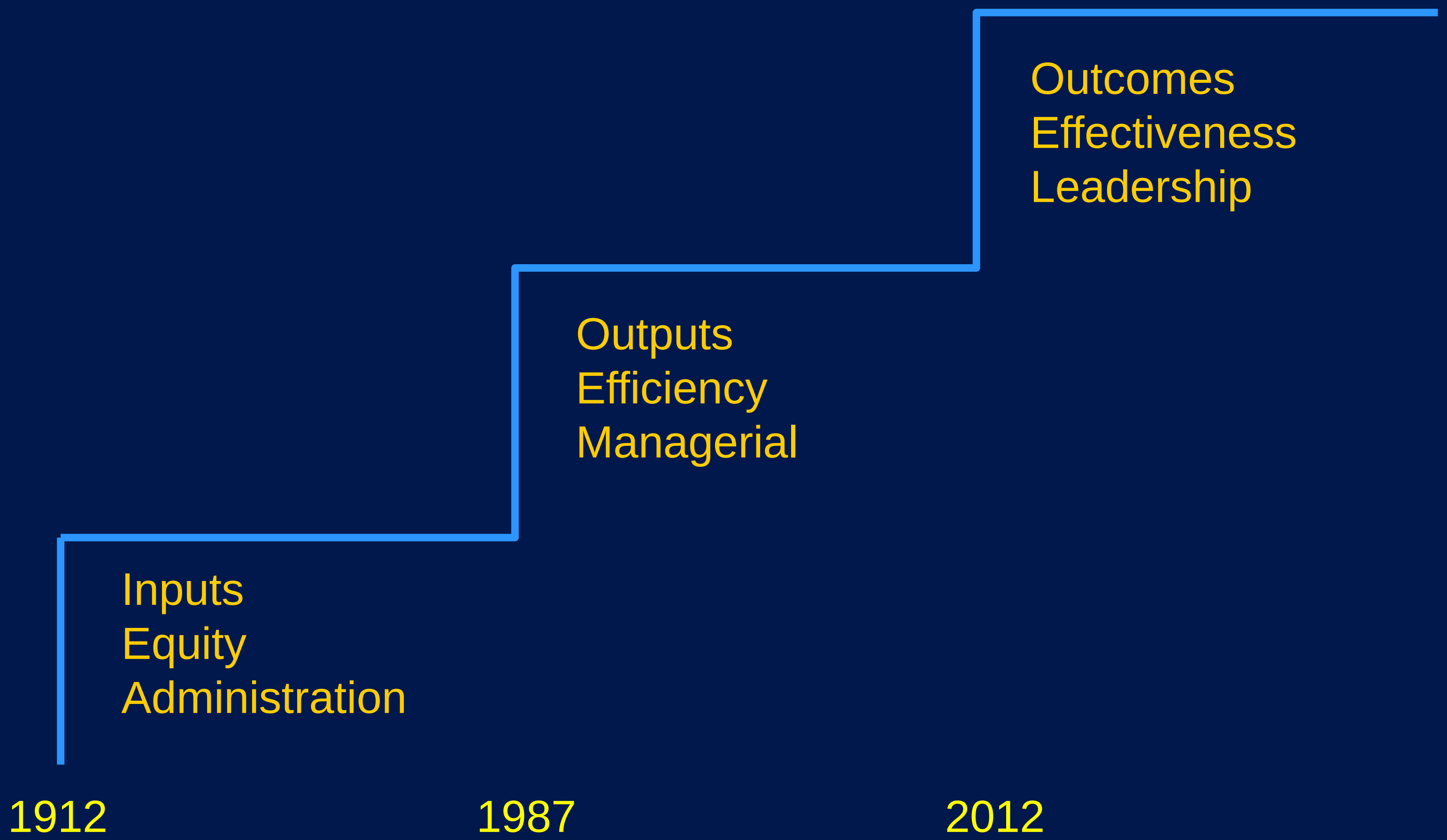
# Accounting for Social Benefits

## Some NZ Developments

# Outline

- Some background as to why NZ in taking a liability management approach to welfare and what led to it
- Actuarial Advice on a framework for financial management of welfare liability
- Accounting Advice on a framework for financial management of welfare liability

# NZ Public Sector Management Development



# Accounting for Accident Compensation

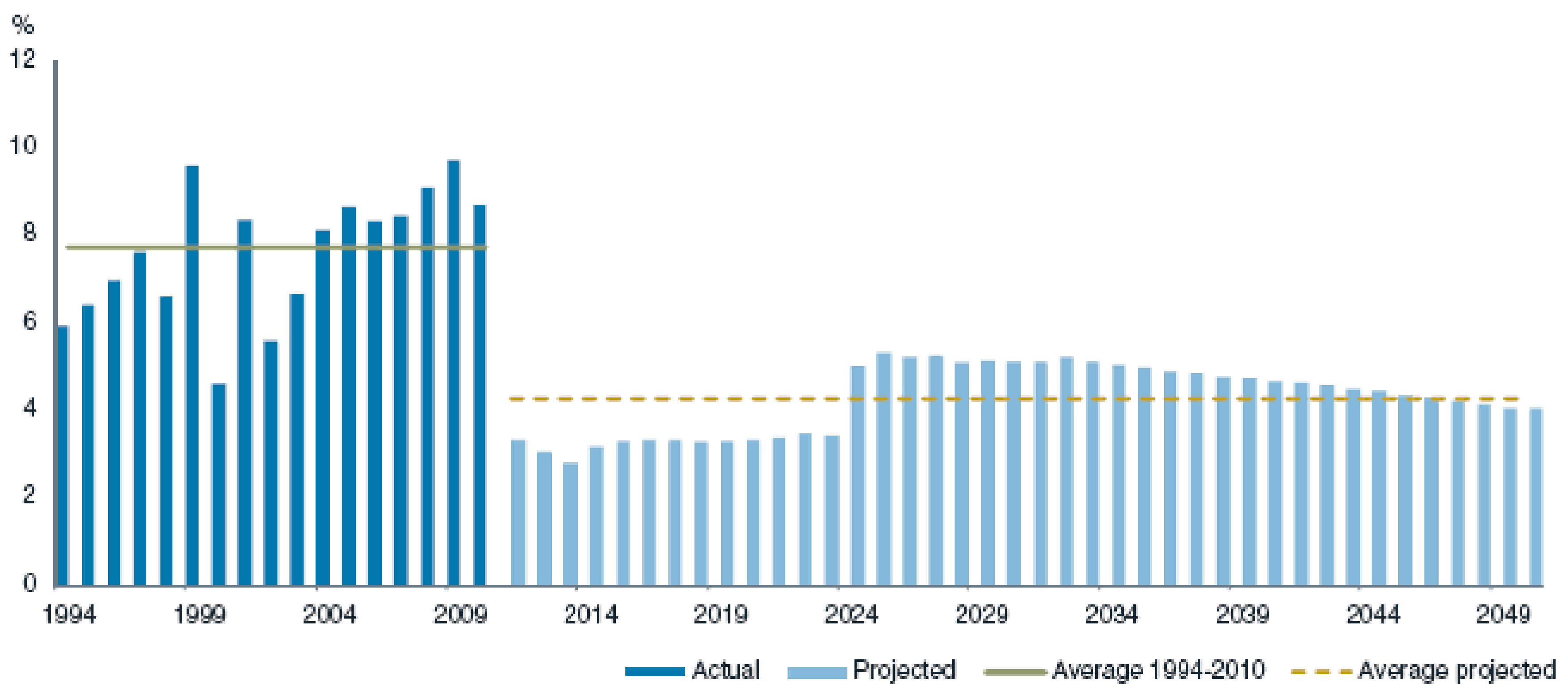
| $ Billions | 2009 | 2008 | 2007 |
|---|---|---|---|
| | | | |
| Investments | 10.4 | 9.6 | 9.3 |
| Other Assets | 4.1 | 3.5 | 3.1 |
| | | | |
| **Total Assets** | **14.5** | **13.1** | **12.4** |
| | | | |
| Outstanding Claims | 23.8 | 18.0 | 15.4 |
| Other Liabilities | 3.4 | 3.1 | 2.5 |
| **Total Liabilities** | **27.2** | **21.1** | **17.9** |
| | | | |
| **Reserves** | **-12.7** | **-8.0** | **-5.6** |

