

When Is Something Broke?

DURING THE COURSE OF MY CURRENT INVOLVEMENT IN THE DEVELOPMENT OF NEW INTERNATIONAL accounting standards for insurance, I've heard many opinions. One I've heard more than once is: "Our accounting systems aren't broke, why do they need radical surgery now?"

Nevertheless, the International Accounting Standards Committee (IASC) and the Financial Accounting Standards Board (FASB) are taking a look at general-purpose accounting models for insurance, as a subset of financial instruments. The American Academy of Actuaries, through its development of a universal valuation system (UVS), is evaluating the need to take another look at statutory accounting models.

Firms in certain fields, such as computer technology, continually have to reinvent themselves to survive. They need to institutionalize the anticipation of and the reaction to change. Accounting and insurance need to do the same.

But when? Acting too soon can be dangerous. And waiting until it's broken may be too late.

Before we can figure out when change is needed, the profession has to answer a few basic questions. Is change necessary? Why aren't the current systems of general-purpose and regulatory accounting for insurance liabilities meeting current needs?

I don't believe these systems are meeting current, let alone future needs, partly because of such macro-level changes as:

- **Globalization of the insurance industry.** Multinational insurers are growing more important, in the United States and elsewhere. At the same time, accounting standards have been diverging worldwide rather than converging.

- **Importance of capital markets.** Now that most insurers rely on the capital markets, isn't it time accounting becomes consistent for consistent products offered by different industries?

- **Convergence among financial services industries** and increasing choice between insurance and alternative risk management vehicles (such as self-insurance). More regulators are involved with the entire spectrum of financial services firms

and not just insurance. The uniqueness of insurers is increasingly being challenged. Insurance and insurance-like options should be chosen on the basis of economic costs rather than accounting treatment.

- **Other areas of accounting are changing**—in many cases to fair values. Incon-



sistency is possible among reported values of assets and liabilities. Increased use of fair values for assets without similar application to liabilities can lead to what might, at best, serve as internally inconsistent financial reports and, at worst, produce misleading results.

The use of historical values is inconsistent with a prospective view of the obligations insurers face. Companies need forward-looking information that's responsive to the levels of risk they're taking. What at one time appeared conservative may hide the effect of current and anticipated experience.

- **Lack of transparency and relevancy of current accounting.** In most cases, only experts can decipher insurance company accounts. This can depress share values and provide avenues for mismanagement. Although the value of experts such as actuaries may increase with less transparency, more understandable reports should benefit all users of such accounts.

Isn't the status quo OK? Evidence from the recent movement to U.S. GAAP by non-U.S. insurers could lead to the con-

clusion that current U.S. GAAP systems may be best. But this may be due more to the strength of U.S. capital markets. FASB is starting to re-evaluate its insurance models, and changes are likely to come.

Other evidence that current U.S. models may not satisfy the users of financial reports is that none of the new accounting models recently developed in the United Kingdom, Australia, and South Africa are close to the current U.S. models. Evidence can also be seen from the number of business decisions based on accounting rules, rather than sound economics, particularly apparent from reinsurance activities. There's a significant need to start from scratch.

Will change be radical or evolve? Tinkering with the system by adapting current models to new products has been the most recent approach used. How much tinkering can be done without a fresh look at the underlying principles and needs?

What's the rush? Every year these issues aren't resolved is one more year the current deficient system has to be tolerated. A long lead time for such change is needed, so if there is agreement that there is a need for change, then why not start the process now?

What about the costs and risks? For many insurers, any new system will be costly to implement. Nevertheless, users will likely demand such change. Actuaries, who understand insurance risks better than anyone else, are at the forefront of these changes. Our insurance accounting systems are proving less adaptable and providing less relevant information than they should. Can we live with the current systems much longer? ●

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