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TRENDS IN GAAP AND STATUTORY FINANCIAL STATEMENTS

Moderator: RICHARD S. ROBERTSON. Panelists: CLAYTON A. CARDINAL, ELLIS D. FLINN, PAUL E. SARNOFF.

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. RICHARD S. ROBERTSON: There is no way that we are going to be able to cover ten topics in an hour and a half, and we are not even going to try. Instead, each panel member has selected one of the topics and has prepared some comments on the one topic. We will present those three topics, allowing time for questions and discussion from the floor. After that, assuming that there's still time remaining, we will consider any of the other seven topics which you wish to discuss.

MR. ELLIS D. FLINN: The requirement for an actuary's Statement of Opinion was adopted at the June, 1975, NAIC meeting as the culmination of the cooperative efforts of both the NAIC and the American Academy of Actuaries Committee on Life Insurance Financial Reporting Principles. While the Academy felt that the 1975 Blank requirement was being adopted before completion of the study that it merited, the Academy wholeheartedly supported the Association in its objective of establishing a uniform nationwide requirement for the Blank. The Academy Committee prepared and released under date of December 12, 1975, Recommendation 7 and Interpretations 7-A, B, and C, stating the professional principles applicable to the newly required Statement of Opinion. The Committee worked very hard under extremely tight time pressure to get this recommendation in the hands of its members prior to the Annual Statement filing period. What I would like to discuss this morning are some of the problems my company had with the Statement of Opinion, some problems which showed up in a survey made by the Academy Committee, and some possible

future problems with which we might have to contend. Also, I hope that we will have time after the prepared talks to discuss some of the problems the rest of you encountered and some of the solutions you may have reached.

To those of us in the consulting business, signing a Statement of Opinion in regard to the annual statement was not completely new. You may recall that the instructions to the annual statement have stated that, in lieu of signing the jurat, a consulting actuary can sign a separate statement in regard to the actuarial liabilities, which can be attached to the statement Blank. My company followed this practice for many years. It has been helpful to us in at least two ways: (1) it reduced our exposure to the inaccuracies in the other items reported in the annual statement, and (2) it enabled us to send our Statement of Opinion to the company after the completion of our work without having to revisit the company to physically sign the statement. As you can imagine, when we visit a company to make our principal review of the actuarial items, it is not possible for the company to have the statement ready to sign. Without the separate statement, we would have had to make an additional trip to each company. We did, however, have a few companies which have been with us for many years and for which we had always personally signed the statement Blank. The new emphasis on an actuarial Statement of Opinion did allow us the wedge we needed to follow the separate statement route for all our clients.

One item which gave us considerable difficulty is reinsurance. We have several companies which accept sizeable amounts of reinsurance from other companies. Often, the reserve for reinsurance is a material amount of the total reserves. The entire recordkeeping is done by the primary carrier and there is no way to review the in force data or the reserve amounts. In most cases, the reserve items have been told to the companies over the phone and confirmed by letter. No basic records have ever been exchanged. Our problem was how to provide a clean opinion about the company concerning work which we did not personally review. There appeared to us to be two ways to handle this: (1) have the actuary for the ceding company provide enough certificates to file in every state in regard to the amount reinsured, or (2) for us to take responsibility for the entire reserve amount but to state a reliance on the other actuaries. We adopted the latter approach, mainly to reduce the logistics of receiving all of the Statements of Opinion along with the reinsured's separate statements in regard to the accuracy of the reinsurance file and attaching these as well as our own certificate and the company's certification on the accuracy of the in-force file. As you can see, if we included separate certifications from each company, and a company had reinsurance agreements with five or six separate companies, the annual statement would literally be bulging with Statements of Actuarial Opinion. I would like to point out that we are not talking about typical reinsurance agreements where the reserve held for any one company might be less than 5% of the total reserves of the company.

While we did adopt the practice of providing in our Statement of Opinion the entire reserve amount held by the company, we may well alter that process this coming year. In one situation, we received a letter from a ceding company stating the amount of insurance and reserve liability. This amount was included in the material supplied to the Insurance Department, for which they issued a certificate; however, when we received the actuary's Statement of Opinion, he provided different numbers. Since the Annual Statement was already printed and since the reserve was overstated on behalf of my client, we did not reprint the Annual Statement or change our Statement of Opinion.

In this case we had no problem stating that the reserves made "good and sufficient provision for all unmatured obligations of the company guaranteed under the terms of its policies." We did have a problem stating the reserves were prepared on a consistent manner with prior years. In this case, I swallowed hard and stated it was not material.

Another problem which arises when you rely on another's certificate is that you have to wait and see if he has included any qualifications. It would certainly look peculiar if the actuary you relied upon had a qualified statement but you didn't.