# Accounting for ACC

| $ Billions | 2011 | 2010 | 2009 | 2008 |
|---|---|---|---|---|
| | | | | |
| Investments | 17.6 | 12.8 | 10.4 | 9.6 |
| Other Assets | 4.2 | 4.4 | 4.1 | 3.5 |
| | | | | |
| **Total Assets** | **21.8** | **17.2** | **14.5** | **13.1** |
| | | | | |
| Outstanding Claims | 24.5 | 24.4 | 23.8 | 18.0 |
| Other Liabilities | 4.0 | 3.0 | 3.4 | 3.1 |
| **Total Liabilities** | **27.4** | **27.4** | **27.2** | **21.1** |
| | | | | |
| **Reserves** | **-6.7** | **-10.2** | **-12.7** | **-8.0** |

# Accounting for Health

**Figure 7.3** – Annual nominal growth in health spending – sustainable debt




Source: The Treasury

# Can Accident Compensation approach work elsewhere?

**Actuarial Advice sought**: Contract requirements

***Is a long-term investment approach to improving employment, social and financial outcomes from welfare benefits and services feasible?***

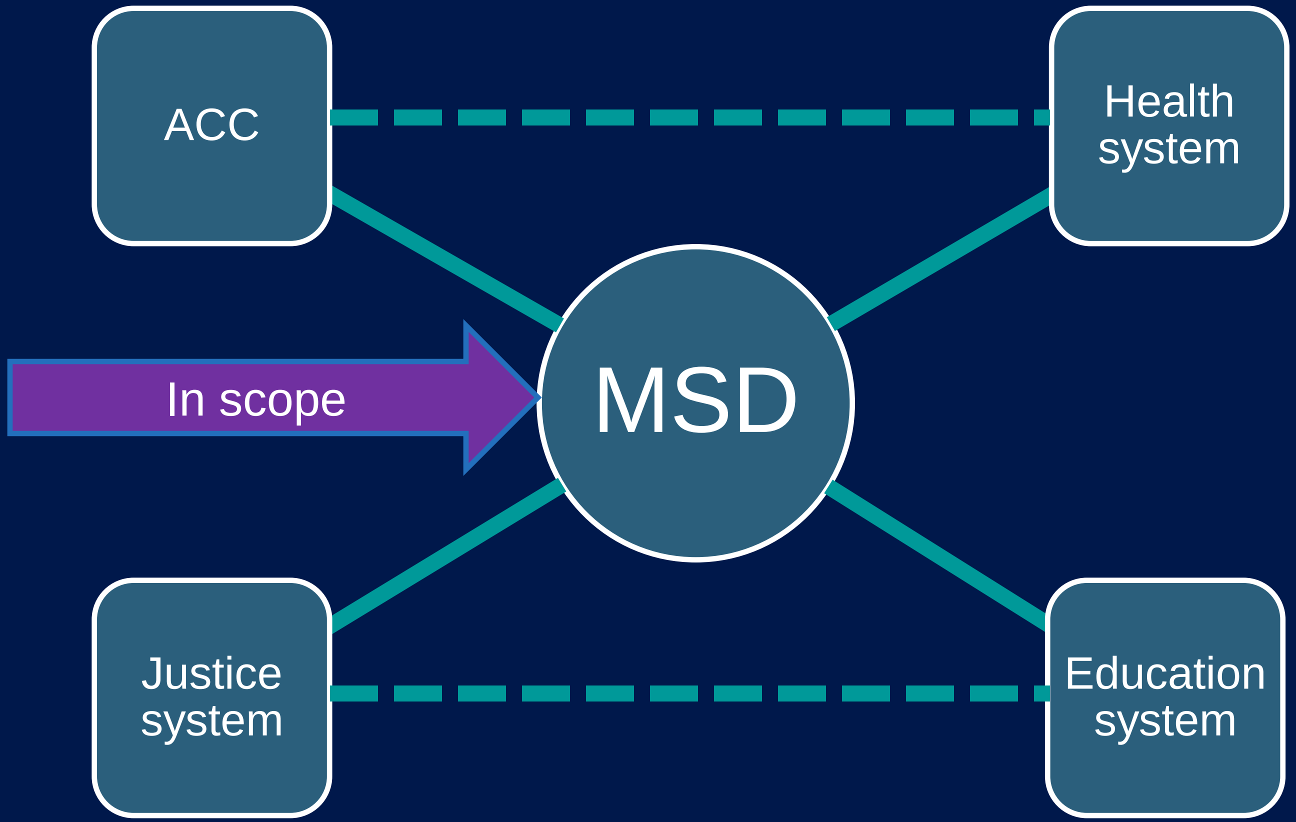
If so...

