakdown of profit into "distributable" and "revaluation" is not enough.

Observers need to know the prospect of continuing distributable profits – and arguably revaluation profits as well.

And if actual numbers are different from those expected, observers need to know why.

Development of this science will be a major exercise. All I can do in this paper is to give some thoughts as to its direction.

A one year forecast would go some way to achieving the first requirement above.

Providing a range of outcomes would then be a starting point for preparing to satisfy demands under the second requirement, ie when reporting at the end of the year.

This range should include at least results of a higher and a lower sales assumption - possibly a standardised "10%.

A breakdown of forecast outcomes according to lines of business could also be mandatory.

Beyond this, there will need to be a balance between the value of providing information against the costs to the shareholders of preparing it – including likely need for independent assessment and auditor sign off.

Normal internal management reporting would be expected to include a breakdown of the Business Fund cash flow items and cash operating income, cash operating expenditure, cost of capital and capital transfer, according to lines of business and types of income and expenditure.

Such a breakdown could be provided both for the year prior to and the year following the balance date (in the different scenarios).

A possible format for this is set out below:

Analysis of Cash Flows

	Current Year		**Next Year**	**Next Year**	**Next Year**
	Expected	Actual	Conservative	Best Estimate	Aggressive
Cash Operating Income					
Type 1					
Type 2					
less					
Cash Operating Expenditure					
Type 1					
Type 2					
less					
Charge for the use of Capital					
= Cash Profit from Operations					
less					
Transfer to (from) Shareholders Fund					
= Cash Profit Retained and Capital Transfer					
= Total Distributable Profit					

This document would be supported by the disclosure of the essential assumptions for the previous year's forecast, the next year's forecasts and the valuation of the business both last year and current.

With the current mood for more transparency, there should be no qualms about disclosure of such numbers and assumptions – provided directors were provided with adequate protection in the event that outcomes did not equal forecasts reasonably made.

There will of course be an issue regarding future unannounced business plans. However, this should be capable of being dealt with simply by requiring forecasts only in respect of current business.

4.11 Financial Gain from the use of All? Capital

Arguably the definition of profit demands a focus on the amount of financial gain from the use of all capital, ie including Debt.

The "bottom line" would then be "Profit before cost of capital and tax".

This approach raises a number of interesting issues in relation to the fundamental measurement of the profitability of the business and the impact of the different tax systems currently applying to the different types of capital.

A move to equivalent tax treatment for all types of capital could give rise to innovative forms of capital structure focussed more on the fundamental needs of different investors and the business, rather than their tax position.

Lack of time has prevented further development of these concepts in this paper.

5 HOLISTIC FINANCIAL STATEMENT FORMATS

5.1 Major Test

A major, if not the most important, test of a purported Holistic Financial Reporting framework is the format of the Financial Statements.

It is in these that messages are conveyed to most observers. Accordingly, it is essential to make these as clear as possible and to focus on the essential elements. While "Notes" to the Statements form the mainstay of the disclosure regime, it is the Statements of Financial Performance and Financial Position which will provide the illumination for most observers and the strongest focus.

5.2 Update

Reflections over the last 4 years have not caused me to change the principles underlining the Statement Formats presented in my 1999 paper.

The focus was on the Balance Sheet with fair/market values of assets and liabilities.

The separation of the accounts into a Business Fund and a Shareholders' Fund facilitated a realistic view of capital and cost of capital requirements, the accommodation of the Value of the Business, and transparency generally.

Profit was simply composed of two items – Distributable Profits – ie cash flow achieved, and increase in the Value of the Business, ie change in present value of future profits.

I believe that these elements remain highly relevant.

However, I feel now that there needs to be a stronger focus on the "quality" of profit.