For one of our companies, we provide a Statement of Opinion to the Board of Directors in addition to the opinion signed by their actuary. When putting together our statement some time after the annual statement was filed, we noticed that our numbers were different than given by their actuary. In talking to the actuary we found that some annual statement numbers were changed at the last minute and nobody thought to change the Statement of Opinion. Two months after filing the annual statement, no Insurance Department has asked a question as to why the actuary certified to numbers different than those given in the annual statement. This company, by the way, is operating in a large number of states.

We had difficulty with the "good and sufficient" provision for several of our companies. If you have a company which is either losing money or making very little money, it appears to us that some additional tests are necessary to prove that the reserves are "good and sufficient." The last things a company in this category needs are more tests and larger expenses. Often they know they're in trouble, the Insurance Department knows they're in trouble, and you know they're in trouble; but to put it in a Statement of Opinion without proof positive is a risky step. It is not clear in my mind when we will have to state an opinion on the reserves being "good and sufficient," but in some cases I'm sure we will leave it out of the Statement of Opinion until the insurance departments force the issue. For these marginal companies, we have simply stated that tests have not been made to determine if the company meets the "good and sufficient" provision.

We noticed that quite a few actuaries were making statements regarding "provision for all actuarial reserves and related statement items which ought to be established," even though they did not establish reserves for conversion benefits on term contracts or for the immediate payment of claims. It is certainly possible that these two items might not be material for many companies. For these companies, it should be stated that the benefits were not reserved and that the amounts are not material.

Exhibit 11 presented some interesting problems. While, for many years, actuaries have developed Incurred But Not Reported figures, the Instructions to the statement called for offering an opinion on Exhibit 11 (Part 1). Part 1 includes not only the IBNR reserve but pending claims, claims in course of settlement, and claims resisted. The question is whether the actuary is expected to offer an opinion on all items included in Part 1. For some companies, it is fairly easy for the actuary to review the pending claims. For some companies that have a large number of resisted claims, any opinion on these items would be primarily legal and not actuarial. For some companies, we bypassed this problem and stated our opinion only on line 3 and not on line 6, and advised our clients that have their own actuaries to do the same. Since line 6 is not specifically referred to, we believe it is proper to sign off only on the Exhibit 11 actuarial items, which are included primarily in line 3.

The American Academy of Actuaries' Committee on Life Insurance Company Financial Reporting Principles has conducted a survey of the Statements of Actuarial Opinion filed by 215 companies. There were several areas which appeared to present difficulty and I will discuss only a few of these areas.

The Instructions state that the scope "paragraph should list those items and amounts with respect to which the actuary is expressing an opinion." Also, Recommendation 7 states that both the items and amounts should be included in the Statement of Opinion. However, only 52% of the companies reviewed included the amounts in the Statement of Actuarial Opinion. From a consultant's standpoint, it would seem imperative to include the amounts, while less so for company actuaries. However, the Instructions are quite clear and the amounts should be included in the future.

Of the Opinions being signed, 91% were signed by only one actuary. Thirty-one percent included a statement by another officer verifying the in force. There were fifteen statements involving the opinion of more than one actuary. Of these, six involved joint signatures on a single statement. Five statements involved separate signatures for different parts of the reserve liability, but stated the reserves made "good and sufficient" provision for all of the company's policies. This, of course, does not make sense. Also, several actuaries stated a reliance on an officer of the company for the accuracy of the in force file but didn't include the certification by the company officer. The Instructions state "if the actuary does not express an opinion as to the accuracy and completeness of the listings and summaries of policies in force, there should be included on or attached to page 1 of the statement Blank the statement of a company officer or accounting firm who prepared such underlying data."

Sixty of the companies included in the survey filed separate account statements. These seem to create some additional complications. For example, references in quite a few of Statements of Actuarial Opinion were made that the reserve amounts in line 1 of page 3 made good and sufficient provision for all of the company's policies. Since many companies did not put in the amounts to which they were offering an opinion, it was difficult to make a complete analysis. It appears, however, that 37% had inappropriate General Account opinions and 33% had inappropriate Separate Account opinions. It looks as if some additional study should be made this year to be assured that the Statements of Actuarial Opinion are appropriate when a company has Separate Accounts.

A number of companies had the Statement of Actuarial Opinion notarized. The Academy Committee believes that it is inappropriate to have a professional Statement of Opinion notarized. The notarization only confirms that the appropriate person signed the form and does not strengthen the professional opinions being offered. The Committee, therefore, recommends that the Statements of Actuarial Opinion not be notarized.