**Recommend a framework for financial management of welfare commitment**

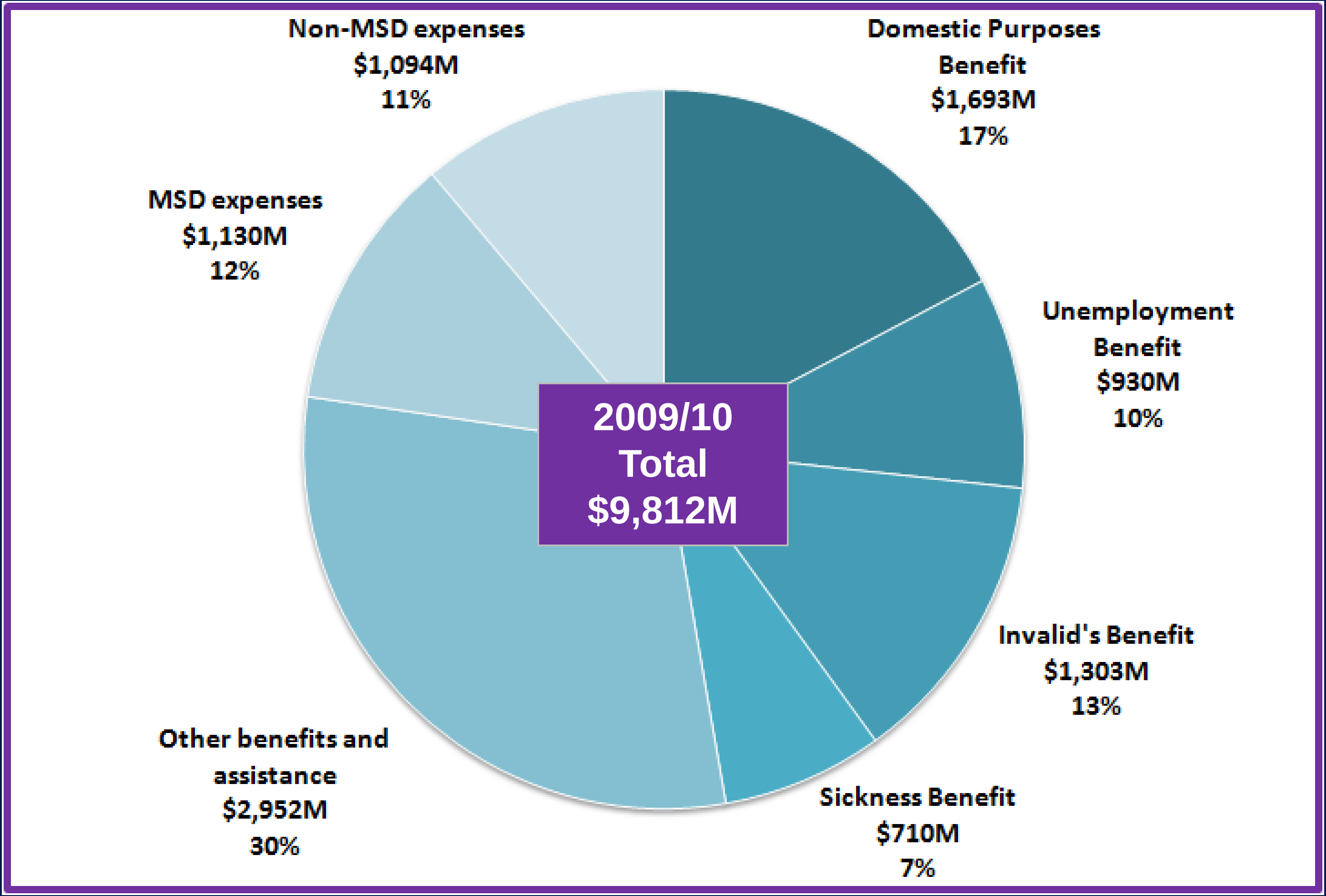
and provide advice regarding

- Considerations to maintain focus on outcomes
- Scope of liability – cost of service delivery, cost of services, welfare benefits
- Peer review of existing MSD capability
- A basis for estimation of the welfare liability
- Funding of the welfare liability
- Implementation issues and barriers