In addition, I am being sufficiently realistic to appreciate that the "ultimate" Holistic Reporting Statement format is likely to be many years away. In the meantime, accommodation of current accounting practices within the suggested proformas may assist in appreciation of the issues going forward. In particular, this includes the management of provisions and intangible assets. These need not be issues in a mark to market environment. However, in practice, the flexibility permitted under current accounting standards will enable management of provisions and intangible assets to continue. Thus, it will be important to ensure that changes in these items are highlighted in the suggested Financial Performance Statement proforma.

The attached proformas attempt to provide additional information that is useful in the current environment - in the form of a breakdown of the increase in the Value of the Business.

5.3 Current Use

For a listed company, there is usually sufficient information in the notes to the Statutory Financial Statements to enable a close approximation to a presentation in the attached format to be developed – except of course for the additional increase in intangible assets item to include the value of the company's own business.

Arguably, for a listed company, the total value of the equity is equal to the sharemarket value at the balance date. Using this, the increase in value of the company's own business can be included. However, this will be subject to the share market movements, which, in many respects, have little to do with the business of the company.

Accordingly, the numbers would need to be accepted on this basis and any analysis carried out recognising this position.

5.4 Proformas

Suggested proformas are set out on the next 2 pages, with illustrative numbers. Reference notes follow these pages.

HOLISTIC FINANCIAL PERFORMANCE STATEMENT

A simplified format is as follows:

	Business Fund	**Shareholders' Fund**	
100	Cash Operating Income	Investment Income from Assets not used in the Business	2
	Less	Less	
(80)	Cash Operating Expenditure	- Shareholder related costs	(1)
20	**= Cash Profit from Operations**	- charge for capital represented by these Assets[1]	(3)
		= Value Added (Lost) from Assets not used in the Business	**(2)**
		Add back charge for Capital above (f)	3
	Less	Plus	
(17)	Charge for Use of Equity Capital in Business Fund[1] →	Charge for Use of Equity Capital in Business Fund[1] (g)	17
	Less	Plus	
(2)	Transfer (to) from Shareholders' Fund[2] ↔	Transfer from (to) Business Fund[2] =**(Cash Value Added)**	**2**
1	**= Cash Profit Retained and Capital Transfer (a)**	**= Distributable Profit**	**20**
	Increase in Other Net Current Assets	Increase in Value of Business[4]	46
6	- before increase in provisions[5]	Less Charge for Investment in the Business[9] (h)	(38)
(4)	- less increase in provisions[5]	**= Business Value Added**	**8**
2	**Increase in other Net Current Assets (b)**	**Cash Value Added + Business Value Added = Holistic Value Added from Business[7]**	**10**
		Less	
6	**Increase in Net Non-Current Tangible Assets, before revaluations [6](c)**	**Value Lost from Assets not used in the Business**	**(2)**
5	**Revaluation of Net Non-Current Tangible Assets (d)**	plus	
4	**Increase in Intangible Assets (e)**	**Charges for use of Capital and Investment in the Business[9] (f+g+h)**	**58**
18	**Increase in Net Assets[4] (a+b+c+d+e)**	**= Total Holistic Profit before Taxation**	**66**

HOLISTIC FINANCIAL POSITION STATEMENT

A simplified format is as follows:

Year 0	Business Fund	Year 1	Year 0	Shareholders' Fund	Year 1
	Assets			**Assets**	
30	Cash	31		Value of Business[3]	
100	Other Current Tangible Assets	106	190	- Net Assets in Business Fund	208
			130	- Excess Value	158
670	Non-Current Tangible Assets	701	**320**	**Total Value of Business**	**366**
50	Intangible Assets	54	30	Other Assets	50
850	**Total Assets**	**892**	**350**	**Total Assets**	**416**
	Less			***Less***	
			10	Liabilities	10
40	Provisions	44			
60	Senior Debt[8]	60			
120	Other Current Liabilities	120			
-	Subordinated Debt[8]	-			
440	Other Non-Current Liabilities	460			
660	**Total Liabilities**	**684**	**10**	**Total Liabilities**	**10**
190	**= Net Assets**	**208**		**= Net Assets**	**406**
	Represented by			***Represented by***	
	Equity Capital allocated to Business Fund[8]			Equity Capital	
155	- Invested in Business (to meet Solvency/Capital Adequacy Requirements)	155	100	- Share Capital	100
35	- Other	53	240	- Retained Profits	306
190	**Total Equity Capital**	**208**	**340**	**Total Equity Capital**	**406**

