

RECORD OF SOCIETY OF ACTUARIES 1976 VOL. 2 NO. 2

TRENDS IN GAAP AND STATUTORY FINANCIAL STATEMENTS

*Moderator: STEPHEN D. BICKEL. Panelists: JOHN H. BIGGS,
DANIEL F. CASE, W. H. ODELL.*

1. Actuarial certification of statutory statements (Recommendation #7)
2. GAAP for participating insurance - stock companies (Recommendation #6)
3. GAAP for mutual companies
4. Use of interest in amortizing acquisition expenses (Recommendation #1)
5. Federal income taxes - considerations in choosing assumptions
6. Interim financial statement (SEC ASR#177)
7. Appropriate surplus levels and objectives
8. Actuarial reports (Recommendation #3)
9. Asset valuation
10. Materiality

MR. STEPHEN D. BICKEL: All of the panelists are members of the Academy of Actuaries' Committee on Life Insurance Financial Reporting Principles. Because of their involvement with this committee, it may be helpful if I outline briefly the work which is being done by members of that committee.

The Committee on Life Insurance Financial Reporting Principles was formed in 1972 and was charged with examining the actuarial considerations applicable to the financial reporting of insurance companies and developing guidelines for the practicing actuary. Subject to procedures prescribed by the Academy's Board of Directors, these guidelines are published as either recommendations or interpretations.

So far, the committee has published seven recommendations, of which the first six dealt with various aspects of GAAP accounting. The subjects covered were the general principles underlying the intermediate release from risk approach, the relations between the actuary and the auditor, actuarial reports and opinions, reinsurance ceded, premium recognition, and the treatment of participating insurance issued by stock companies. This last recommendation was distributed to the membership of the Academy a few weeks ago.

The seventh recommendation was published late last year and contained guidelines to be used in preparing the new certification of statutory statements which was added last year. Recommendation seven is the only one so far which involves statutory accounting.

There are about fifteen members of the committee, and they meet about six or eight times a year. Between meetings the members exchange great volumes of correspondence with each other. As the subjects arise, task forces of two to four people will generally be appointed to develop a topic and make suggestions to the committee as to whether or not a recommendation or interpretation should be prepared. At the present time, there are about a dozen such task forces, each assigned to topics such as guidelines for determining materiality, methods of applying purchase accounting, GAAP for mutuals, GAAP accounting for Federal Income Taxes, and selection of GAAP assumptions. The committee also monitors developments affecting life insurance financial reporting which come from the various governmental and accounting bodies.

MR. W. H. ODELL: We will first consider Topics 1 and 8 which deal with statements by actuaries in connection with statutory and GAAP statements respectively. Before discussing these topics, it is well to note the considerable amount of activity going forward in connection with actuarial statements of different types. First, there is material that has been and will be published on a formal basis by the Academy's Financial Reporting Committee: Recommendation 8 and Recommendation 3 and related material. Second, the Guides to Professional Conduct offer advice concerning actuarial reports. Also, the related Opinions A-3, A-4 and A-6 offer advice about actuarial reports. Also, the discussion report of the Joint Committee on Independence of the Actuary addresses the subject. Further, task forces of the Academy's Financial Reporting Committee are presently working on surveys concerning this subject (a portion of the results of which will be commented on here). Finally, joint task forces of the Academy's Committees on Financial Reporting and on Guides to Professional Conduct are examining this welter of activity with an eye to recommending ways of coordinating the advice in light of the present overall environment.

With respect to actuarial statements of opinion in connection with statutory statements, it will be recalled that the requirement for such opinions was developed by the NAIC during 1975. From the beginning, the Academy indicated willingness to work with the NAIC on this subject, but, at the same time, expressed the reservation that work should not proceed too precipitously. The requirement which went into effect last fall was the subject of discussion at the fall Society meeting in Miami.