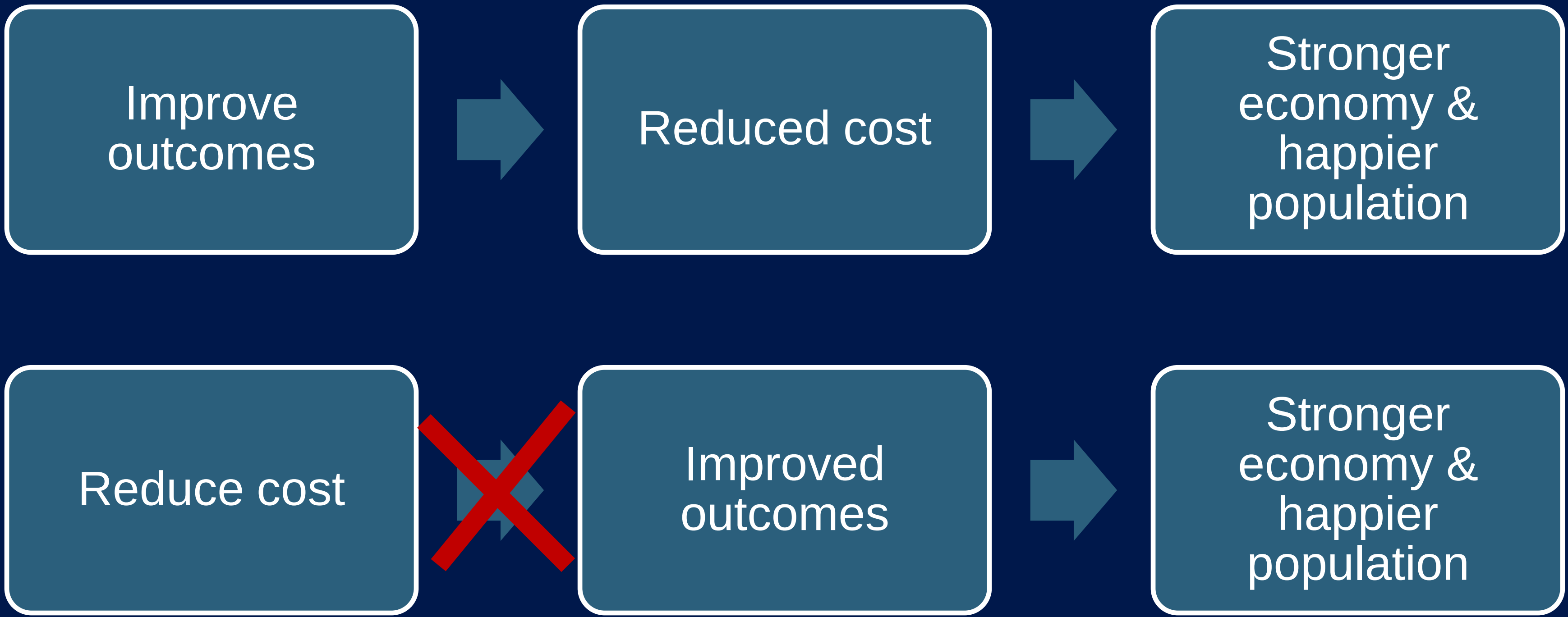
# **Background:** Scope



# **Background**: Scope



# **Background:** Aims of the approach



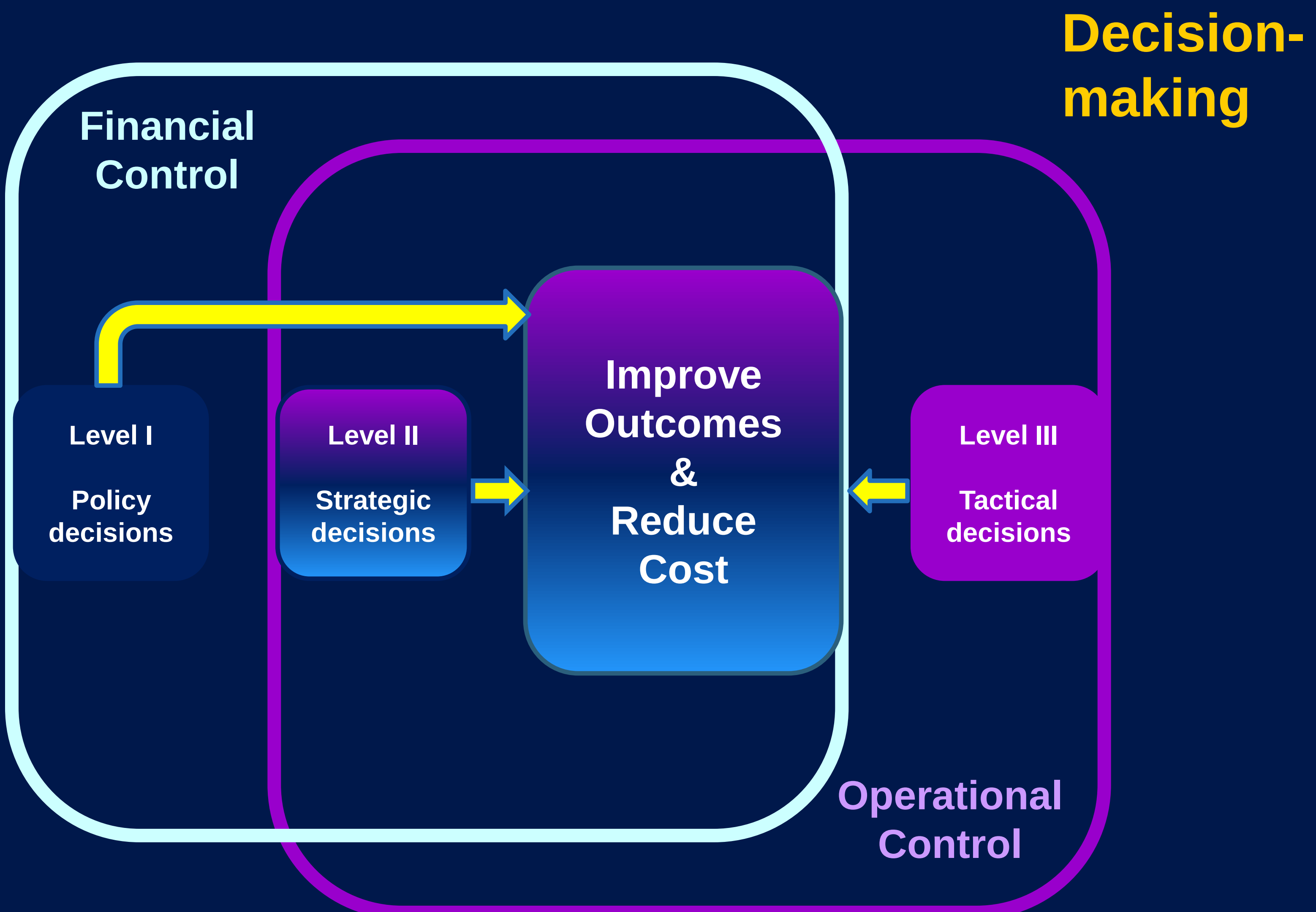
# **Actuarial Advice**: Is it Feasible?

***Is a long-term investment approach to improving employment, social and financial outcomes from welfare benefits and services feasible?***

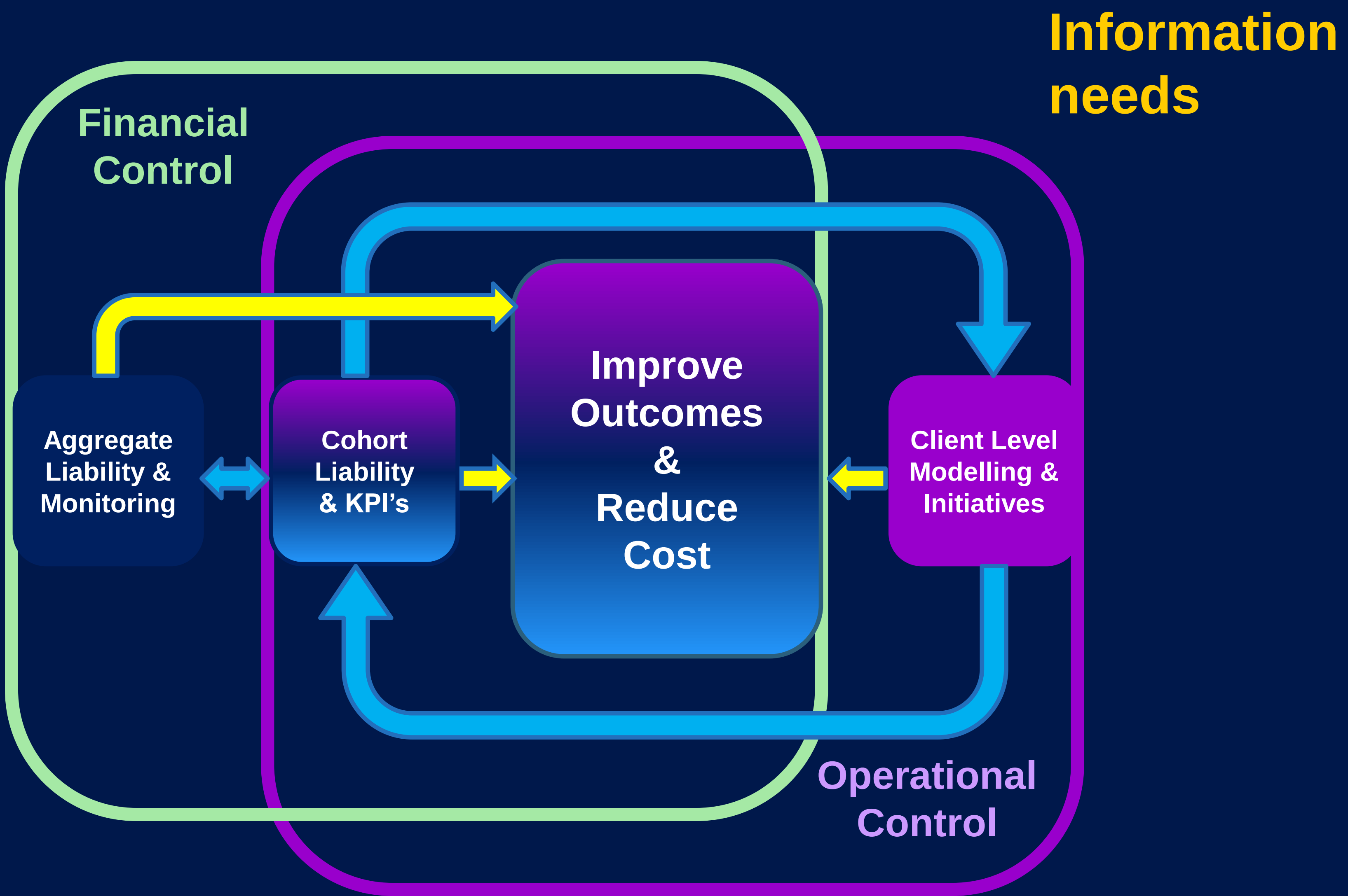
***YES.  It is.  There are proven examples in various organisations of this sort of approach.***

***The proposed framework borrows from actuarial, financial and operational management of insurance schemes and social welfare systems and from relatively recent developments in various industries to employ statistically based evidence as the basis of decision making.***

# **Proposed Framework**: Overview



# **Proposed framework**: Overview



# **Proposed framework:** 3 level approach

| | |
|---|---|
| **Level I**<br>Aggregate actuarial liability valuation & monitoring | • Enables financial control of the welfare benefit system<br>• Improves accountability and transparency of the cost of welfare<br>• Improves policy decision making process |
| **Level II**<br>Actuarial and statistical modelling of cohort liability and KPI’s | • Aids strategic decision making in the delivery of services<br>• Informs Level I evaluation of aggregate liability of financial impacts due to Level III initiatives<br>• Aids frontline staff in the delivery of appropriate services via meaningful & statistically based KPI’s<br>• Allows performance measurement of cohorts |
| **Level III**<br>Statistical modelling and evaluation of client level initiatives | • Enables tactical decision making based on evidence of outcomes<br>• Enables rigorous evaluation of total financial impact of initiatives<br>• Allows analysis of funding requests for wider roll out of initiatives |