The new Statement of Actuarial Opinion regarding statutory reserve liabilities has provided a sizeable increase in the actuary's responsibility and one which, we believe, most actuaries accepted. There are a few additional items currently being discussed which the Academy Committee believes are not in the best interest of the actuary. It is difficult to say at this time what the final outcome of these items will be and, therefore, they may never become a real concern to the actuary.

The first item is in regard to the assets of the company. There are several people who believe the actuary should be in a position to offer an opinion that the assets, interest earned on the assets, and future premiums are sufficient to meet the company's liabilities as they fall due. The Committee believes it is appropriate for the actuary to be assured that the company is not investing in long-term obligations when there is a need for short-term cash, but it is quite another thing for the actuary to be in a position to offer an opinion on the value of a piece of raw land in Florida. The Academy Committee is doing its best to make sure the actuary is restricted to offering an opinion on only those items on which he is an expert.

There is also some concern that Statements of Actuarial Opinion will have to be offered by line of business. From a solvency standpoint, it is the total reserves that count and not the results by individual line of business.

We are also under the impression that one state is in the process of writing a manual which will set forth actuarial standards and practices. We believe the setting of actuarial standards and practices should be left to the profession and not dictated by any insurance department.

Further, it is our understanding that the Blanks Committee will be following the results of the Statements of Actuarial Opinion for the next few years and may make some changes in the Instructions if they feel it is appropriate. We believe, therefore, that this is only the beginning and that various changes will take place in the future.

MR. JEROME S. GOLDEN: Paragraph 7 of the December 12, 1975 release from the Committee on Life Insurance Company Financial Reporting Principles states that "it is important to note that the actuary is expressing an opinion on the adequacy in the aggregate of all the enumerated reserves and that possible deficiencies for individual components of the total reserves may be offset by margins in other items." If the aggregate reserves enumerated in the opinion include separate account reserves which are insulated against claims from the general account, it should also be noted that margins in such separate account reserves may not be available to offset deficiencies in general account reserves. It appears, therefore, that the actuarial certification should be in two parts, one covering separate account reserves and the second covering total reserves excluding separate account reserves. I would hope that the Committee focuses on this question.

On a related matter, I would suggest that the Committee put on its agenda the question of the applicability of GAAP to variable life insurance. This is a topic which, I believe, deserves the Committee's attention since it carries with it some of the same questions being studied in connection with the applicability of GAAP to mutual companies.

MR. CLAYTON A. CARDINAL: As accounting methods must flow from a consideration of accounting principles, so must accounting principles flow from a consideration of accounting objectives. If compliance with certain principles bring financial statements closer to realizing accounting objectives, then those principles should be endorsed and adoption of the related methods should be encouraged. The converse is also true. That is, if compliance with certain principles take financial statements further from realizing accounting objectives, then those principles should not be endorsed and the adoption of the related methods should be discouraged. A necessary condition is that the objectives not only be clearly understood but be consistent with economic objectives.

If the use of interest in amortizing acquisition expenses were to be required, the accuracy of financial statements would not be improved because of the imperfections of GAAP as promulgated for stock life insurance companies. Consider the following observations.

1. The use of a zero rate of interest in the amortization of acquisition expenses is validated by Appendix B of Audits of Stock Life Insurance Companies (the Audit Guide). In determining general purpose financial statements, actuarial prescriptions independent of the Audit Guide are inferior to the prescriptions set out in the Audit Guide since the latter are derived by statutory authority. Therefore, the actuarial profession has no authority for repudiating the use of a zero rate of interest in amortization which has already been validated by proper authority. This does not say, however, that all prescriptions in the Audit Guide are proper and that attempts should not be made to change those prescriptions considered to be materially in error.

2. The justification of the use of interest in amortizing acquisition expenses currently lacks merit. Those acquisition expenses subject to deferral by the prescriptions of the Audit Guide are materially less than the acquisition expenses incurred in the acquisition of business. The acquisition expenses not subject to deferral are expensed against income in the year in which they are incurred. The impact of expensing these nondeferrable acquisition expenses against income exceeds considerably the impact of not using interest in the amortization.

   The actual charge against income for total acquisition expenses is the sum of (1) acquisition expenses not subject to deferral and (2) the amortization of acquisition expenses deferred with or without provision for interest. In any year, this sum is dependent on (1) the growth rate of business, (2) the rate of interest, (3) the amortization period, (4) the rate of amortization, and (5) the level of acquisition expenses not subject to deferral. If amortization with interest of the deferral of total acquisition expenses is the proper economic standard against which all provisions for charging acquisition expenses against income are to be compared, then, based on the limited testing which I have done, the sum of nondeferrable acquisition expenses and the amortization without consideration of interest of deferrable acquisition expenses comes closer to this standard than does the sum with interest considered in the amortization.