The Academy's Financial Reporting Committee has surveyed, under the direction of Paul Sarnoff, 215 general account statements and 60 separate account statements submitted as of and for the year ending 1975. The results of this survey will be made available to the membership in fairly detailed form prior to the end of the calendar year. Because your presence at this panel indicates a particular interest in the subject, we have selected a few of the more interesting points revealed by this survey to share with you today. Amounts of liability are shown in 52% of the opinions. (Such amounts are called for in the Instructions and Recommendation 7). Of the companies surveyed, 126 printed the statement of actuarial opinion on the first page, the remainder attached it. In 91% of the cases, the document was signed by only one actuary. In 32% of the cases, items were reported in addition to the four required. Opinions accompanied all but one statement. Only 5% of the opinions were qualified and these not in a substantive manner. The wording from the Instructions was used in 94% of the cases and the Recommendation 7

wording in 6% of the cases. Both sets of wording are intended as an example. This is because only the signing actuary has responsibility for the wording he is signing - neither the NAIC nor the Academy. The Recommendation 7 wording was developed after considerable study of the wording which had been previously prepared for the Instructions. It appears that some refinement is required in the types of wording used where separate accounts are involved. Information presented to the Academy's Committee on Financial Reporting distinguishes between, on the one hand, making a professional statement of opinion and, on the other hand, swearing to the validity of a known fact. The statements of actuarial opinion fall in the former category and hence should not be notarized.

Turning next to the subject of actuarial reports and actuarial opinions rendered in connection with GAAP statements, the Academy's committee conducted a survey with respect to 1974 statements. That committee again wishes to thank those who participated in the survey. The results of this survey will appear shortly, we understand, as an item in the Academy's newsletter. The following comments are a digest prepared for your information today from drafts of that release:

With respect to the 48 companies replying indicating that they were on GAAP:

- 15 - prepared no report or opinion and none was prepared by a consultant
- 19 - prepared no report or opinion but a report or opinion was prepared by a consultant
- 6 - prepared a report or opinion but none was prepared by a consultant
- 8 - prepared a report or opinion and a report or opinion was also prepared by a consultant

It is clear from the survey that the practice of preparing statements of actuarial opinion and actuarial reports is far from universally followed. The responses to the survey suggest that actuarial reports are used more frequently by consulting actuaries than by company actuaries. This is understandable, considering the particular need for the consulting actuary to document the scope of limitation of his work and describe precisely what he has done and what his conclusions are.

It should be noted that the Guides to Professional Conduct do not limit the need for an actuarial report to consulting actuaries. Paragraph 4 of Opinion A-6 states the following:

"When an actuary's work relates to financial statements prepared in accordance with generally accepted accounting principles, it is the opinion of the Committee (on Guides to Professional Conduct) that Guide 2(c) requires that an actuarial report should be furnished to the company and to the company's independent auditor, if any. Such actuarial reports should identify the actuary, his relationship with the company, and the scope of his activity in relation to the financial statement involved."

The following arguments have been advanced to support the premise that actuarial reports should be prepared whether the preparing actuary is a company actuary or a consultant.

1. Management and other interested parties are entitled to the determination of actuarial statement items (which account for the preponderance of most companies' liabilities and require a high degree of professional expertise to determine) by a competent person who will take personal responsibility over his signature for his work.
2. When the financial statements are audited by an accounting firm, the accounting firm frequently may encourage or require an actuarial report. Even when this is not the case, the actuarial report can represent an important part of the audit trail. The inclusion of a single report of the actuarial assumptions and procedures used and the actuary's opinion as to the reserves and other items can frequently save both the auditor and the company substantial time and expense.
3. The actuarial report may serve as useful documentation for reference in future years, particularly as a company's personnel change and other files lose their timeliness. Such documentation may also be helpful in defining the responsibilities assumed by the actuary and by other members of management in the preparation of the financial reports. It is true that the documentation function has been often served by other company records, and very likely this is one reason why use of actuarial reports is less prevalent among company actuaries.
4. Importantly, the preparation of an actuarial report represents an important phase of the actuary's acting in a truly professional capacity and not simply as an employee of his company. Such action is particularly important if we, as a profession, are to make visible our professional standards in the eyes of our various publics.

Samples of some of the actuarial reports and actuarial opinions will be available from the Society's office upon request.

It appears that the very taking of this survey in the fall of 1975 led to these actuarial documents being prepared in a number of situations where this had not been done previously.

Actuarial opinions are still included only infrequently in the annual reports presented to shareholders.

MR. DANIEL F. CASE: I will discuss the topic of participating business of stock life insurance companies.

The Stock Life Company Audit Guide has just a couple of pages about how to handle the participating business of a stock life company. Those two pages, though brief, are pretty good. They point out that the treatment depends on whether the company is limited by law, or by its charter, or by company policy, to giving only a certain amount of the participating earnings to its shareholders.