# Does anyone else do this?

| | |
|---|---|
| Level I | • All insurance companies incl.accident compensation<br>• Competence varies, but core part of business and usually done reasonably well.<br>• When not done well can lead to insolvency (e.g. Lloyds) |
| Level II | • Variations used in most insurance companies and accident compensation schemes<br>• Greater variation in competence.  Sets smart players apart from the rest |
| Level III | • Recent application in consumer dominated industries<br>• Insurance: solid use in pricing, scattered use in other areas e.g. claims management<br>• Other : telecoms, banking, energy, aviation, retail etc |
| Whole framework | • To our knowledge not implemented holistically as proposed<br>• NZ social welfare would be starting with a clean slate<br>• Combines elements of best practice at each level of operational and financial control |

# **Implementation**: Risks, issues, barriers

## Level III Framework

- Some form of controlled trials is critical for the success of the Level III framework
- Trial design must be rigorous to allow confident decision making and evaluation of financial impacts
- Continual process to monitor experience and isolate issues
- Creativity and experience required for initiative design
- Failure of some trials is expected and is part of the process

## MSD Capabilities

- Level I – needs new team or external consultant. Internal actuarial capability difficult to develop in the short term. External team needs appropriate qualifications, skills and experience
- Level II & Level III – capability under development. During initial phase important to set up appropriate methodologies and framework. Improves likelihood of success via rigorous analysis and decision making and enables knowledge transfer between staff

# Is an actuarial approach to welfare feasible

Accounting advice sought:

**Does accounting provide obstacles to implementing a framework for financial management of welfare or can it assist?**

- Is welfare a liability?
- Use of accounting Standards?
- Integration with GAAP based accounts?

# The story so far ...?

## **G**enerally **A**ccepted **A**ccounting **P**ractice

Current status:

- Provisions and contingencies– An Exposure Draft
- Social Benefits – Consultation papers and a withdrawn ED
- Insurance Accounting – A preliminary standard and an Exposure Draft

# A Liability? – the latest word

## What are liabilities in public sector financial statements?

The three characteristics necessary for a complete definition of a liability relate to:

- The substance of a liability
- How to determine if it is the reporting entity's liability, and
- How to determine if it is a liability at the reporting date

### The substance of a liability

Is the substance of a liability an economic obligation, even if future economic sacrifice might not be required to settle?

Is an unconditional obligation, including unconditional obligations to stand ready to ensure against loss, a liability?

Is an obligation to perform in a specified manner a liability?

Is an obligation to provide access to, or forego resources in the future, a liability?

Is the notion of requiring settlement by a certain date useful to the definition of a liability?

### Is it the reporting entity's liability?

What are the most appropriate criteria to use to decide if an item is the reporting entity's liability?

- The entity's duty or responsibility to another entity?
- Absence of a realistic alternative for the entity to avoid the obligation due to:
  - Its legal enforceability?
  - Its legal enforceability, and other constructive and equitable obligations associated with exchange transactions?
  - Its legal enforceability and all other obligations from which the entity cannot realistically withdraw, including those associated with non-exchange transactions?

### Is it a liability at the reporting date?

Should existence at the reporting date be part of the element's definition or be identified as a separate recognition criterion?

Is it necessary to specify that a liability arises from a past transaction or event?

Where the obligation develops over time, e.g., from a political promise, through legislation, through conditions being met; when is the most appropriate recognition point?

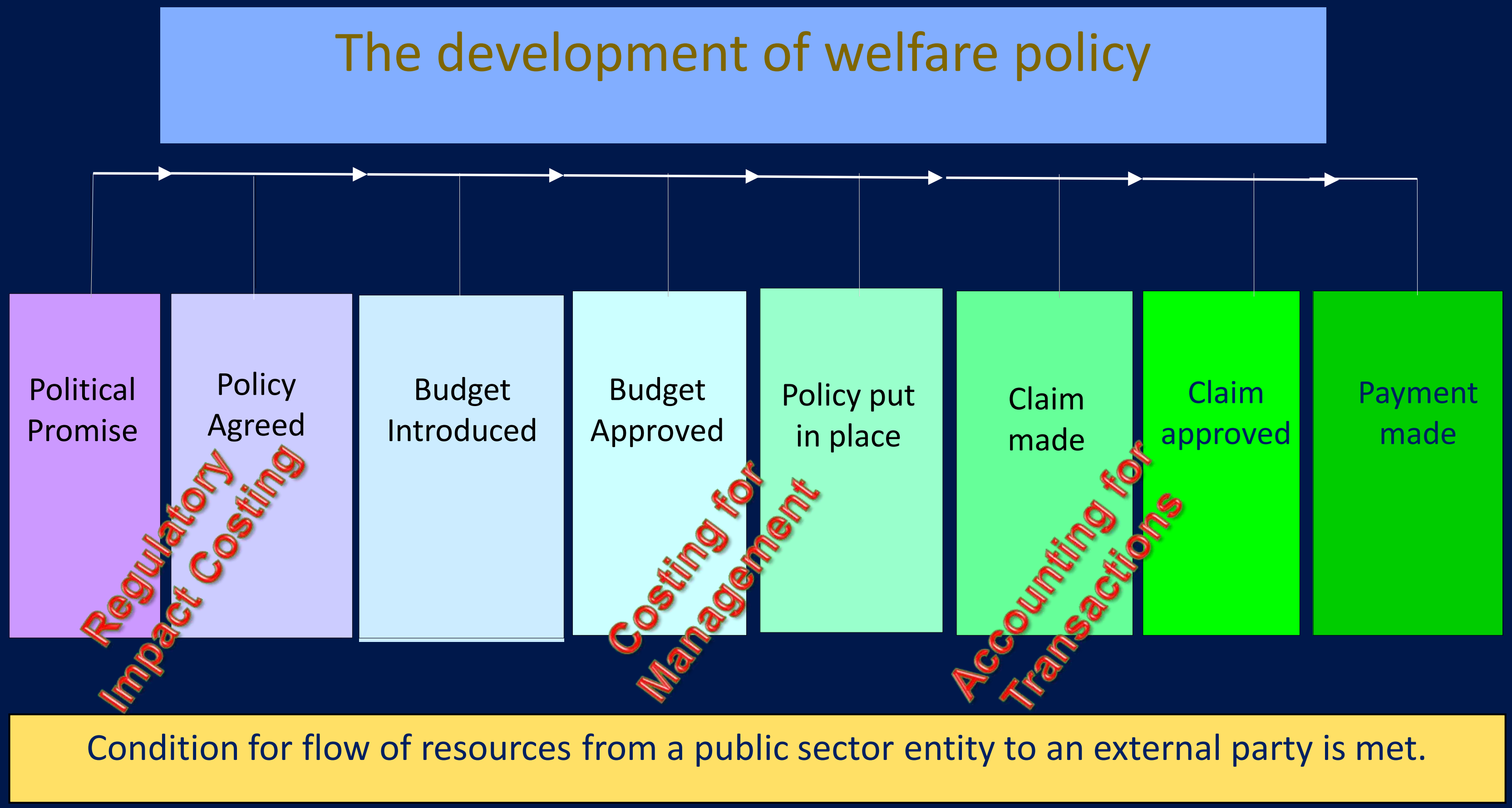
# Recognition

The development of welfare policy

- Political Promise
- Policy Agreed
- Budget Introduced
- Budget Approved
- Policy put in place
- Claim made
- Claim approved
- Payment made

Condition for flow of resources from a public sector entity to an external party is met.