3. The consequence of not using interest in the amortization of acquisition expenses, when compared to the proper economic standard, is no more realistic in comparison to the consequence of amortizing with interest, or is immaterial.

For a rapidly-growing company, the total charge against income for acquisition expenses, with or without provision for interest, exceeds materially that charge resulting from application of the economic standard. As such, amortization without interest is no more realistic than amortization with interest.

For a mature company with a steady rate of growth, the difference between (1) the total charge against income for acquisition expenses without interest provision in the amortization portion and (2) that charge resulting from application of the economic standard is not material.

4. By validating the use of a zero rate of interest in amortizing acquisition expenses, the Audit Guide permits management a choice of methods. If a choice of method exists, management should choose that method which effects earnings measurement in the direction which is most consistent with its perceptions of the economic enterprise which it manages.

   An economic measure of earnings generally accepted is defined as the difference in the discounted values of future cash flow over the reporting period. Management, in choosing any accounting method for a specific transaction, is in the best position to judge whether that method, taken together with accounting for all other transactions, effects earnings measurement in a direction consistent with the economic measure of earnings.

5. The Audit Guide suggests that application of an intermediate form of the release-from-risk valuation method should produce a result consistent with the objectives of the Audit Guide. The intermediate form of the release-from-risk valuation method calls for a provision for adverse deviation in each of the elements entering into the valuation. Inasmuch as no provision for interest in the amortization of acquisition expenses produces a charge against income slightly in excess of that produced by amortization with provision for interest, amortization without interest appears to be consistent with the intermediate form of the release-from-risk valuation method.

6. Finally, item 13 of Recommendation 1 of the Committee on Financial Reporting Principles of the American Academy of Actuaries states that, in the interest of practicality, the actuary should feel free to adopt approximate procedures as long as he is satisfied that the results of using such procedures do not differ materially from applying

> the Recommendation directly. Hopefully, for those actuaries who feel that Recommendation 1 calls for using interest in amortizing acquisition expenses, the preceding observations are convincing that the use of a zero interest rate is at least consistent with item 13 of Recommendation 1.

MR. RICHARD S. ROBERTSON: If no one else is willing to take the other side of this question, I will, for it is an issue on which I have strong feelings.

First, I agree with Mr. Cardinal that in practically all cases the difference between using interest and not using interest is unlikely to be material. When this is the case, it is entirely appropriate to amortize expenses without considering interest as a reasonable approximation to the result. Consequently, I do not view this as a particularly important issue.

Nevertheless, there are some important philosophical considerations here, and I wish to speak to those.

First, the Audit Guide is quite clear in stating its preference for the use of interest in amortizing expenses. It is true that it does not go so far as to absolutely forbid amortization of expenses without interest. But, neither does it suggest that either alternative is equally acceptable.

Suppose for the moment this were not the case. Suppose the Audit Guide did allow either approach without expressing a preference for one over the other. Given these circumstances, if an actuary is faced with two alternatives which are permitted by accounting rules and one is consistent with sound actuarial principles and the other is not, should not the actuary choose the method that is consistent with his professional principles?

Based on the principle that the value of a dollar realizable in the future is less than that of a dollar realizable currently and because the time value of money is fundamentally basic to an actuary, I think the need to use interest in amortizing the expenses would be fundamental.

Furthermore, there is the importance of calculating the assets and liabilities in an insurance company financial statement on a consistent basis. The reserves clearly recognize interest; so should the assets.

MR. PAUL E. SARNOFF: In December, 1970, the American Institute of Certified Public Accountants released an exposure draft of an Audit Guide for use in the audit of stock life insurance companies. The Audit Guide was intended to help answer the needs of securities analysts and stockholders by providing standards for reliable and rational earning statements to use in evaluating life insurance company shares. The Audit Guide would represent the first attempt to define generally accepted accounting principles for stock life insurance companies in a single comprehensive document.

In May, 1971, the Joint Actuarial Committee, which was sponsored by four professional actuarial bodies including the Society of Actuaries, released its response to the Audit Guide exposure draft. This response concentrated on stock life insurance companies, including both participating and nonparticipating business. The response also covered, in Appendix C, the question of generally accepted accounting principles for mutual life insurance companies.