If there is no limit on the shareholders' earnings, then the company can calculate GAAP policy reserves with future policyholder dividends built in as planned disbursements, and the shareholders' GAAP earnings will be whatever falls out after the increase in those reserves is charged each year.

If only, say, 10% of earnings from the participating operation may inure to the shareholders, then 10% of pre-dividend GAAP earnings for the year should generally be reported as GAAP earnings for the shareholders. This is like calculating statutory earnings before policyholder dividends and then taking 10% of it, except that in this case the calculation is based on GAAP instead of statutory. The difference between 10% of statutory and 10% of GAAP for the year is a "timing difference", which is a concept familiar to any of you who have had to deal with deferred taxes under either GAAP or statutory accounting.

If the company's shareholders can get only, say, 50¢ per thousand dollars of life insurance in force during the year, then the shareholders' GAAP earnings are limited to 50¢ per thousand, and there is no timing difference on pre-dividend earnings above that amount.

After the Audit Guide came out, the Academy Committee on Financial Reporting Principles looked over the section on participating business to see how we might be of help to practicing actuaries. We found two areas where we could, perhaps, offer additional guidance. One area was the problem which can arise when a company is subject to alternate limits, such as the greater of 10% of participating earnings and 50¢ per thousand, and may find itself subject to different limits at different times. The other area was in the choice of reserve assumptions.

We exposed a draft Recommendation and Interpretations to the Academy membership in November, 1974, and got back a number of comments which led us to study the first area a good bit further. We found that it is difficult or impossible to set down specific rules which can handle all possibilities for a company which is subject to alternate limits. We tested a number of possibilities on some illustrative cases and found that strange things sometimes happened, either when the illustrative company "flipflopped" from one alternate limit to the other or when the illustrative participating operation wound down. As a result, we fell back on rather general language.

Interpretation 6-A, as we expect to release it shortly, will give "General approaches to the determination of stockholders' profits from a typical established, on-going line of participating business." It will say, "Suitable modifications of the general approaches are likely to be required when the participating business is newly introduced or running off, or otherwise changing markedly."

Interpretation 6-A will finish up with an overall caveat, as follows: In any situation it is likely that considerable judgment will be required. In the course of judging whether the approach is reasonable, the actuary should consider the following questions:

- a. Will reported stockholders' profits over the lifetime of the participating operation actually inure to the stockholders under the applicable restrictions?

- b. Will past and/or future dividend payments to policyholders reduce the amount available to stockholders below the amount which would otherwise be indicated by the applicable restrictions? (In other words, you could follow one of the "general approaches" and suddenly find that, because you have not taken into account the full amount of the policyholder dividends which you have actually paid, you have reported more stockholders' GAAP profits over the past years than can possibly emerge over the lifetimes of the blocks of policies involved.)
- c. Will stockholders' profits be reported in a reasonable manner? Will there be material fluctuations in reported stockholders' profits from year to year, even in the absence of unexpectedly favorable or adverse fluctuations? (Accountants generally abhor "normalization" of earnings, which is where by artificial means you smooth the reported earnings from one period to the next despite the fact that the actual experience has fluctuated. What we are saying here is that if there have been no significant actual fluctuations in the experience, the reported earnings should not jump around capriciously because of the method chosen to handle the alternate limit case.)

Interpretation 6-B will discuss the choice of reserve assumptions. It will describe two possible choices for when you are calculating predividend GAAP profits (because your shareholders are subject to a limit on their profits). The first choice is "to employ reserve assumptions containing provisions for adverse deviation which are comparable to those used for the company's nonparticipating business. This approach is consistent with that interpretation of the release-from-risk reserving theory which holds that reserve assumptions should be based on reasonable and realistic conservatism which is not necessarily related to gross premiums."

The second choice is to "employ reserve assumptions consistent with gross premium assumptions, containing substantial provisions for the risk of adverse deviation. Such provisions would normally be much larger than those for nonparticipating business, recognizing the larger provisions for adverse deviation contained in gross premiums. This approach is consistent with the interpretation of the release-from-risk reserving theory which holds that conservatism contained in gross premiums to cover the risk of adverse deviation should be retained in reserves and not released into profits until the company is released from the risks provided for by the gross premiums." We could not arrive at a clear preference between these two approaches.

Finally, Interpretation 6-B will discuss the choice of reserve assumptions for when you are including policyholder dividends in your GAAP policy reserves as planned disbursements. Here your assumptions might reasonably contain smaller provisions for the risk of adverse deviation than the assumptions used for nonparticipating policies, because there would usually be less margin between the valuation premium on most-likely assumptions and the gross premium (because of the presence of policyholder dividends as disbursements in the valuation formulas).

