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Reconciling The Opening And Closing Balance Of Insurance Liabilities—It's Important!

By Jim Milholland

The topic once again is IFRS for insurance, with the usual set of acronyms; namely, the revised Exposure Drafts (ED) and the International Accounting Standards Board (the Board). RA stand for the risk adjustment and CSM stands for the contractual service margin. P&L is profit and loss and OCI is other comprehensive income.

This time it's about the analysis of the movement in the liability. It applies to contracts that use the building blocks (i.e., those that do not use the alternative approach) and to claims liabilities.

It may be a boring subject. But bear with me and I'll help you avoid some real difficulties that will occur if you don't take it seriously enough.

The analysis, which the second ED refers to as a reconciliation of the opening and closing balance of the liabilities, has been a part of the Board's thinking from the beginning. The revised ED would make it a required disclosure. If memory serves me, the commenters on the ED expressed no objections to the requirement to disclose the reconciliation. Silence is consent, so apparently many people see the value in the reconciliation. Or perhaps they see it as "just a disclosure," one of those things that you do late in the reporting process after the pressure to release earnings has passed, and reasonable enough, so there is no need to object to it. The goal of this paper is to convince you that the reconciliation is indeed valuable.

The description in the revised ED is succinct. In paragraph 78 it says that the reconciliation should be made for each component separately and it specifies that the reconciliation should show premiums, claims, relevant amounts recognized in profit or loss, gain or losses on modification or de-recognition of contracts, and any additional amounts needed to understand the change in the liability. It is left to the actuary to work out the details.

And there are details. In addition to the expected progression, the reconciliations will be affected by experience deviations, changes in estimates, changes in discount rates, re-measurement of the risk adjustment, and the effects of acceleration or deceleration of cash flows. The last items are the effects on the liabilities of the fact that experience deviations result in more or fewer contracts than had been expected.

The disposition of the reconciling items is important. Some go to P&L, others affect OCI, and others are caught up in CSM. Some, like premiums and repayments, are simply deposits or withdrawals and affect the liability directly.

It is evident that the reconciliation will be challenging. Nonetheless the reconciliation can be well-defined and a process can be put in place to make it routine. With some forethought, the items that are needed can be captured, either from the models that measure the liability or from general ledger accounts. There is really no new information that must be created to do the reconciliation. There is however the need to capture the required information and this need should be anticipated as the reporting process is set up.

So the important point for now is not the details of the reconciliation, but why it is important - why it is not just a required disclosure that can be left to the late stages of the reporting process. The answer is twofold.

The first reason the reconciliation is important is because it is a significant control on the measurement of liabilities. The liability calculations are complex and dynamic. The ability to reconcile the results from the prior period to the end of the current period is key to developing comfort that nothing material has gone wrong. The reconciliation should flow from the data gathered in the valuation process and the reconciling items should appear reasonable when compared from period to period. Difficulties reconciling the liabilities from the information provided by the routine valuation process or peculiarities in comparative amounts may indicate that something has gone wrong with the valuation.

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Jim Milholland, FSA, MAAA, is a retired partner from Ernst & Young, LLP. He can be reached at actuary@milholland.com.

The reconciliation is also important because there is valuable information in the reconciliation that may not be apparent from looking at the financial statements. I expect that readers of financial statements will be especially interested in the progression of the CSM and the RA. The CSM is already characterized by some actuaries as future profits. Readers of financial statements will look to the progression of the CSM to get a view of the insurer's future prospects. They will want to know if CSM is growing and why. CSM that is growing bodes well for the future. They will also want to know how much new business is adding to CSM, to get an indication of whether margins are being maintained on new business. They will be interested in how much the changes in estimates affect new CSM, and they will use this information to form a view about whether the insurer has been optimistic or conservative in setting expected values.

The RA will also likely be viewed as future profit. Its contribution to profit is less assured and more volatile than the contribution from CSM, but if in fact the value of future cash flows is an expected value, then the RA is expected to contribute to profit over time. The addition from new business and the effects of re-measurement of the RA will influence reader's evaluation of the performance and prospects of the insurer.

The statement of comprehensive income will not provide the details needed for these evaluations. Hence the disclosures become very important.

For these reasons the reconciliation of the liabilities should not be left to late in the reporting process. It should be made before the measurement of liabilities is final and earnings are released. If I am right about the attention that readers will give to the reconciliations, insurers may in fact decide to report elements of the reconciliations as part of the information provided with the earnings release.

So the moral of the story is this: embed the reconciliations into the valuation process. Design the models and valuation systems to capture the required information when the measurement is made. This forethought will avoid the possibility of needing to re-engineer the systems when the importance of the reconciliation becomes obvious, and it will greatly reduce the chance of a material error in the measurement of liabilities. The reconciliation of liabilities is as important as the measurement itself and an appreciation of this fact should become part of the mindset of actuaries involved in IFRS reporting. ■