In 1972, based on the responses it received to the Audit Guide exposure draft, the AICPA released the Audit Guide for stock life companies now in effect. It became effective for general purpose financial reports for the year 1973, although there were some companies whose reports in earlier years were based on the exposure draft version. The current version includes the following with respect to mutual life insurance companies: "...The committee believes that the needs of the situation are best served by publishing an Audit Guide which applies to stock life insurance companies, but not to mutual life insurance companies until applicability of generally accepted accounting principles to mutual life insurance companies has been determined. Notwithstanding the foregoing, specified portions of the stock life insurance company Audit Guide should be used by auditors as a guide for audits of mutual life insurance companies." The specified portions included the description of the nature and conduct of the business, the section on reliance on actuaries, the supplementary internal control questionnaire, and the glossary of terms. In addition, there should be disclosure of the principal accounting policies and practices of mutual life insurance companies, as required by APB 22. There should be considered for inclusion in these disclosures, "A general statement that the financial statements have been prepared on the basis of accounting practices prescribed or permitted by insurance regulatory authorities." While none of these requirements were trivial, they had relatively slight impact on the auditor's reports on financial statements of mutual life insurance companies.

In the fall of 1975, the auditing standards executive committee (AUDSEC) of the AICPA considered establishing a requirement that only a special report be issued in connection with financial statements of a mutual insurance company. Essentially, the special report would have stipulated that the statements were prepared in accordance with regulatory practices but that the authoritative bodies within the accounting profession had not made a determination that these practices were in conformity with GAAP. This special report could have presented problems because it may have been perceived as "qualified" by the SEC and other governmental agencies.

The auditing standards executive committee deferred the issuance of the requirement to permit the AICPA insurance accounting task force to develop a position on GAAP for mutual insurance companies. This task force is now actively working on the project. In the light of these developments, the American Academy of Actuaries appointed a task force to monitor the developments and work with the AICPA task force to produce a satisfactory definition of GAAP for mutuals. Dale Gustafson is the chairman and Hank Ramsey, Dick Robertson, and I are members.

Let's turn to the specific question of the definition of GAAP for a mutual life insurance company. My own position, with which many other professionals on the staff of my company who have studied the matter agree, is essentially that of Appendix C of the Joint Actuarial Committee's May, 1971 response to the Audit Guide exposure draft.

Mutual life companies are fundamentally different from stock life companies. Mutual life company financial statements are reports on only two classes of existing interest: those of the currently covered persons ("policyholders") in the aggregate, and those of private or governmental creditors for such items as unpaid expenses and taxes. Stock company general purpose statements are concerned, indeed primarily, with a third class of existing interests, those of the current owners ("stockholders"). Because of the simple proportionate relation of an individual stockholder's interest to the aggregate

interest of all stockholders, stock company statements are of use as well to prospective stockholders. Since any sizable mutual company contains scores of thousands of dividend classes, with widely varying relationships to the aggregate for all dividend classes, no aggregate statement for a mutual life company can be as useful to a prospective policyholder as a dividend illustration for the particular policy he has in mind purchasing.

Unlike stock companies with respect to nonparticipating policies, the mutual company undertakes to provide insurance to each dividend class at as close to averaged cost as possible, whatever that cost may turn out to be. This undertaking is an integral part of a participating life insurance contract issued by a mutual company and must be recognized in any representation of the aggregate of such obligations as of statement date.

At issue, the gross premiums of the policies of a dividend class must be set at a high enough level so that the likelihood of their proving insufficient is small. After issue, the company must look to accumulated funds plus future gross premium and investment income as the bulwark against deficiencies. Future premiums and investment income are significantly affected by external factors. The company can control accumulated funds within limits by varying dividend pay-outs. The determination of the funds required at each duration is clearly central to the dividend process. The measure of fund adequacy must necessarily be how bad the adverse periods in the future might plausibly be. It is not the "average" future which must be considered; it is the adverse future. If the cyclical nature of economic history is any guide to the future, we must anticipate the likelihood that investment yields will some day return to levels such as we experienced in the 1940's. The aggregate funds accumulated under a typical cash value policy will reach their maximum some thirty years after issue. It is, of course, at that point that earned interest is most significant. Business issued today must be in a position to weather one or two periods of low interest rates during its course. These considerations are the major reason for choosing larger margins - deltas, if you will - in the statutory reserve interest assumption for participating policies issued by mutual companies.

On each December 31, the company must demonstrate that its total assets less current liabilities exceed <u>statutory</u> reserves so determined. The company must be able to pass this solvency test by an amount that makes it very unlikely that it would fail to meet a sudden emergency in asset losses or a claim catastrophe.

The statutory policy reserve of a mutual life insurance company may be properly characterized as the aggregate amount judged by the company's management and board of directors to be needed, together with future premiums, investment income, and surplus held to provide for unforeseen contingencies, to pay when due future benefits guaranteed to the holders of in force policies and contracts, and to fulfill the obligation to continue to provide insurance to each dividend class at cost, even through future periods of persistently adverse experience. While not explicitly provided for, expense reserves and recovery of previously disbursed acquisition expense from future premiums of the dividend class are clearly part of this formulation.

