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Accounting Concepts and Principles

Accounting concepts and principles may vary from country to country, although efforts are being made to achieve greater **harmonization** of **international accounting practice**. The principles used may also depend on the purposes for which the accounts are designed.

In recent years changes in **Accounting Standards** have placed greater emphasis on **neutrality**, rather than **prudence**. For trading companies there has also been a move away from historical cost towards 'fair value'.

Investment companies, including financial product providers, have prepared accounts using the **market value of assets**, or some proxy for it, for many years. This means **revaluing assets and liabilities** at the end of each accounting period. **Gains and losses** on revaluation are included in some form of income statement for the period. For a financial product provider, this can lead to **volatile results** if assets and liabilities do not move consistently.

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Accounting Concepts and Principles

Accounting concepts include the following:

- cost
- money measurement
- going concern
- business entity
- realisation
- accruals
- matching
- dual aspect
- materiality
- prudence
- consistency.

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2 Interpreting the Accounts of Financial Product Providers

Analysis of accounts

Before attempting to interpret the accounts of a provider, it is necessary to be familiar with both the rules governing the preparation of the accounts and also the accounting rules and conventions that apply in the country concerned.

In developed economies, the published financial statements of financial product providers are usually prepared on a **going concern basis** and are intended to give a **true and fair view** of the provider's performance and financial position.

The prior year's figures will normally be shown alongside the current year. **Changes in accounting practice** will be identified and, if material, the prior year's figures will be restated on the current basis to enable fair comparisons to be drawn.

The figures published by the company should be capable of being compared with those of the previous year. This requires **accounting policies** to be consistent over the years, unless there is a good reason for changing them. The changes made need to be highlighted and their impact explained.

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In any case if the **accounting policies are changed**, then changes need to be made to the previous year's reports in that manner to allow for comparison.

Reports accompanying accounts

The reports accompanying the accounts may reveal much more about the company than an analysis of the published numbers.

These **additional reports** might include:

- Chairperson's and CEO's statement
- Investment report
- Strategic report
- Risk report
- Remuneration report
- Corporate governance report

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☐ Chairperson's and CEO's Statements

Depending on what is said elsewhere in the reports, these might give **details of the successes** of the year. Little will be said about the failures.

Performance against key objectives should be reported.

These reports normally refer to changes at **Board** and **senior management level** and give an idea of whether the company is flourishing or not. The statements may also contain information on **exceptional events** that have happened during the period, including Mergers and Acquisitions, Changing in partnerships and Unusual claims experience

☐ Investment Report

This would be a summary of **investment strategy and performance**. It is often included within another report.

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☐ Strategic Report

This should refer to the company's long-term and short-term strategic objectives, report how they have been met, and the progress being made to achieve the long-term objectives. Performance against Key Performance Indicators may be given.

☐ Risk Report

If not included elsewhere, this might explain the company's attitude to risk, the key risks it faces, and how it manages and mitigates those risks.

☐ Remuneration Report

As well as recording the pay of executive and non-executive directors for comparison with other similar companies, this would also show attendance at Board meetings and the turnover of directors, both giving an idea of the state of the company.

☐ Corporate Governance Report

This would normally describe how the company is organized in terms of Board and Board committees. Statements on how the Board assures itself of independence would normally be included.

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Insurance companies

Insurance business is subject to **cyclical effects** that may affect many providers at more or less the same time.

This makes it necessary to compare the **profitability of a provider's business** with the results disclosed by the accounts of other providers, especially those transacting similar types of business.

A cyclical claims experience affects general insurers particularly such as seasonal weather variations along with the **underwriting cycle**.

Other methods of making provision for liabilities and margins may be used, for example by including a prudential margin in each element of a valuation basis. It may be that there is no information given in the accounts to assess the size of such margins.

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In some countries, insurance companies may be required to put their **methods** for calculating a **risk-based capital requirement** into the public domain in a separate report that is filed alongside the accounts. It may be more appropriate to use this **additional report** for any **comparative financial analysis**, particularly when comparing companies that use a prescribed standard model for the risk assessment.

It may be possible to get a quick, but limited, indication of the financial position of an insurance company by examining individual accounting items and various ratios of one to another and comparing them with the accounts of earlier years.