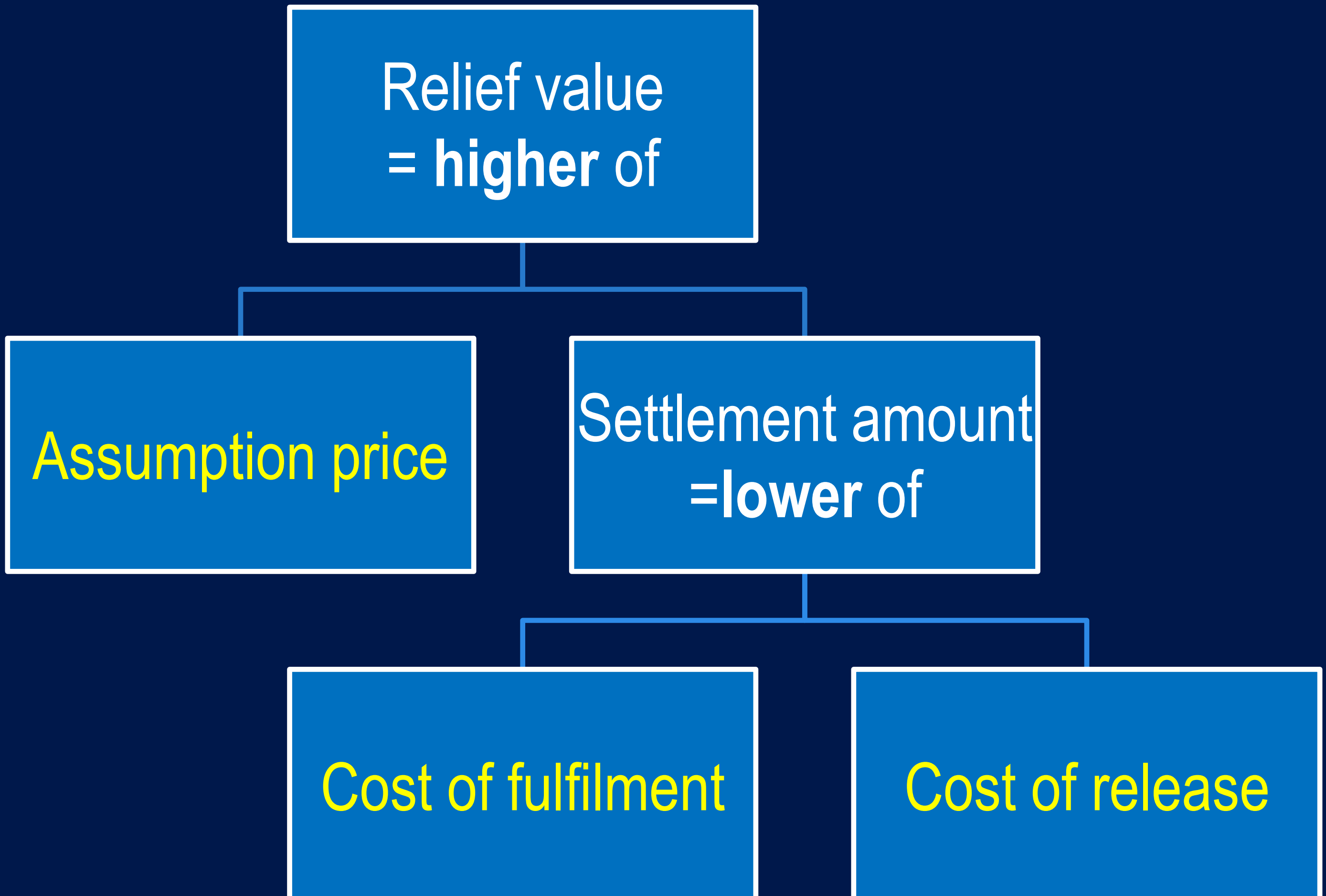
# Recognition



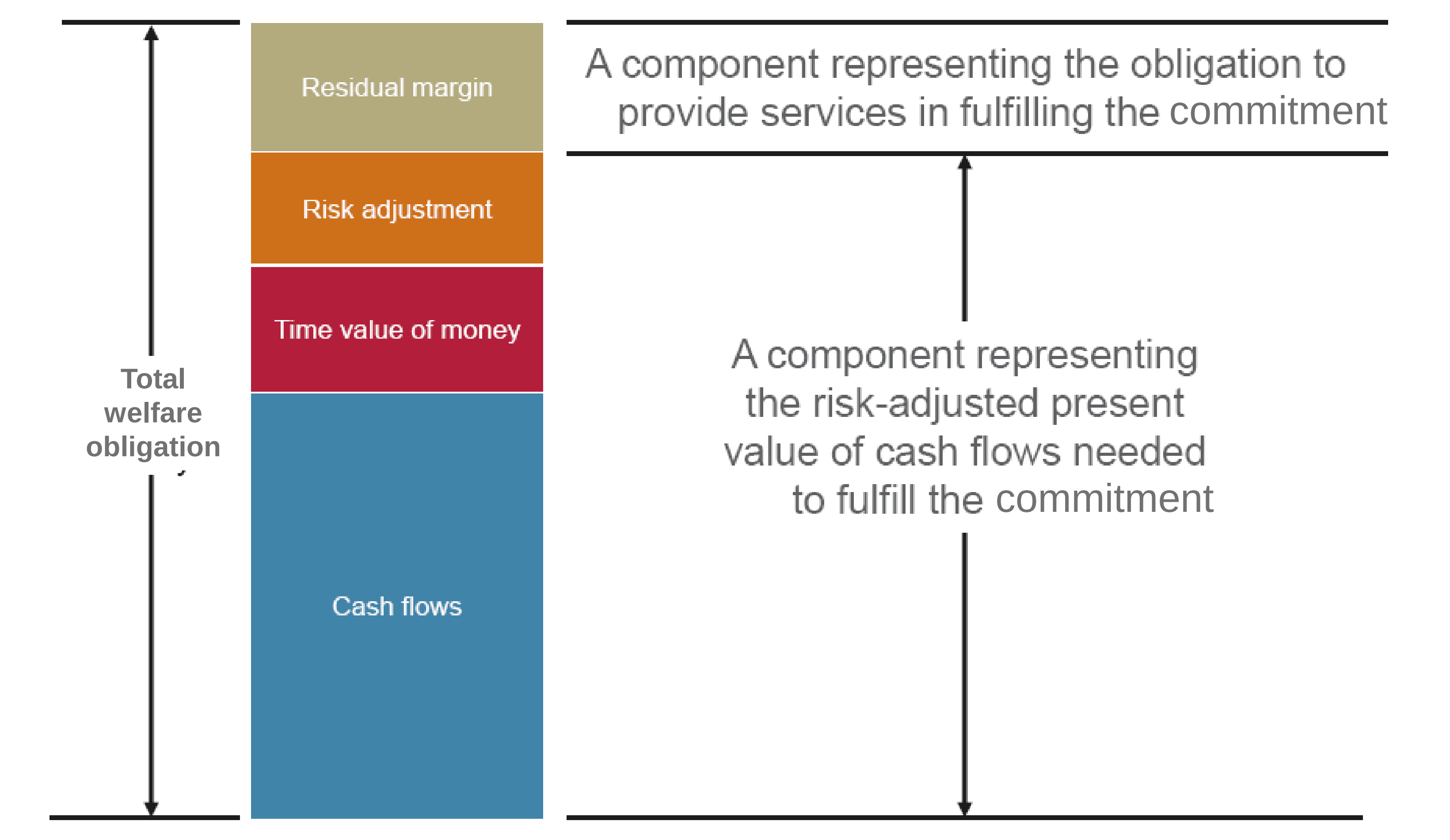
# Accounting Advice: Recognition of Social Commitments

