from left

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Management Discussion and Analysis of Operations

The year 2000 is the Company's first full year of operation since its IPO. After careful preparations, the Company went through Y2K without a glitch in its IT or other operations.

In the year 2000, several important events took place in the life insurance industry in general, and in the Company in particular. A few notable ones are:

(1) The Insurance Authority in Hong Kong introduced a licensing examination for life insurance agents (IIQAS);

(2) The Mandatory Provident Fund Scheme was implemented;

(3) The Company changed its accounting policies; and

(4) The Group received an "A- (Excellent)" rating from A.M. Best.

The following sections provide a detailed review and analysis of 2000 results and segmental performance. The left-hand column provides annotations on business nature and industry practices.

1. Change in accounting policies

Accounting for life insurance companies has always been a difficult issue and is rarely fully understood. It has a peculiarity in that new business written incurs a very high up-front acquisition cost. For a new and fast growing company that is writing a significant amount of new business, this up-front acquisition cost creates what is called "new business strain", i.e. under conventional accounting methodology, expenses incurred in successfully writing more business can have the effect of depressing the current year earnings. In the 1970s the US insurance industry developed a US General Accepted Accounting Principles ("GAAP") to better reflect the going-concern value of life insurance companies to shareholders. Instead of expensing all acquisition costs in the year in which they are incurred, an explicit intangible asset called deferred acquisition cost ("DAC") was created which is then amortized over the expected life of the associated policy. Two main features of the US GAAP are: (a) it is intended that profits should emerge, generally speaking, as a constant percentage of the premium income over the life of the policy and, more importantly, (b) the DAC must meet the recoverability test, meaning that there must be sufficient margin in future premiums to amortize the DAC.

In the early 1990s, the Canadian insurance industry developed a Canadian GAAP, called Policy Premium Method (PPM) for a similar purpose. The approach, however, is somewhat different. First, no explicit DAC is created, instead, it is netted against the policy reserve (alternatively called actuarial liabilities). Second, there is no requirement

There is no uniform standard for life insurance companies in Hong Kong since there are very few life insurance companies listed. The Company decided to change its accounting policy when it became apparent that its financial reinsurance program had given rise to a great deal of confusion and misunderstanding. In relieving its new business strain, the Company has now chosen to use the explicit "Deferred Acquisition Cost" ("DAC") Method.

In acquiring business (i.e. by accepting premiums and issuing policies), the Company incurs certain acquisition costs. These include commissions, underwriting medical examination fees, IT costs, advertising and other costs directly or indirectly related to the acquisition of new business. The benefits (i.e. profits) of business acquired will slowly emerge in subsequent years over the life of the policies. The accounting matching concept requires that acquisition costs be matched against ensuing benefits. Either the future profits should be brought to the present to match the cost of acquiring business (as is done in the Canadian approach) or the acquisition cost should be deferred to the future to match emerging profits in later years (as is done in the U.S. approach). When acquisition costs are deferred, an intangible asset known as DAC is created.

The Company has decided that DAC be amortized over a 10-year period using the straight-line method. The primary reason for the choice of this method is its simplicity and greater transparency which will better explain a complicated business/industry concept. In this regard, the Company does perform rigorous recoverability tests, including the use of independent actuaries, to verify that all deferred costs are recoverable against future related earnings.

that profits should emerge evenly over the duration of the policy. Instead, after providing an adequate margin for future contingencies, benefits and expenses, the remainders may emerge as profit in the year in which the business is acquired.

In the late 1990s, the Australian insurance industry developed an Australian GAAP, called Margin on Service (MOS) to achieve the same purpose. It is similar to Canadian GAAP in that no explicit DAC is created. On the other hand, it is similar to the US GAAP in that profits are expected to emerge evenly over the duration of the policy.

Three other important changes made are:

(a) the establishment of a much stronger "net level premium" reserve (future insurance liabilities);

(b) the inclusion of future payments under financial reinsurance as part of future insurance liabilities; and

(c) the inclusion of future payments under coinsurance as part of future insurance liabilities.

The simple example below shows how the profits from one policy will emerge over time under various different accounting methods. The numbers are purely illustrative and are intended to give the shape and trend of the emergence of profits, but not necessarily their magnitude.

Profit (loss) emergence under different accounting methods

	PCI – old accounting method	PCI – new accounting method	US GAAP	Australian GAAP	Canadian GAAP
Year 1	-1,900	800	800	800	3,500
Year 2	1,100	800	800	800	500
Year 3	1,100	800	800	800	500
Year 4	1,100	800	800	800	500
Year 5	1,100	800	800	800	500
Year 6	1,100	800	800	800	500
Year 7	1,100	800	800	800	500
Year 8	1,100	800	800	800	500
Year 9	1,100	800	800	800	500
Year 10	1,100	800	800	800	500
Total	**8,000**	**8,000**	**8,000**	**8,000**	**8,000**

For those who are not familiar with interpreting the accounts of life insurance companies, the DAC being an intangible asset may appear unduly large as compared with the Company's total net assets. In order to establish a proper perspective, the following is a comparison of relevant numbers between PCI and the median of 7 major U.S. life insurance companies: