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The Challenge of Financial Reporting during the 21st Century

by Ghislaine Royer and William R. Horbatt

Challenges Facing Insurance Company Management

Financial reporting demands on insurance companies continue to increase each year. Beginning in 2005, publicly traded companies in Europe will be following International Accounting Standards (IAS). In addition, companies publishing embedded values will need to comply with the new European CFO Forum guidelines, and Solvency II for insurance companies is just around the corner.

Organizations that suited companies during the past may not be sufficient to meet these new demands. Company systems that were predicated upon cost basis accounting, deterministic actuarial projections and simple solvency margins may not be conducive to a "brave new world" of market value accounting, stochastic valuations and active risk management. Organizational structures based upon "silos" of expertise do not have the flexibility to adapt to a rapidly changing environment that requires interdisciplinary cooperation. Manually intensive procedures that worked well in an environment of semi-annual or annual financial reporting may not work as companies report results quarterly, monthly or even more frequently.

What is needed as we enter the 21st century is an organization that is fast, flexible and intelligent. Let us explore this in greater depth and detail.

Our Changing Business Environment

Dramatic changes have occurred in both business practices and financial reporting over the past two decades. Changes occurred first outside continental Europe, but as the globalization of business accelerates, Europe is catching up fast. In the 1990s many of the largest European companies adopted generally

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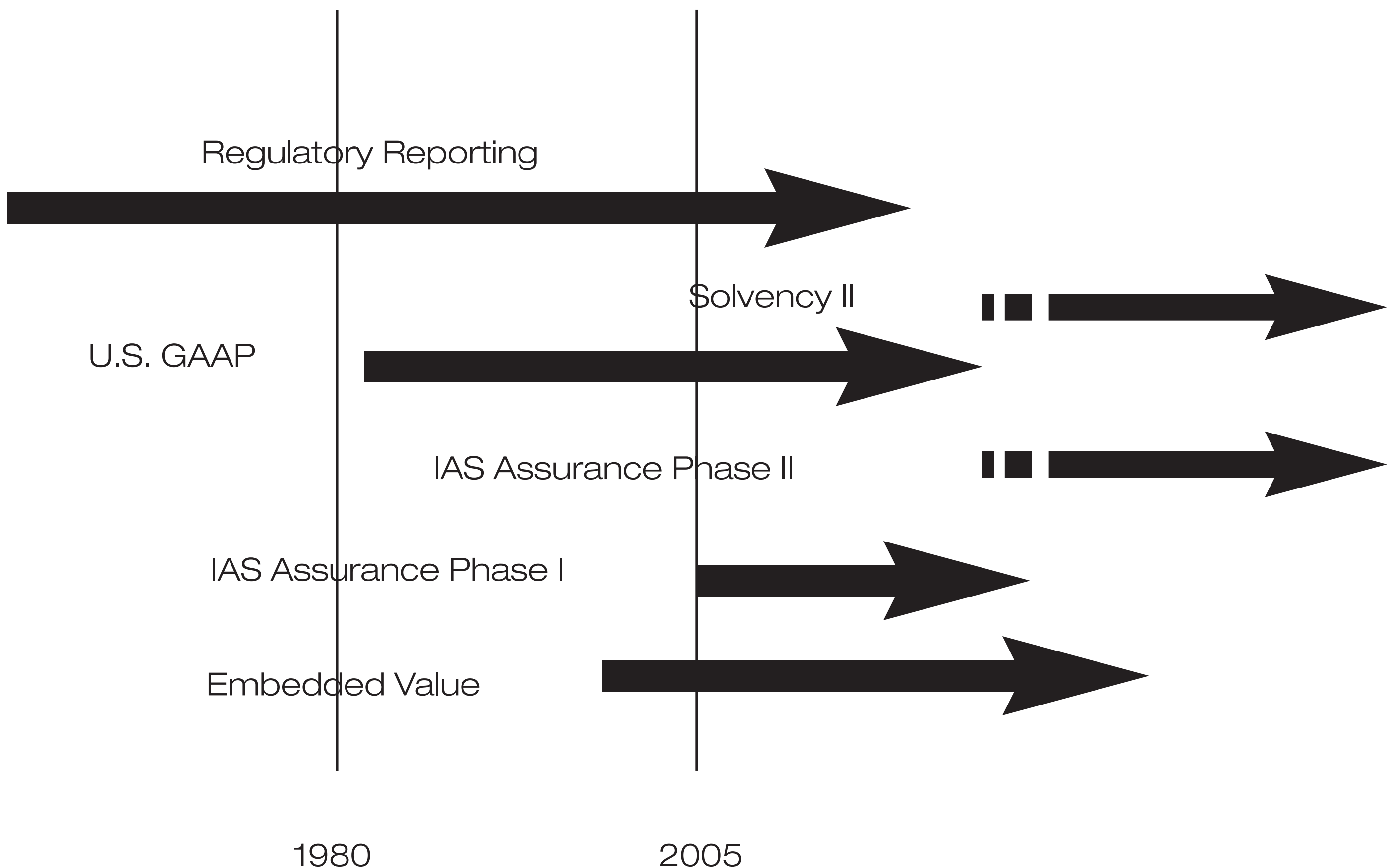
accepted accounting principles (GAAP), which had been promulgated for United States life insurance companies in 1982. Even some companies that are not listed on U.S. stock exchanges adopted U.S. GAAP insurance standards, in whole or in part, for stockholder reporting.