- Logic is that there is not one but several recognition points
- Information in balance sheet currently driven by "present obligation" idea per GAAP.
- Social Policy Commitment information (i.e. future obligation idea) is valuable
- Therefore statement of "future obligations" should accompany and be integrated with balance sheet information.
- This is a more nuanced approach than a simple (Is it a liability?) approach

# Accounting Advice: Measurement



# Measurement Assumptions (using insurance accounting methods)



# Measuring the cash flows

Residual margin

Risk adjustment

Time value of money

Cash flows

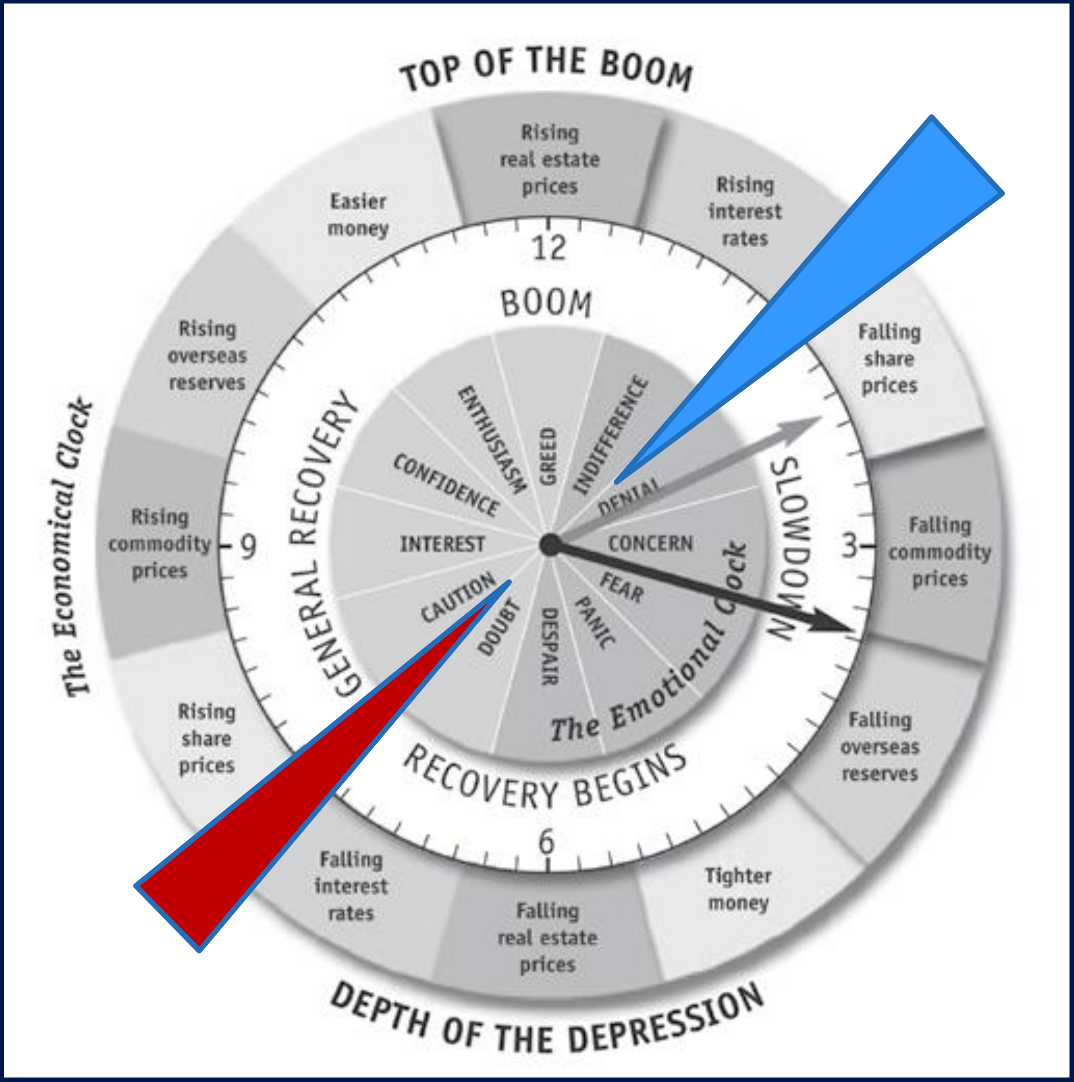
| Issue | Suggested Approach |
|---|---|
| Recognition Point | IASB insurance suggestion: when coverage period begins subject to prior onerous test |
| Obligation Boundary | Currently 4-yr fiscal forecasts, 40-yr LTFS, USA uses 75 yrs. IASB suggestion: “To the point no longer required to provide coverage |
| Take-up assumption | Process to combine top down (macroeconomic) view with bottom up (managerial) view: Independent review? |
| Price assumption | As for take-up |
| Maturity assumption | As for take up |