So that's about what you'll find in Recommendation 6 and Interpretations 6-A and 6-B. We hope it will be helpful.

MR. JOHN H. BIGGS: My comments are concerned with the application of GAAP to mutual companies. Like most actuaries, I am still in a position of evaluating the various proposals for Generally Accepted Accounting Principles (GAAP) for mutual life insurance companies. I know enough to appreciate that the problem is indeed difficult and, like most in the industry, continue to be puzzled to know what benefits will derive from solution of the problem.

First, let me remind you of the brief history of GAAP for life insurance companies. You will recall that the first exposure draft of the American Institute of Certified Public Accountants (AICPA) appeared in December, 1970. In an astounding burst of activity, the Joint Actuarial Committee sponsored by the four professional actuarial bodies developed by May, 1971, a lengthy and extraordinarily thoughtful response to the Exposure Draft. I would especially urge you to reread Appendix C of that Report which outlines the view of the Joint Committee on the subject of GAAP for mutuals.

You will also recall that after review of the responses the AICPA released the final audit guide in 1972 and made it effective for financial reports in the year 1973. However, that final audit guide exempted mutual life insurance companies from its provisions as to accounting principles. At the time the AICPA argued that major theoretical problems in defining accounting principles for mutuals still existed and more time was needed.

Little has been done since 1972 by either the accounting profession or our profession in developing a theory for mutual life insurance companies. One important actuarial paper was published in 1972, Donald D. Cody's "Adjusted Earnings for Mutual Life Insurance Companies." To my knowledge, papers since that time on GAAP have not dealt with the mutual company question. The American Academy Committee on Life Insurance Financial Reporting Principles has not had this question on its active working agenda during the period.

In late 1975, the Auditing Standards Executive Committee (AcSEC) of the AICPA was studying the problems of financial reporting for nonprofit institutions and they included in this category mutual life insurance companies. The committee observed that GAAP had not been developed for mutuals, and was about to issue a release instructing accountants to say so in their opinions. The mutual life insurance industry immediately observed that such action would have the effect of turning the accountant's report into a qualified report which would probably not be acceptable to the SEC. AcSEC recognized this concern and delayed the implementation of their requirement until September, 1976. The AICPA immediately organized an insurance accounting task force to develop GAAP for mutual life companies. The American Academy established its own task force to provide the views of our profession to the accountants. Dale Gustafson is the task force chairman and its members are Henry Ramsey, Dick Robertson, Bill Spare and Paul Sarnoff.

Thus it appears at this point that a deadline is upon us of September, 1976, for adoption of GAAP for mutuals. I would submit that this is an impossible deadline in view of the fact that no exposure draft exists at this time and obviously no work has begun among any of the companies to prepare for a 1976 GAAP statement. I am presuming that if the AICPA's AcSEC group refuses

any further delay in implementation of its position, then the accountants would require some form of GAAP statement or would be required to qualify their statements for mutual companies for 1976. I am not clear at all as to what mutual life companies could do under such short notice.

In my most recent conversation and correspondence with Dale Gustafson, I learned that the AICPA task force had set itself a goal of developing an exposure draft by April 1, 1976, but at this time has not yet released such a draft. Among the actuaries on the Academy task force, there has been extensive written correspondence, with a number of positions delineated on the subject. However, the task force is somewhat at a loss as to how to proceed until some more definite steps are taken by their AICPA counterparts.

My own view is that something will probably percolate to the surface during 1976 and that GAAP for mutuals will be formulated during 1976 and 1977 and perhaps implemented in 1978 in actual financial statements. I think that is a fairly aggressive timetable although it might not satisfy the AICPA's AcSEC.