It is also essential to this formulation that, as experience factors change significantly, adjustments be made in the dividends paid in order to keep the company's funds at the proper level. Dividend illustrations are required to show the dividends the company would pay on business now being issued if

the experience factors underlying the dividend scale now being paid continue. Hence, these illustrations cannot be projections or estimates of what the company regards as "most likely." Indeed, we fully expect that future experience levels will change, as they have in the past, and we will make corresponding adjustments in dividends then actually paid.

It should be pointed out that this formulation does not include the concept of a fund accumulation for termination dividends. Companies that provide termination dividends do so to pay to terminating policyholders the portion of accumulated funds, over and above the guaranteed benefit, which are no longer needed to assure the company's ability to meet its future obligations on policies continuing in the dividend class. The company does not accumulate funds to pay termination dividends; it pays them because it has funds accumulated for general purposes. Hence, the segregation of a portion of policyholders' funds for future termination dividends is a misleading and improper representation of the actual operation of a mutual life insurance company paying termination dividends.

Let's now address the question of defining the earnings of a mutual life insurance company. As I indicated previously, mutual life insurance companies are basically different from stock life insurance companies and, for that matter, different from any other typical proprietary enterprise. For one thing, dividends are not paid out to owners - there are none in any usual sense - nor are they paid out of the "earnings" of the year. Instead, they are the return to the policyholders of accumulated funds that arose from their contributions and which are no longer required for the operation of the enterprise. Whatever the proper definition of mutual life insurance company earnings is, it comprehends only some kind of residuum after dividends to policyholders.

One way of looking at this residuum is in terms of the total life of a mutual company. A mutual company is a cooperative enterprise whose funds will be completely distributed to its members so that the final net result of all revenues and costs is zero, however assigned to intervening periods by the dividend process. This approach suggests that a proper matching of cost and revenue in a mutual life insurance company should produce zero earnings for its business each statement year, an accounting period which contains a fresh determination of the dividend action required by the experience as currently observed and to accomplish, in an orderly manner, the final net result. With this approach to earnings, the question of summarizing the operations of the year comes down to a relatively simple statement of sources and applications of funds. The required information is largely available from the statutory statement.

The statement of condition on this basis would show policyholder funds split between statutory funds and additional amounts held for policyholders. Illustrative financial report forms starting on page 609, show how such financial statements would appear under GAAP.

This statement of condition shows the total assets of the company, the liabilities to third parties, and the balance which represents policyholders' funds. The third parties referred to consist of employees, sales representatives, the tax authorities, vendors of goods and services, and creditors with respect to borrowed funds. As previously described, the policyholders' funds as displayed in this statement are a natural derivative of the statutory reserve process. In that sense, I regard reserves that meet statutory accounting principles as also meeting generally accepted accounting principles for mutual life insurance companies.

It has been suggested that quite aside from the problem of how policyholder reserves shall be defined and calculated for general purpose statements, fair presentation requires that the total amount be split into two components. The first component would be the amount required to mature contractual guarantees on a "most likely" basis. The balance of the total policyholder reserve would be shown separately with a title along the lines of "additional amounts held to assure the protection of policyholders."

Any such division of policyholder reserves is unwarranted. It rests on the tacit assumption that the mutual contract is a separable collection of undertakings. In fact, the company guarantees the total contract in consideration of a unitary premium. The funds it holds are the amount required to support this package of guarantees. No portion of the funds is "more necessary" than any other. The separation is unnecessary by demonstrated fact. Mutual companies do not analyze their business this way and have no need to do so. They retain only the funds they need to mature their contracts with minimum likelihood of requiring subsidy between blocks. Nor do the regulators have need of such figures under the present method of defining statutory reserves and, as mentioned before, no aggregate statement is of as much value to a policyholder as a dividend illustration for the policy he has or is contemplating purchasing. The system has no need of "most likely" assumptions and makes no use of them.

It has also been suggested that mutual life insurance companies should set up an asset for deferral of acquisition expense.

To policyholders, it is of central importance to know the statutory surplus on statement date, its relation to assets then held, and its change during the year then ending. It is difficult to understand what can be gained by tinkering with the statement to policyholders to show unavailable amounts like deferred acquisition expense on the asset side, when an offsetting item must be set up on the liability side in order to show the only kind of surplus that has meaning to a mutual life policyholder - the statutory surplus, after apportionment of dividends, available to meet unforeseen contingencies. It is, after all, this statutory surplus by which the reasonableness of the amount of the year's dividends to policyholders is measured under applicable statutes.