Among the **ratios** to be considered could be:

- Incurred expenses to premium income
- Commission to premium income
- Operating ratio, ie the total of incurred claims and expenses to premium income – this ratio makes more sense in case of short-term classes of business instead of long-term classes.
- Outward reinsurance premium income to gross premium income

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Care is needed when drawing conclusions from such high-level analyses. For example, a sharp rise in premium income may be a sign of competitively low, and perhaps unprofitable, premium rates, or it may represent the market success of a new popular product unique to the company concerned.

An increase in aggregate premium may be a result of large volumes of business due to lower premium rates than the competitor or because the company has been able to exploit a niche market so as to gain a large market share and make profits.

Benefit schemes

☐ Why Benefit Scheme Reporting is Different

Reporting on the progress of benefit schemes is different from the reporting of results by corporate entities. **Benefit schemes** do not generate profits or losses. Indeed, if actuarial valuations of the scheme are not made annually, there are no entries that can be made on the liability side of the balance sheet of a benefit scheme, other than 'accumulated fund'.

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For a corporate body, its success is measured by the level of profit made. However, estimating the **profitability** of a benefit scheme is difficult. Its success could however be measured in terms of stability of contributions required or by reference to some measure of assets compared with the liabilities.

Since **benefit liabilities cannot be valued**, the benefit, benefit scheme reporting is restricted to a statement of the net assets at a specific point in time and a reconciliation of how the net assets have changed since the past reporting date.

The main reasons for the **actuarial valuation** of a benefit scheme are to:

- Demonstrate solvency of the scheme
- Determine the future contribution rate required

The results of the actuarial valuation of the scheme generate a figure for **accumulated surplus or deficit**. This amount may be used to adjust the contribution rate for the succeeding period.

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☐ Disclosure – Beneficiaries

In many countries, it is recognized that it is important that the beneficiaries are given **sufficient information** about their entitlements. This disclosure to beneficiaries is also commonly used as a **legislative requirement** as a means of attempting to improve the security of non-State provision.

Disclosure could include **details** of the:

- benefit entitlements
- contribution obligations
- expense charges
- investment strategy
- risks involved
- treatment of entitlements in the event of insolvency.

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Guidance or legislation on the precise **form of the disclosure** of such information is important in ensuring that the beneficiaries are not misled, either intentionally or unintentionally.



Give examples of how disclosure could help to improve the security of non-State provision.

Disclosure – Regulation

Where disclosure is required by legislation, this may relate to **information** given to beneficiaries:

- on entry
- at regular intervals
- once payments commence
- on request
- a combination of these.

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Disclosure – Benefit Providers

Disclosure may be important to **providers** as well as to **regulators**. Well-designed information can help to encourage individuals to make non-State benefit provision.

Although it is largely the form of the benefits that will dictate how well it is to be understood by members and potential members, it is usually possible to present the same set of benefits in different ways, some of which may be clearer to members than others.

Poor disclosure can lead to future problems for providers, as it may give rise to the beneficiaries gaining false expectations of their future benefits. For example, a 40-year old with a current salary of \$20000, may be satisfied with an estimate of an annual pension of \$25,000 at age 65. however, assuming even a relatively minor level of 3% pa inflation over the rest of their working life, this is less than half their current income in real terms.

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Disclosure – Owners of Benefit Providers

Where benefits are **sponsored by employers**, it is important that the **owners of the capital** of the company (and potential owners) are aware of the **financial significance** of the benefit obligations that exist. Therefore, it is common practice in many countries for these financial obligations to be shown as part of the company's accounts.

In presenting benefit costs in the accounts, it is important that the readers of the accounts can form a realistic opinion of the company's current and future financial position.

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Interpreting the Accounts of Financial Product Providers

A number of different accounting standards exist, with some common aims that most of the standards attempt to achieve:

- **recognizing the realistic costs of accruing benefits** – for instance benefits accruing over the beneficiary's working lifetime may be required to be shown as steadily accruing over the working lifetime.
- **avoiding distortions** resulting from fluctuations in the flow of contributions from the employer to the pension scheme
- **consistency in the accounting treatment** from year to year (although not necessarily from company to company)
- **disclosure of appropriate information.**

Topics covered

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