THE INSTITUTE OF ACTUARIES OF AUSTRALIA
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GUIDANCE NOTE 260
DIFFERENCES BETWEEN END OF OFFICE YEAR (ACCOUNTING PERIOD) VALUATIONS AND INTRA OFFICE YEAR VALUATIONS UNDER AS1.01

APPLICATION

Appointed Actuaries of Life Insurance Companies.

LEGISLATION

This Guidance Note ("GN") provides supplementary guidance on the application of Actuarial Standard 1.01 "Valuation of Policy Liabilities" issued by the Life Insurance Actuarial Standards Board (LIASB), as updated, amended or replaced from time to time (referred to in this GN as "AS 1.01"). This GN applies in circumstances where policy liability valuations that are to be published are being performed under AS 1.01 at an intra office year date.

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CLASSIFICATION

This Exposure Draft provides supplementary guidance on the application of the principles underlying AS 1.01. While AS 1.01 is not a professional standard of the Institute of Actuaries of Australia, it is a legislative instrument in accordance with Section 101 (3) of the Life Insurance Act (1995). This Exposure Draft should not be read in any manner which would sanction departure from AS 1.01.

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1. INTRODUCTION

1.1 Apart from yearly valuations at the end of each office year, life insurance companies often perform valuations at more frequent intervals.

1.2 This GN sets out the major differences between an end of office year valuation and an intra office year valuation. It also outlines some of the practical issues encountered in performing intra office year valuations. This GN has application only to valuations being performed for publication purposes.

2. GENERAL PRINCIPLES

2.1 The purpose of an intra office year valuation should be to produce profit results which reflect actual experience over the period reported upon, without undue influence by what may be expected to occur over the remaining annual reporting period.

2.2 It is important to note that it is generally not appropriate to treat each part year profit reporting period in the same manner as the full accounting year.

2.3 The reason for this is the basic principle that a company's annual results should not be affected by whether or not it has undertaken one or more intra year valuations.

The AS1.01 results in respect of profit margin recalculation, loss recognition, acquisition profit deferral and analysis of profit can thus be viewed as "interim" in the context of an intra office year valuation, as balances are not carried forward to year end.

2.4 The most practical approach to intra year valuations is thus:

> Conduct each valuation (part year or full year) in the normal fashion, but based on the <u>full accounting year to date</u>.
>
> The profit for each part year is then obtained by taking the <u>difference</u> between the full period to date result and any previously reported part year result.

2.5 One consequence of this approach is that, because intra year valuation results are ignored once a subsequent valuation has been performed, some streamlining of the valuation process can be made. For example, for a Related Product Group with no loss recognition issues (ie the business is profitable on old or on any new assumptions that would apply), there is likely to be no need to recalculate profit margins to carry forward.

3. BEST ESTIMATE ASSUMPTIONS

3.1 For end of year valuations, assumptions need to be fully reviewed, often resulting in a totally new set of best estimate assumptions as compared to the previous end of year.

3.2 For intra year valuations assumptions should be reviewed but the review may be to a less detailed level.

3.3 Some assumptions will, however, require detailed review to ensure a realistic profit is reported. These include acquisition expense assumptions, investment, inflation and discount rate assumptions.

3.4 Where potential loss recognition and/or reversals are involved, then a detailed review of all those assumptions potentially affecting this issue would be required.

4. SEASONALITY EFFECTS

4.1 Results of intra office year valuations are likely to be affected by seasonal variations. These variations can be caused by fluctuations in such things as new business volumes, new business and maintenance expenses, claims patterns or discontinuance rates.

4.2 As a general matter, accounting principles require the matching of revenue recognition with the pattern of expense to which those revenues relate. For example, AASB1023 requires general insurance premiums to be earned in a manner consist with the underlying pattern of the expected incidence of claims.

4.3 However, in making specific allowance for seasonality patterns in the treatment of revenues or expenses in the determination of policy liabilities, the following should be noted:

4.3.1 Such adjustment is only appropriate where the seasonality pattern can be reliably measured.

4.3.2 While the principle is readily applied in the context of the deferred recognition of income already received, an accounting test of “virtual certainty” of recovery is typically applied in the case of deferring the recognition of costs already paid.

4.3.3 In particular, the implicit creation of internally generated goodwill in the case of expense recognition deferral needs to be avoided.

4.4 These points would generally lead to conclusions as follows.

4.4.1 Where there is a well established non-uniform pattern of claim cost incidence over the year, and this is material to the emerging profit results, this should be allowed for in the pattern of revenue recognition. This may be achieved via suitable adjustment to the policy liability.

4.4.2 Similarly, where there is a need to consider other ongoing assumptions (in the case of loss recognition or reversal), appropriate adjustment may be made to remove the effect of uneven accrual or incidence of experience over the year. For example, where there is significant fluctuation in maintenance expenses for the period concerned or in other assumptions, such as discontinuance rates. A full year view may be more appropriate in this situation.

4.4.3 However, while seasonality of new business can cause volatility of acquisition unit costs, producing results that appear more or less profitable than are expected to be the case over the full year, nonetheless in setting acquisition expense assumptions it is normal to use actual experience for the year to date.

That is, in terms of 4.3.2 and 4.3.3 above, it would be unusual to make adjustments for seasonality in new business volumes. For example, not recognising capitalised losses created by low first half year new business could produce misleading half year results if the second half year's anticipated new business does not eventuate.

4.5 These points highlight the impact that accounting principles can have on the determination of the policy liabilities and the importance of actuaries ensuring the approaches they adopt are consistent with those principles.

5. OTHER PRACTICAL ISSUES

5.1 DATA MODELLING & APPROXIMATIONS

5.1.1 Policy data is often modelled to gain an improvement in the size of files or the speed of computation. Some care is needed when adopting models for intra year valuations.

For example, one common method of data modelling requires the grouping of policies with commencement or maturity dates falling in the same period (eg in a 3 months or 6 months interval). Such a method produces results that are generally acceptable for yearly valuations provided commencement or maturity dates are evenly distributed throughout the year. However, for intra year valuations, significant distortions of results can occur and action may need to be taken to remove these.

5.1.2 Similar distortions can arise where approximate calculations are used, for example, where unearned premium reserves are relevant to the valuation method but are calculated on an approximate method.

5.2 FORMULAE USED FOR VALUATION AND ANALYSIS

5.2.1 It should be noted that formulae developed for the end of year valuation and analysis may not be directly applicable without modification for intra office year valuations.

5.2.2 A number of calculations may need to be adjusted to reflect the actual length of the valuation period.

An example in the liability calculation is the formula used for determining cost of bonus (best estimate and declared). This should be adjusted to reflect the length of the valuation period.

END OF GUIDANCE NOTE 260