Notes:

1. Charge at Equity Capital cost rate, assumed 11% p.a.

2. Transfer includes amounts reflecting capital movements, and represents Cash Value Added (i.e. after allowing for cost of capital). Capital transferred between the Shareholders' and Business Funds loses its identity, and simply represents cash profits and losses.

3. Value of Business is fundamentally the value of expected future Distributable Profits from the Business Fund discounted at the rate of cost of equity capital. However, this must be assessed on a market value basis by an independent valuer.

4. The Increase in the Value of the Business will effectively include the Increase in Net Assets in the Business Fund. Breakdown of Increase in Net Assets is for analysis only.

5. Provisions in respect of committed expenditure and against doubtful current assets. No provisions are held against non-current assets, since any necessary are assumed to be allowed for in the determination of the market value of the assets.

6. Increase in Non Current Tangible Assets less increase in Liabilities.

7. Increase in Value of Business includes the "roll forward" effect of releasing the discounting at the cost of equity capital rate; this is equivalent to inclusion of the charge for the use of "capital" as the Value of the Business, in the increase in the value. Investment in the Business is the Value of the Business at the beginning of the period.

8. Amounts and transactions involving different forms of Capital would be separately identified.

9. Business Management Performance = Holistic Value Added from Business. This is the Holistic Profit less the cost of equity capital return on the Shareholders' Capital Investment in the business.

6 FURTHER DEVELOPMENT

6.1 Reflections to Date

Arguably, my 1999 paper was a speculative and simplistic look at the way in which the future direction of Fair Values and Market Values might take us.

But it was also a recognition that such development could and should involve the actuarial profession.

That position is now much stronger. The views within the accounting bodies vary and indeed ebb and flow in and from the direction of Fair/ Market values. Indeed there are some which suggest that it should apply to only some aspects of accounting and <u>some</u> financial instruments, but not more broadly. But it is clear now that the trend is inexorable. Because the <u>only</u> form of Balance Sheet presentation that is realistic for the purposes of judging the financial position of the company is one where all assets and all liabilities are marked to market value on a consistent basis. This is surely more important than continuing to attempt to seek a "realistic" profit through further refinement of traditional accounting standards.

In my view that part of the debate is over. The machinations of the accounting profession will need to continue in order to achieve political consensus. This may not be achieved in 2005. But it will be eventually. And ultimately will apply to all industries – not just financial services. The real task now is to address the issues that arise when we do have realistic balance sheets.

Profit will have a totally new meaning. It will be volatile and will need even more analysis. Actuaries will have the capacity to provide a lot of input. Will we rise to the challenge?

6.2 Actuarial Involvement

Actuaries have often been involved in the development of Accounting Standards. The involvement has focussed on areas where they are considered to have expertise. Where the actuaries have attempted to involve themselves in the "whole picture", this has not always been welcomed.

Yet the moves towards fair/market value accounting are revolutionary. The ultimate result will be very different from the picture presented today.

Actuarial training enables actuaries to understand the broader picture. Our involvement should not be only as experts in certain industries. Our involvement should be as experts in financial reporting.

6.3 Education

Of course, we are not there yet. Our courses of education do not extend sufficiently to cover the jargon and subtlety of Accounting Standards, but it could be. Creation of Valuation Balance Sheets is traditional actuarial work, and requires a thorough understanding of accounting – if not full knowledge. Developing knowledge and understanding of Financial Reporting further will assist in the establishment of actuaries as experts. It should also assist in the establishment of better reporting generally.