I sense that there is no broad consensus among actuaries as to the appropriate GAAP principles for mutuals. Appendix C of the May 1971 Joint Committee Report presents a persuasive case for treating statutory accounting principles as GAAP (with some minor modifications). On rereading that appendix and considering the discussions and new concerns that have arisen since the Audit Guide for Stock Companies was released, I find that it stands the test of time rather well. There are two interesting aspects of that appendix that I hope those people considering GAAP will keep in mind. The first is the observation that the important financial statement to a potential buyer from a mutual life insurance company is not the company's general purpose financial statements, but rather the dividend illustration. If accountants and actuaries really wish to accomplish something useful for policyholders of mutual life insurance companies, they ought to focus their attention on developing further discipline for dividend illustrations rather than refining the balance sheet and earnings statement. Obviously, much has been done in this area by actuaries in meeting consumerists' concerns about price disclosure. A second point of considerable interest in the Joint Committee's view was that the format of the mutual company's statement should be reexamined and perhaps the results cast in a source and use of funds format. This may seem radical to the AICPA Committee but I hope that we can urge them to take a fresh view of the question of accounting statements for mutuals. For instance, I am not sure that comparability with stock life insurance companies is really an appropriate goal. Perhaps it would be more appropriate to look at the financial statements promulgated by the AICPA for nonprofit institutions such as college and universities for financial reporting comparability. Some of the fund accounting concepts used for such institutions may make more sense for mutual life insurance company reporting than do the typical profit and loss and balance sheet formats used for stock company financial reporting.

The other end of the spectrum in approaches to GAAP for mutuals place emphasis on adaptation to mutual companies of release-from-risk theory as developed for stock life companies. I, personally, would predict that the final adopted principles would be nearer the statutory end of the spectrum.

One final point is intriguing and has perhaps significant implications. When one asks the question who is promoting the adoption of GAAP for mutual life companies and who stands to benefit from it, one ends up with a very narrow and even bureaucratic answer. It appears that the SEC in the interests of consistency does not accept qualified statements, yet the AcSEC body states that accountants must qualify their opinions for mutual life companies because there is no formal statement of GAAP for mutuals. Thus it appears that the entire motivation for this extremely difficult and quite expensive proposition is a narrow concern of the top accounting and regulatory groups for consistency. One should remind them of Emerson's famous quote that "A foolish consistency is the hobgoblin of little minds." Certainly the consumerists who advocate better information for policyholders are wasting no time on the subject of GAAP for mutuals; they understand fully that such financial statements serve little purpose for policyholders and that the proper focus is on dividend illustrations. Certainly the policyholders are not pressing for GAAP principles, and, if they were well informed, they would probably oppose them since the cost of developing this information (if they are substantially different from statutory principles) will reduce their dividends. It is well-known that the state regulatory officials have resisted the adoption of GAAP and are satisfied with statutory principles for mutual companies. Obviously, there are not stockholders who have an interest in the subject. I doubt seriously whether there is any significant interest among creditors. On the other hand, I do see some interest and mild internal pressure coming from the senior management of the mutual life insurance companies. They are accustomed to emphasizing the primacy of the earnings statement in investment decisions and in performance evaluation.

The statutory gain from operations does leave something to be desired in terms of evaluating the direction of the companies they manage. I would suggest, however, that management information which is not useful to external parties should not be a pressing concern to the AICPA and the SEC. If it were once settled that statutory financial principles were essentially GAAP for mutuals, our own internal management could develop appropriate principles for adjusting our earnings statements (as some mutuals have already done).

MR. ODELL: We should keep in mind that the cost of GAAP for a small company, either stock or mutual, is very high. The gain from using GAAP may not be worth it.

MR. CASE: That's an important point. We ought to ask two separate questions. First, what are GAAP for stock companies? Second, should GAAP be required for stock companies? The same two questions apply to mutual companies. We can't say whether GAAP should be required of mutual companies unless we know what GAAP are. Two approaches to mutual company GAAP are statutory accounting and the Stock Life Company Audit Guide. At least two other approaches have been suggested.

MR. BICKEL: The next subject is GAAP accounting for federal income taxes. One task force of the Academy Committee on Life Insurance Financial Reporting Principles is charged with studying the impact Federal Income Tax considerations should have on the choice of assumptions and determination of reserves. We have been attacking the problem from basic principles, attempting to establish what we would do if we did not have APB 11 to contend with.

So far we have not been able to agree on a single overall approach that would be workable for life insurance companies. However, we have made considerable progress in determining how the Federal Income Tax could be built into the life insurance reserve calculations as if it were any other expense, given a particular tax situation. I would like to outline how this procedure could work.

The most striking feature of the method we are discussing is that the first step is to recalculate benefit and expense reserves using an interest assumption equal to 52% of the assumption you might otherwise have made. The increase in reserves which results from using the lower interest assumption is then offset by the value of the tax deduction for either required interest or the increase in reserve, depending on the particular tax situation.