As contrasted with statutory accounting, the illustrative GAAP statement of condition reflects realistic going-concern values for such items as furniture and equipment and agents' balances. It shows on the liability side, as allocated surplus, the excess of these GAAP values over the statutory statement admitted values. Allocated surplus can also be used to state other amounts excluded from statutory unassigned surplus by regulatory authorities, such as the Mandatory Securities Valuation Reserve, provision for nonadmitted reinsurance, and interest guarantees higher than statutory standards.

The proliferation of specified contingencies,for which amounts must be retained from surplus currently divisible to policyholders, however, can only result in a higher proportion of the actual ultimate costs of the insurance provided a dividend class being borne by the holders of those policies that terminate early. Moreover, as a matter of statement presentation, items of allocated surplus obscure the fundamental fact that all the net assets of a mutual life insurance company are available to:

supplement future premiums and investment income to the extent that proves necessary to provide future guaranteed benefits and meet sudden emergencies, and

distribute in future dividends the amounts necessary to adjust each dividend class to as close to averaged cost as possible.

Only the future can tell how much of the present net assets will be used for each.

MODEL GAAP MUTUAL LIFE INSURANCE COMPANY

Statement of Assets

December 31, 1974 and 1973

ASSETS	December 31 1974	December 31 1973
Bonds	$12,957	$12,887
Mortgage loans on real estate	12,306	11,653
Preferred stocks	996	846
Common stocks	1,164	1,732
Loans on policies	1,812	1,632
Real estate, cost (less $311 accumulated depreciation)	1,304	1,122
Investment in stock of subsidiaries	417	284
Other investments	380	287
Cash and temporary investments	152	67
SUBTOTAL - CASH AND INVESTED ASSETS	$31,488	$30,510
Accrued investment income (net of $5 allowance for uncollectibles)	402	369
Premiums secured by policy reserves (net of $13 allowance for uncollectibles)	1,149	1,041
Property and equipment	198	182
Separate Account Business assets	2,663	2,916
Other assets	49	46
TOTAL ASSETS	$35,949	$35,064

MODEL GAAP MUTUAL LIFE INSURANCE COMPANY

Statement of General Liabilities and of
Net Assets Available for Policyowners and Beneficiaries

December 31, 1974 and 1973

	December 31	
GENERAL LIABILITIES	1974	1973
Accrued taxes	$ 125	$ 134
Mortgage loans payable	75	52
Accrued expenses	37	31
Other liabilities	51	41
TOTAL GENERAL LIABILITIES	$ 288	$ 258
NET ASSETS AVAILABLE FOR POLICYOWNERS AND BENEFICIARIES		
Insurance and annuity reserves	$29,999	$28,877
Policy and contract claims	520	475
Other policy liabilities	2,836	2,648
Dividends apportioned but not due	733	711
Reserve for fluctuations in values of securities	25	360
Assigned to meet statutory surplus requirements	55	48
Special contingency reserve	500	500
Unassigned surplus	993	1,187
TOTAL NET ASSETS AVAILABLE FOR POLICYOWNERS AND BENEFICIARIES	$35,661	$34,806

MODEL GAAP MUTUAL LIFE INSURANCE COMPANY

Statement of Changes in Net Assets Available for Policyowners and Beneficiaries

For the Year Ended December 31, 1974

	Year Ended December 31 1974
Income:	
Premiums and Considerations:	
Life and annuity	$ 4,188
Accident and health	1,267
Investment income (net of related expenses of $232)	2,095
	$ 7,550
Benefits:	
Death benefits	$ 1,015
Annuity benefits	480
Accident and health benefits	1,025
Other	666
	$ 3,186
Dividend charges for the year	$ 927
Insurance operating expenses	966
Income taxes	272
State premium and other insurance taxes	108
Realized and unrealized capital losses	1,498
Balance of above	$ 593
*Increase in obligations to policyowners and beneficiaries for items accrued but unpaid, or received but not due	262
Increase in Net Assets available for policyowners and beneficiaries	$ 855
Net assets available for policyowners and beneficiaries:	
December 31, 1973	34,806
December 31, 1974	$35,661

*Calculation of $262:

Increase in	
Policy and contract claims	$ 45
Other policy liabilities	188
Dividends apportioned but not due	22
Assigned to meet statutory surplus requirements	7
	$ 262

MR. CARDINAL: In order to judge what, if any, generally accepted accounting principles (GAAP) apply to mutual companies, it is necessary to understand how those principles are derived and at whom general purpose financial statements are directed. The tentative determination of the accounting profession is that GAAP is not applicable to mutual companies. However, the mutual companies dislike this determination. They are arguing, as is Mr. Sarnoff, that GAAP is applicable to mutual companies and that, because of the nature of mutual companies, the application of GAAP results in general purpose financial statements which are, for all practical purposes, identical to the statutory statements.