# Measuring the time value of money

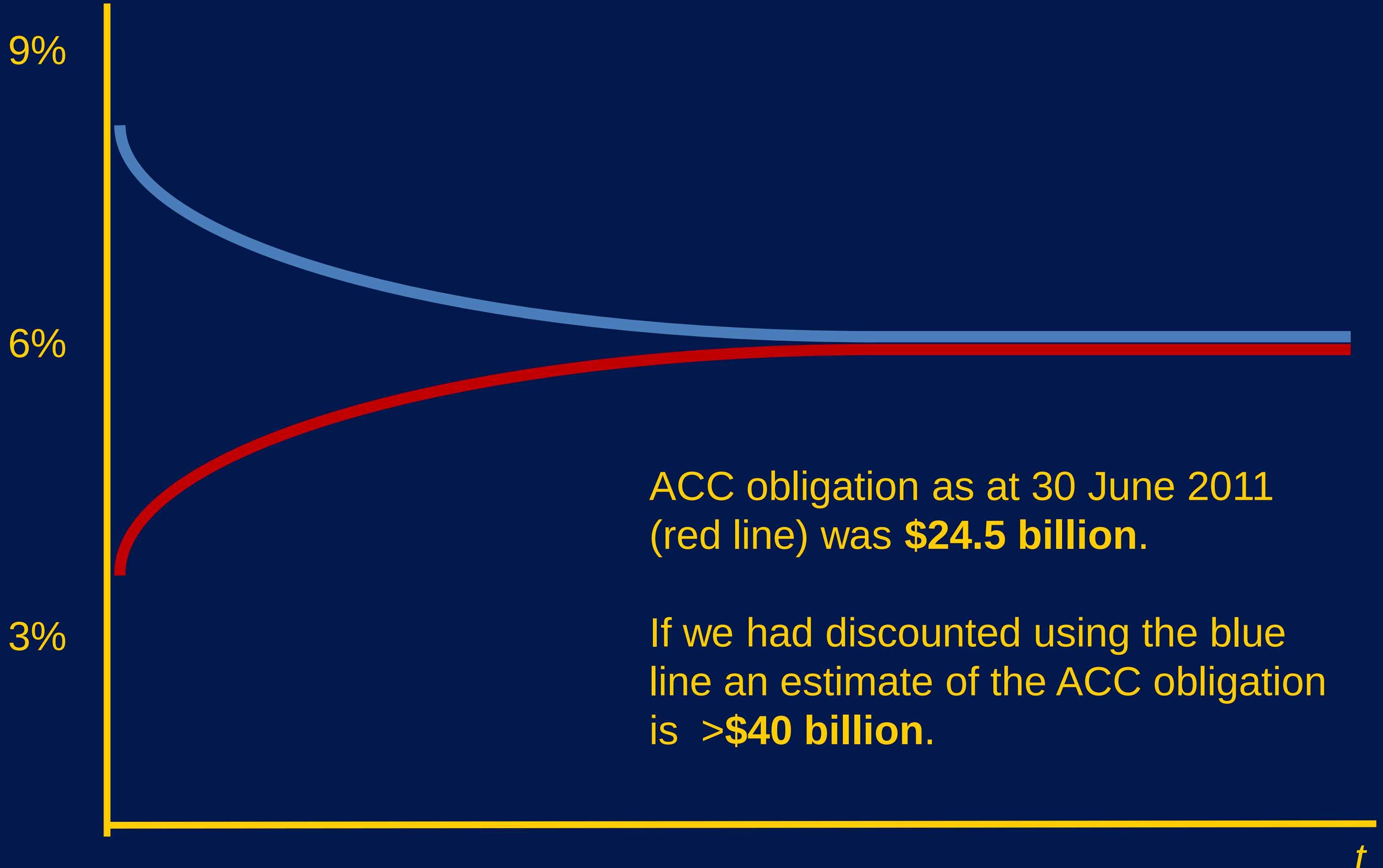
- Residual margin
- Risk adjustment
- **Time value of money**
- Cash flows

| Issue | Suggested Approach |
|---|---|
| Impact of matching assets held today | Ignore, use risk free rate as we are measuring gross commitment, not the net commitment |
| How regularly updated | At each assessment, tools have simplified this process |
| Volatility | Quarantine and explain through presentation |

# The volatile time value of money



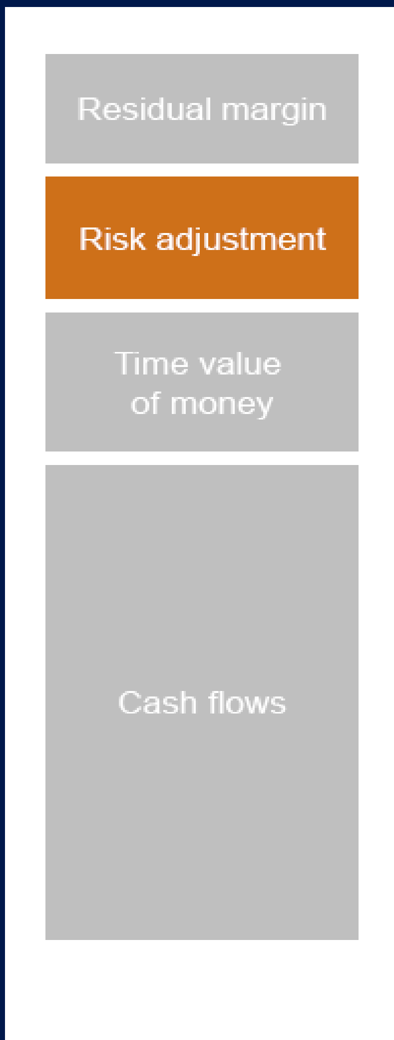
# Risk-Free Discount Rate




ACC obligation as at 30 June 2011 (red line) was **$24.5 billion**.

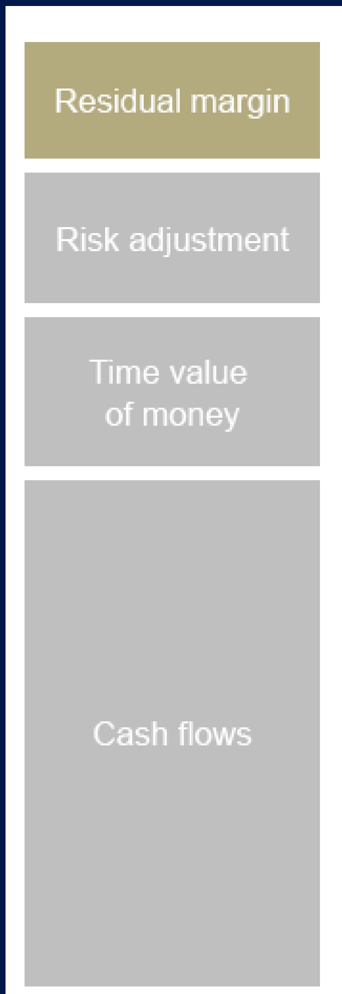
If we had discounted using the blue line an estimate of the ACC obligation is >**$40 billion**.

# Accounting for a risk margin?




| Issue | Suggested Approach |
|---|---|
| Is it useful?<br><br>It represents:<br>“The ***maximum amount the*** insurer would ***rationally pay*** to be relieved of the risk that the ultimate cash flows exceed those expected.” | This approach, while it may provide relevant information in a private sector insurance context, where reinsurance contracts are available to release insurer of obligations, is at odds with the relief approach that IPSASB is suggesting. |
| or conversely:<br><br>“The ***compensation the*** insurer ***requires to bear the*** risk that the ultimate cash flows could exceed those expected” | Propose not to use as the basis of measurement.<br><br>However consider disclosure if it is useful for risk management purposes, particularly if mgmt action can alter the shape of the risk curve. |

# Accounting for a residual margin?




| Issue | Suggested Approach |
| --- | --- |
| Is it useful? | While in the private sector context, this is simply a device to ensure that profits on writing an insurance contract are reported over the life of that contract, rather than being recognised immediately – its relevance to the public sector is that it provides a measure of the cost of administering the social policy commitment. |
| | Suggest that this be measured, but need to develop other (cost based) approaches, rather than basing it off the insurance premium |

# Accounting for Social Commitments

## Social Welfare Statement

| | |
|---|---|
| **Policy impact** | |
| Change in Estimates: | |
| - New policy | xx |
| **Management Impact** | |
| Change in Estimates | |
| - New procedures | xx |
| Experience Adjustment | xx |
| **Financial impact** | |
| Boundary extension | xx |
| Discount unwind | xx |
| Change in value of money | xx |
| Change in value of commitment | xx |

New measures to target and manage to !

The commitment could be impacted by policy decisions as recorded during Regulatory impact cost benefit judgements.

Management may perform better or worse than expected during the year, (experience adjustment) and some of this will translate into expectations for future years.

# Accounting Advice: Summary

- No currently generally accepted accounting practice for recognising, measuring and presenting  social welfare commitments, but an issue that standard setters have been worrying away at.

- Insurance accounting does provide a useful and credible approach to this issue

- Social commitment information should supplement and integrate with current GAAP produced statements to enhance rather than weaken the credibility of both

- Significant number of assumptions would require judgement and buy-in.   Propose the development of  an independent review panel.