U.S. regulators began requiring "stress testing" of asset-liability management during the 1990s, while ratings agencies included stress tests when evaluating insurance company financial strength. The European CFO Forum has just introduced requirements that companies explicitly value options and guarantees in their insurance products while Solvency II for insurance companies may follow the new Basel II standards for banks that reward companies practicing rigorous risk management with lower capital requirements.

During 2005, European Union life insurance companies will be implementing new accounting standards for shareholder reporting, most notably IAS 39 for investments and International Financial Reporting Standard (IFRS) 4 for insurance liabilities. The requirement to hold assets in the balance sheet at market value will be a challenge for many companies, while IFRS 4 offers options like discounting liabilities at current interest rates that may not be possible using existing valuation systems and procedures.

Waiting in the wings is Phase II of insurance accounting standards, which may require that the "fair value" of insurance liabilities be calculated or which may converge with U.S. accounting standards. In any event, there is a clear and growing trend to require companies to hold their balance sheet at market value. In addition, the Solvency II project may be expected to change how minimum required company surplus is calculated.

Figure 1



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The Shape of the Future

Stakeholders in insurance enterprises, including stockholders, regulators, policyholders and other interested parties, are looking for more financial information, more frequent reporting of results and more accurate results. Stakeholders do not like surprises — rather, they want to see steady progress and growth.