Consider first Situation A where a company is taxed on the basis of taxable investment income less \$250,000. We know from marginal tax considerations that there are three elements which determine the tax: There is a tax on the investment income itself, which is generally at a 48% rate; there is a small tax on assets; and there is a negative tax on reserves.

The tax on investment income and assets can be considered together. If 6% is a reasonable pretax interest assumption, the tax generated in each policy year will be about 3% of the asset share or GAAP reserve.

The negative tax on the statutory reserves is a function of the average earnings rate, ten-for-one adjustment, 818(c) election, etc. In current conditions it will probably produce an after-tax benefit each policy year of about 2% of the net level statutory reserves.

Since these elements provide for all the tax that will be generated by a given policy in this environment, the precise calculation of GAAP reserves would involve using the 3% interest assumption to discount all premiums, claims, and expenses, and, in addition, to take credit for a benefit of 2% of net level statutory reserves.

Since the GAAP benefit reserves and the tax return reserves will generally be in the same magnitude, the end result of the benefit reserve calculation will not be too different from calculating benefit reserves at 5% interest. Thus benefit reserves under this method would be about the same as the company might have computed in any event so long as it was attempting to justify its assumption as an after-tax interest rate. The reserve for deferred acquisition costs, however, might follow a slightly different pattern, since the interest assumption has been reduced. The initial reserve for deferred acquisition costs, of course, is the same whether the 3% or 6% interest assumption is used.

For Situation B, consider the case of the company which is permanently being taxed on the gain from operations before special deductions less \$250,000. In this case not only the investment income, but also premiums, claims, and expenses, have an effect on taxes. In this case the first step is to calculate the reserve using 52% of your normal interest assumption, but then the second step is to throw away 48% of your reserve. If you will incur after-tax claim costs of only 52% of the deaths and surrenders, you only need 52% of the reserve to fund them.

However, there is one more element affecting tax in this situation, and that is the deduction for the increase in reserves as shown in the tax return. This deduction produces a benefit to the company in the years when reserves are increasing, and a cost when reserves are decreasing, and thus the level premium reserve for these benefits and costs will be significantly positive at all durations. When this element is added back to the GAAP reserve, you will end up with a reserve which is higher than you would get at a 5% calculation, principally because of the benefit of the reserve increase deduction in the first policy year. As a trade-off for this addition, no accrual of deferred tax credit should be necessary since all the taxes on "timing differences" associated with this policy are now provided for.

If we now consider the other tax situations, Situation C is the same as Situation A, except the special deductions such as the nonpar reserve increase come into play. Reserves under Situation D, of course, are the average of those for B and C.

Now these exercises are very intriguing and, in my opinion, are mathematically sound. However, we could use some help in figuring out where to go next. It seems to me the next step is to consider the case of the company which is not firmly embedded in any one tax situation, or the company which has sufficient growth that it is not paying taxes at all at this time. Possibly this could be handled by calculating reserves assuming something like Situation A for the first ten policy years, Situation B for the next ten policy years, and Situation D thereafter.

Another problem is that a company may not feel that all of its policies are issued under the same tax situation. In one of the companies I am associated with, for example, we normally sell enough new business so that no tax is incurred.

If we did not sell any new business at all, we would pay taxes on the basis of Situation D. Thus the tax effect of issuing new business in any one calendar year is some combination of zero, 24%, and 48% tax rates. The relative weight of each of those categories will depend on external factors, such as whether or not the Group department makes money or loses money. I don't know the solution to these problems, but you can see that there are many problems to be solved if we attempt to allocate the Federal Income Tax paid to each individual policy by duration.

All of the techniques I have been describing have been labeled the Level Premium Reserve Approach. We have been using this name because the process amounts to allocating the Federal Income Tax to each policy and duration, and calculating a level premium reserve for the tax effect. A second general procedure we have considered is what we call the Discounted Liability Approach. This is an aggregate technique where we simply take the timing differences in force at the end of the year and discount them.

The philosophy behind the Discounted Liability technique is to assume that no new business is written after the date of the financial statement, and that all existing timing differences begin to reverse, depending on the assumed persistency rates. The difference between the GAAP reserve increases and tax reserve increases each year is multiplied by an appropriate tax rate, and discounted at an interest rate equal to 52% of a pretax assumption. Since the calculation is completely prospective, it is not necessary to attempt to determine the actual tax effect of issuing new business each year.

The relative merits of the two methods seem to depend on whether or not taxes can be consistently allocated to each policy. If they can, the Level Premium Reserve Method produces a correct matching of revenue and cost. If they cannot, the Discounted Liability Method produces more reasonable results.

MR. JOHN A. MAURER: Isn't the point of all these tax methods mainly to discount deferred taxes with interest? This is exactly what the accountants don't want to do.

MR. BICKEL: Yes, we are attempting to discount deferred taxes with interest. APB11 rejects the use of interest because it implies that deferred tax credits are liabilities. The liability approach had been rejected because they didn't know what to do if the government changed the tax rates. It's my opinion that only a liability method makes sense for a life company. Problems created by changing tax rates can be handled through loss recognition tests. Perhaps the ALIA could make a presentation to the FASB along this line.

MR. BIGGS: Our final topic is materiality.

The Committee on Life Insurance Company Financial Reporting Principles has tried to develop a position for actuaries on materiality.

As actuaries on the Committee and others who have been concerned about financial reporting principles have reviewed each recommendation and interpretation, there has sometimes been a concern expressed that a practicing actuary might feel required to take literally each and every sentence in the statement. One could imagine the unfortunate results of such treatment when applied to meaningless and trivial items. The benefits to such an actuary's client or employer might be nil or even negative while the costs of complying with the perceived requirement might be significant. Additionally, it could well turn out the disclosure would be hopelessly cluttered with minor information making it difficult for the user to find what is significant. Each time this has occurred, however, two points have been made as to why we should not limit the reference to materiality to the questioned item: (1) If we said the materiality judgment applied to a specific item, an actuary might be uncertain as to the applicability of materiality to other items where no mention was made, and (2) Materiality is a fundamental professional concept that actuaries would be expected ordinarily to bring into question. For instance, Opinion A-6 of the Academy's Opinions as to Professional Conduct includes the statement that "Approximations and approximate methods may be used, provided that the actuary has satisfied himself that the result does not differ materially from the result of using more precise methods." Many of you have doubtless noted that the AICPA formerly and the FASB currently have included at the end of all of their formal statements: "that the provisions of this statement need not be applied to immaterial items."

A final item of background is the fact that the FASB issued on March 21, 1975, a Discussion Memorandum of the criteria for determining materiality. Public comment has been requested in the Discussion Memorandum and hearings will be held shortly. If the FASB feels that solid ground has been achieved, the next step would be the issuance of an exposure draft of a formal statement.

In response to these concerns and external developments, the committee established a task force which I have chaired, to develop a position for actuaries on this broad and elusive concept of materiality. Several points quickly occurred to us:

1. It did not seem to make sense to limit a statement by the Academy of Actuaries on materiality to financial reporting for life insurance companies. Obviously, such a concept was needed also for property/casualty questions and for pension actuaries. In short, materiality affects not only all of the work of the life actuary but is a broad professional concept that pervades all branches of actuarial science.
2. It also seemed to us that the best way to proceed was not in a mode of reacting to the FASB discussion but to address the problem directly for the actuarial profession. It is hard for actuaries to comment on another profession's view of a financial reporting concept when we do not yet have a clear view ourselves.
3. We also concluded that simple quantitative approaches would be inadequate and that we must have address aspects of quality and disclosure.

Accordingly, we have developed at this point a draft recommendation relating to materiality for life companies that our committee has tentatively reviewed and forwarded to the other applicable committees in the Academy dealing with pensions, property/casualty reporting, and guides to professional conduct.

Our recommendation includes the following paragraphs:

1. A statement that the concept of materiality is well grounded in actuarial practice and literature, with a reference to the key opinion and a relevant paper.
2. A general guide that an actuary should apply the concept in all aspects of his work.
3. A series of examples.
4. An emphasis on basing the judgment of materiality on the appropriate users of financial statements.
5. The interrelationship between actuaries and accountants.

Three interpretations have been drafted; the first outlining typical users of life company financial statements; the second providing quantitative guidelines on materiality; and the third describing qualitative considerations.

We hope that during 1976 we can develop a broad Academy position on this subject. The benefits we hope to gain would include: strengthening the professionalism of the actuary, clarifying his position in financial reporting vis-a-vis the other participants in that process, and educating the actuary. There is relatively little in our literature on this subject and we felt that, in those few difficult instances in an actuarial career where important materiality judgments have to be made, an actuary would be guided by and also protected by a professional opinion of the Academy.