In order to make an intelligent decision on the applicability of GAAP to mutual companies, we need to understand the economic objectives which need to be met by GAAP. Accounting principles are means, not ends. As such, we need to identify the ends, the economic objectives, if the means to obtain these ends are to be deemed necessary and sufficient.

A basic objective of any financial statement is to provide information which is useful to the users of that statement for making economic decisions or judgments. Users' needs should be met if management bias, misrepresentation, misunderstanding, immateriality, unreliability, and noncomparability are to be avoided.

Who are the users of financial statements? Obviously, owners, managers, other employees, investors, creditors, consumers, governments, and suppliers are among those using financial statements. Some of these economic decision-makers have significant resources or authority available to obtain and analyze the financial information which they deem necessary and sufficient to their purposes. Because of this, general purpose financial statements should serve primarily those investors and creditors who have limited authority, ability, or resources to obtain necessary and sufficient financial information about a company's economic activity. This objective underlies the disclosure requirements of the S.E.C.

Since mutual companies have so few creditors and enter into so few relationships with investors, it is easy to see why the accounting profession feels that general purpose financial statements are unnecessary and inapplicable to mutual companies. However, if a general purpose financial statement were to be provided by a mutual company to creditors and investors in those few situations where such might be necessary, what are the financial objectives which should be met by that statement?

The information needs of creditors and investors are essentially the same. Both concern themselves with a company's ability to generate expected cash flows to them and with their own ability to evaluate, compare, and predict the amount, timing, and uncertainty of these cash flows. The information most useful in analyzing this ability is information on a company's ability in reaching its own goal.

The primary economic goal of a mutual company is to provide insurance as close as possible to the lowest average cost for each policyholder dividend classification by using cash to generate cash. General purpose financial statements should provide information useful to creditors and investors for:

(1) evaluating the effectiveness of a company's management of resources in achieving its goal, that is, success in using cash to generate maximum cash;

(2) assessing a company's interpretations of events relevant to its goal and their consequences;

(3) knowing the major assumptions underlying a company's interpretation of events so that they can evaluate those interpretations in terms of their own criteria for risk and return;

(4) determining whether they achieve their own goals incidentally or as a result of the company's reaching its goal by the consequences of its economic decisions; and

(5) increasing their ability for making comparison of competing economic opportunities.

From the preceding, one can see why the information provided by the statutory statements is insufficient for meeting the objectives of general purpose financial statements. When one appreciates that the substantive economic characteristics of a company's cash flow (that is, amount, timing, and uncertainty of its cash flow) should be highlighted in general purpose financial statements, regardless of formality of ownership structure, one can also appreciate that the information provided in the statutory statement is insufficient for meeting the objectives of general purpose financial statements for mutual companies as well as for stock companies. Information is useless unless it is relevant and material to creditor and investor decisions.

Since a company is accountable to those who furnish resources and who must make economic decisions about it, the company must provide the necessary information in its financial statement if that statement is to be described as a general purpose financial statement. Since the mutual companies do not want to provide that information, one can further understand why the accounting profession is reluctant to say that the statutory statements of mutual companies have been determined in compliance with generally accepted accounting principles.

Because of its goal of providing insurance at the lowest average cost possible within each dividend classification, the mutual companies argue that they should be exempt from any performance measurement other than statutory, regardless of their responsibility. This argument incorrectly implies that there is no measurement of management performance which general creditors or investors need since mutual companies only administer the distribution of available funds equitably between policyholder dividend classifications. Since the necessary information is not provided in statutory statements, this argument preempts general investors and creditors from analyzing the future cash flow of mutual companies.

Mutual companies argue that their premium levels are such that few dividend classes will experience average costs greater than funds available to such classes. Therefore, general creditors and investors should be satisfied with the information provided in the statutory statements for making their decisions, even though the information is inferior to that provided in a general

purpose financial statement. This incorrectly implies that the nature of mutual companies is beyond and above the information needs of general creditors and investors.

When mutual companies solicit funds from general creditors and enter into arrangements with general investors, they should be required to provide financial information which meets the objectives of general purpose financial statements. That heretofore they have been required to provide essentially only that information in statutory statements constitutes an "exemption" by the S.E.C. disclosure requirements which preparers of general purpose financial statements are subject to. I suggest that mutual companies leave well enough alone by dropping their request that their statutory statements be certified as being in conformity with generally accepted accounting principles, lest they jeopardize their "exemption" from the S.E.C.'s disclosure requirements.