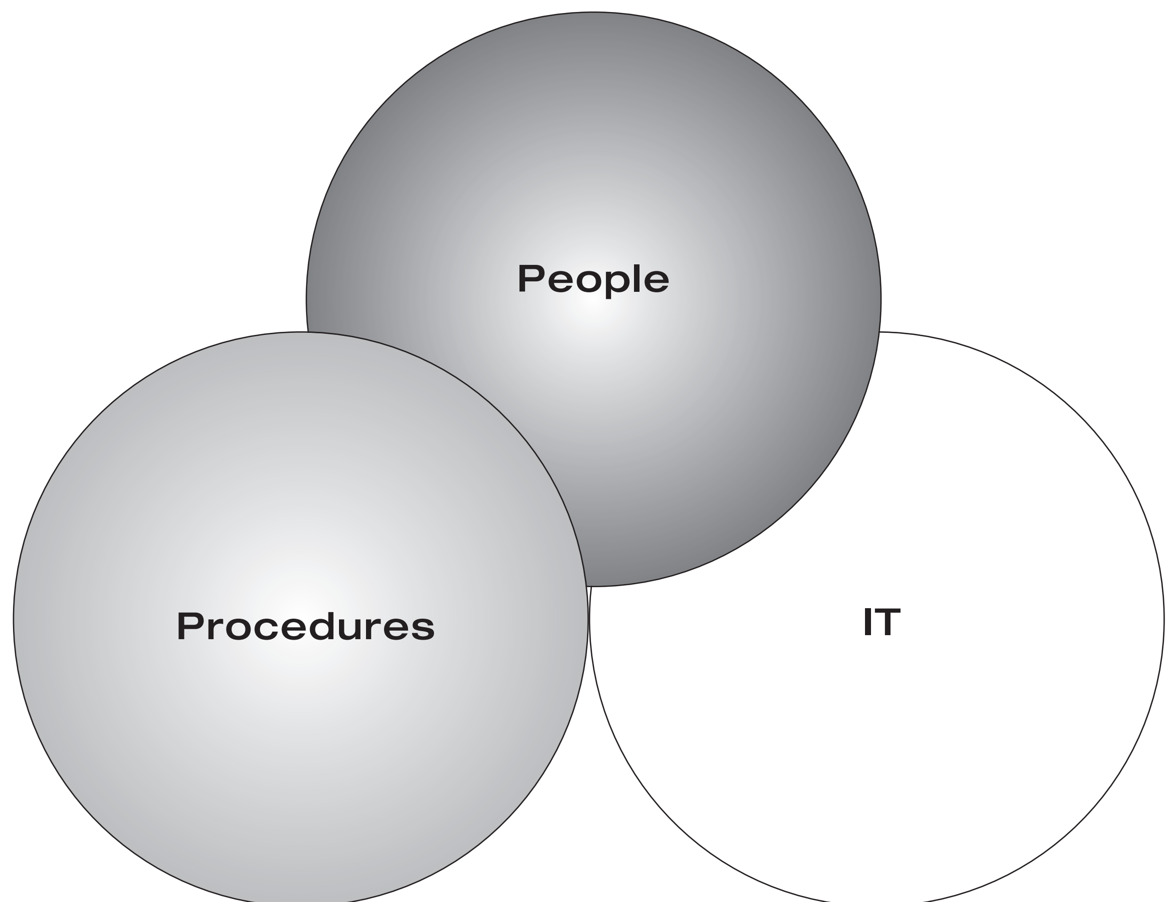
Insurance companies and the consulting firms supporting them have developed solutions to portions of this challenge. For example, "fast close" projects reduce the time and effort required to report financial results, balanced scorecards and "dashboards" provide actionable information on a real time basis and re-engineering projects have improved productivity in many areas of companies. However, there is a need for a holistic solution that can be implemented throughout the organization.

Organizations need to adapt to the emerging requirements by changing how they work. In particular, optimal solutions to this challenge involve the following three attributes:

- **Collaboration** – no one professional specialization is sufficient during the 21st century, so teams need to be formed with all of the appropriate skills for the task at hand.
- **Flexibility** – today's solution may not be appropriate for tomorrow, so organizations need to be able to "change on a dime" to meet unanticipated needs.
- **Low cost** – financial reporting is an overhead cost that simply reduces the organization's profits and surplus, so costs must be as small as reasonably possible.

To envision a holistic approach, one may wish to think of any solution to the evolving challenge as involving three organizational elements: staff, procedures and systems.

Figure 2



Creating a 21st Century Organization

Before sketching out our proposed solution, let us look at typical organizations from a different perspective. One may also wish to view the reporting process as people managing data. Figure 3 at the bottom provides a simplified illustration of how raw information is transformed into financial reports needed by stakeholders.

The real world is much more complicated than this illustration:

- **Data Accessibility** – Data resides in many computer systems and some data is only available in a paper format. Excessive manual steps may exist and interfaces may be inaccurate.

- **Interdependencies** – Different functional areas need to collaborate to meet corporate objectives. For example, finance needs the actuaries' projections of future cash flows to select appropriate assets with matched cash flows for ALM while actuaries need policy records from the administrative system.

- Inefficiencies – Procedures can become inbred and not change with changing requirements. Sometimes, inefficient "stop gap" measures become permanent while new technical possibilities remain undiscovered.

A solution to these limitations can be addressed in several organizational redesigns (which are not necessarily sequential):

- **Data Warehouse**[1] – Data is extracted from individual systems and placed into a single database that can be accessed by individual users. This can be referred to as a data warehouse or, more accurately, a "pseudo" data warehouse.

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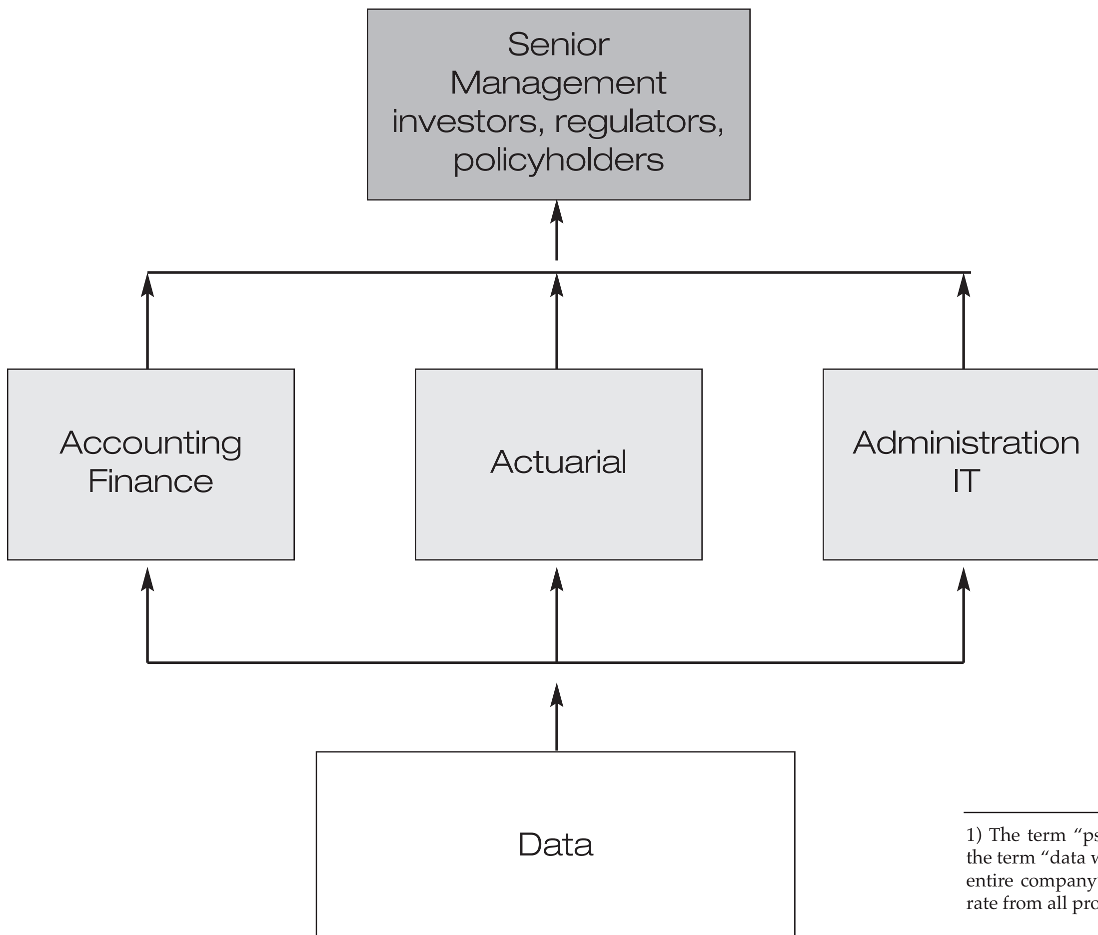
Figure 3



1) The term "pseudo" is used since IT professionals use the term "data warehouse" to connote a system where the entire company's data resides in a single database separate from all programs.

- **Team Creation** – Teams are formed from different disciplines to develop the reporting tools that access the data warehouse and generate the financial reports required.

- **Procedure Reengineering** – All related procedures can be reviewed in light of the new approach, eliminating procedures that are no longer needed and improving other procedures to improve efficiency.

The concept behind this structure is simply to have accurate data efficiently placed in one place that can be accessed by all the professionals that need it. Alternative technologies can be adopted provided that they meet this single requirement.

This is not a simple process, but can be achieved incrementally over time at reasonable costs. The professional teams will improve both processes and the quality of data, first on a project basis then later as part of normal day-to-day operations.

Referring back to Figure 3 on page 5, we will now present our views on people, procedures and systems.

21st Century Staffing

Obviously, an organization needs to have qualified staff, staff that bring expertise to the organization and who can work well with their associates. The maximum flexibility occurs when staff members are organized into matrices of overlapping responsibilities and when teams can be formed rapidly to accomplish a mission and then disband.

Teams can either be temporary or the organizational structure can be transformed into a permanent matrix structure wherein cross-functional relationships are formalized. In some organizations, individuals may move from team to team, never taking a permanent line or staff position. What is most important is that the teams be composed of the organization's "best and brightest" people and that successful team efforts be considered an essential characteristic of all successful employees.

21st Century Procedures

Organizations run based upon multiple layers of procedures ranging from elementary procedures followed by administration units to record premiums to procedures followed by the board of directors to make strategic decisions. As time passes, procedures become outdated and overly complicated for current business requirements. Too much time may be spent on activities that add little value (or even subtract value) while higher priority projects receive little attention.

One solution to outdated procedures is to empower teams of the best and brightest staff to evaluate current procedures compared against business requirements and develop new, improved procedures. These teams can "map" current procedures, identifying obvious inefficiencies, then ask the question "why?" This uncovers outdated and outmoded inefficiencies that would otherwise continue indefinitely.

One solution to outdated procedures is to empower teams of the best and brightest staffs to evaluate current procedures compared against business requirements and develop new, improved procedures.

The multi-disciplinary team also adds perspectives and insights that no one functional area can contribute alone. IT professionals can suggest automation, actuarial resources can develop simple yet elegant alternatives and administrative staff can advise on what really will work and what will not.

A procedure review can be thought to follow several well-defined steps:

- **Identify Customer Requirements:** Although this article focuses on financial reporting, companies should always remember who generates the money that is reported – customers! Similar to the physician's oath to "first do no harm," a procedure review/redesign is predicated on maintaining (or improving) appropriate customer service.

- **Process Mapping:** Financial reporting can be subdivided into a number of distinct processes, each of which can be "mapped" to understand what information is input into the process, how this information is handled and what information is output to other processes. When the results of this are represented in a "spaghetti diagram," areas for improvement become self-evident. Redundant, useless or otherwise inefficient steps that are just opportunities to make mistakes can be eliminated.

- **Process Change:** Teams recommend appropriate improvement plans to an oversight group composed of more senior management and, if acceptable, they are implemented. Procedural improvements may involve people's responsibilities, tasks performed and alternatives. Automating additional tasks is frequently a critical element of this phase and may be achieved in a low-cost manner.

Once the original process redesign has taken place, staff should continuously search for further improvements. During one Italian

project involving the author, closing time was reduced from eight to three working days. After completion of the project, the company's staff continues to reduce the closing time further.

21st Century Systems

Procedural reviews invariably encounter the company's computer systems, ranging from basic administrative systems to more sophisticated systems such as the general ledger and actuarial modeling systems. System issues frequently encountered include:

- **Vendors:** Companies may not be using the full functionality of existing systems. In other cases, computer system vendors can suggest efficient modifications of their systems to meet client requirements.

- **System replacement:** It is difficult to recommend a full-scale replacement of a given computer system unless it can be conclusively demonstrated that this solution is cost effective. Costs to be considered include internal costs of training employees and possible client disruption during a conversion.

This being said, the costs of excessive labor being routinely spent correcting system errors or poor policyholder service may justify such a decision. For example, one continental insurance company was operating four different administrative systems (as the result of acquisitions) where the savings from adopting a new system outweighed the cost of system migration.

- **New technologies:** New technologies continue to emerge that can improve financial management.

Overall, managers need to identify a broad outline of what a "perfect system" platform would look like and then empower its professionals to incrementally implement it.

Can this really be done?

It is difficult to find an international insurance company that would demonstrate that fast, flexible financial reporting is really feasible, since virtually all such companies take two months to report financial results after the close of a fiscal year. However, Cisco systems — an international technology company — did accomplish a "virtual close" during the 1990s. Larry Carter, Cisco's chief financial officer, stated that on the first day after the end of the financial reporting period:

> *We're done by 3 or 4 p.m. I get an e-mail with the revenues, margins, EPS and so on, but I already know them because I can track them every day.*[2]

Although it took four years to accomplish it, Cisco reduced the closing time from 14 days to less than one day and cut financial reporting costs in half.[3] Echoing some of the concepts introduced in this article, Larry Carter explained how this was accomplished:

> *Achieving the virtual close was not just a matter of rolling out new technology. It required a sustained, companywide effort to redesign our processes and align disparate parts of our business. Every month, we meticulously reviewed the closing process to pinpoint opportunities for improvement.*[4]

Reiterating the point that the objective of improved financial reporting process was to improve business capabilities, not just financial reporting, the *Fortune* article describes one of the early steps in the four-year project:

> *Carter began as all change managers should: with a highly visible project that mattered to people who set the tone for the company. At Cisco — which has grown 58 percent a year for the past five years — job one is to keep the salesmen happy. They were fuming because they spent too much time filling out expense reports and waited weeks to get reimbursed. So Cisco moved expense reporting to the Web and made it virtually instantaneous for all employees. Carter then worked to automate paying commissions — a giant step toward real time because it meant calculating revenues and commissions as orders were entered.*[5]

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2) "Making Decisions In Real Time." *Fortune*; 06/26/2000, Vol. 142 Issue 1, p332

3) Carter, Larry. "Cisco's Virtual Close," *Harvard Business Review*, April 2001

4) ibid

5) *Fortune*, ibid

continued on page 8

Chairperson's Corner

by Marc Slutzky

It is my privilege this year to become chair of the SOA International Section. In assuming the post, I must thank retiring section chair, Yiji Starr, and section council members, Rejean Besner and Mike Enright, as well as newsletter editor, Randy Makin for their efforts and accomplishments over the past years. I also welcome new council members Michele Chong-Tai Bell, Frank Buck and David Parmee, as well as newsletter editor, Cathy Lyn.

We had a well-attended activity at the SOA Annual Meeting in October 2004 in New York. Section members and guests toured the United Nations and enjoyed a cocktail reception there as well. The members attending included the SOA ambassadors to South Korea and New Zealand. There was an informative tour of the building and we learned about the history of the United Nations, the building, its agencies, members and staff. Many thanks to Lois Chinnock and Martha Sikaras of the SOA who helped arrange it. Over the last several years the section activity at the SOA Annual Meeting has proven to be one of our most popular functions, and I expect that next year's will be as interesting.

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The next year promises to be an exciting one for the section. The section and practice area evolution within the SOA is well under way, and this will allow us to participate in more SOA activities and have more frequent and meaningful communication with all of the other areas in the SOA. At the section council meeting in October, we agreed that the primary activities of the section are to provide a sense of community and opportunities for our members to interact, and to obtain and communicate information and ideas on current and emerging relevant issues for our members, as well as other activities.

The council is eager to learn about any of your desires and needs for section activities, plans and initiatives. Please let us know what these are so that we can consider them, and, if possible, make them happen.

I look forward to an eventful year. ☐

Thanks,

- Marc

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Although insurance companies follow different business models from Cisco and have different financial reporting requirements, it appears feasible for them to achieve improvements similar to those achieved by Cisco.

Conclusions

Successful managers know that they can gain 80 percent of the benefits from any project from only the first 20 percent of efforts. In a rapidly changing world this is a reasonable objective since even perfect results will quickly become obsolete. To be successful, a company should:

- Have full senior management commitment, since these people will have the most to benefit from access to real time information.

- Aim for perfection — the virtual close — but willingly accept incremental progress. Think long-term, but focus on short-term actions — actions that can improve results in months rather than years.

- Focus on improving internal capabilities to make continuous improvement a permanent part of the organization. Use outside resources only when absolutely necessary — for example, for training or specialized purposes. Staff that has been trained to improve processes once can do it again!

- Focus on customer requirements — if the customer is happy, then the business will grow and an increasing revenue base will more than cover overhead expenses.

- Optimize systems and processes in place, replacing them only when cost justified.

Improving financial reporting at reduced costs is not only possible, but has already been done. The example given in this article, Cisco systems, proves that a company can accomplish virtual closing at half the prior cost in just a few years. ☐

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