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LIFE INSURANCE ACCOUNTING

I, *A*. Should the Mandatory Securities Valuation Reserve be a liability or a part of surplus?

MR. JOSEPH C. NOBACK: The Mandatory Securities Valuation Reserve is reported in the Association Blank as liability item 25, just above the surplus section. From all appearances, therefore, it is a liability.

To many students of the business, this item is looked upon as a securities portfolio reserve, a pooled reserve. In this role it is really not a liability.

The MSVR has been carefully designed to absorb those capital losses which will, in all likelihood, be sustained in the future by the bonds and stocks currently held by the company. The reserve anticipates that some of these securities will be realized at less than their association values. To many, the MSVR is analogous to the bad debt reserve set up by a commercial company against its accounts receivable.

From the point of view of the actuary, it is analogous to a reserve for paid-up term insurance. In each of these cases, losses will occur—we do not know exactly when or where. There might be none; or, there might be a great many.

There are a great many reasons for the fact that some persons working with the life insurance statement considered the MSVR a part of surplus. Perhaps we can cite four of them:

1. First, since this reserve is not a true liability, an amount owed a creditor, and since it is reported in item 25, very close to the surplus block, it is only natural for some to consider it a part of surplus.
2. Second, and more important, is the fact that the "appropriations to" and the "take-downs" from the MSVR are handled directly through the surplus account, which includes items 34–51. Net deductions from the MSVR are reported in surplus item 41; net additions to MSVR are reported in surplus item 48. The treatment of the "additions to" and the "deductions from" the MSVR tends to lead the student to consider the reserve itself as a segregated part of surplus.
3. Third, many investment analysts classify the reserve as a part of surplus. When they encounter the MSVR, they apparently conclude that, since it is not a true liability, it must be part of the capital stock equity. These men are attempting to determine a realistic value for the "capital stock equity per share." They deal with many different businesses in their work, and they take a pragmatic view toward our statement. They are looking at us from a liquidation point of view.

4. Finally, companies which are taxed under Phase I of the Federal Income Tax Law tend to view this reserve as part of surplus because the MSVR tax treatment is analogous to that of "surplus." This may not be a good reason, but it does exist.

I suppose that none of us are ready to commit ourselves as with regard to a particular treatment to be accorded this item. However, a good case could be made for the argument that the MSVR is a negative asset. We noted earlier that it is analogous to the bad debt reserve. Perhaps, then, it might be possible to reclassify it as a deduction from the relevant asset values.

The observed tie-in between the MSVR and surplus could be eliminated if some method were found by which net capital losses could be charged to the income account and net capital gains could be added to income account rather than to surplus. If that were done, the charge or credit for the MSVR itself could also be carried into the income account (rather than surplus). This would minimize the argument that MSVR is a surplus item.

When the investment analyst reclassifies the MSVR into surplus, he tends to overlook the basic fact that the life insurance business is a long-term operation and that, in fact, investment losses will be sustained. If it were conceded that there will be investment losses in the future and if it were conceded that the MSVR formula makes a reasonable provision for such losses, it would follow that the reserve is a negative asset item.

However, there are difficulties in reporting the MSVR as a negative asset. The MSVR is a "pooled reserve" in which the provisions for losses in bonds, preferred stocks, and common stocks are somewhat intermingled. This makes it difficult to report the item separately on the asset side of the balance sheet. In addition, we should remember that the industry thoroughly reviewed the MSVR with the NAIC only four years ago. As a consequence, while this is an interesting subject to discuss, it would be best to retain the present treatment for the time being!

We are therefore led to the conclusion that (1) MSVR is not a part of surplus, (2) MSVR is best treated as a liability, and (3) MSVR is a rather unusual and unique liability.

MR. W. HAROLD BITTEL: The National Association of Insurance Commissioners has always required that the MSVR be treated as a liability in the annual statements of life insurers and fraternal beneficiary societies. The annual statement forms include this reserve as a required item on the liability page.

The present requirements for this reserve separate it into the bond and

preferred stock reserve component and the common stock reserve component with specific provision that these components can be utilized for losses and fluctuations only in the case of the specific securities for which they are held. At the time these requirements were adopted, it was intended that both of these reserves be treated as liabilities, because that for bonds and preferred stocks was specifically related to probable future losses on such securities and that for common stocks was in lieu of a proposal to carry such securities at their cost in the annual statement. Even the SEC, during our discussions with them prior to the adoption of their current article applying to life insurers, agreed that the bond and preferred stock reserve component is a liability but, while they would have agreed to use the cost for common stocks, they had reservations about the common stock reserve component's being a true liability. Their compromise requirement of showing this MSVR as neither a liability nor as a part of capital and surplus was agreed to as a result of these discussions.

MR. WILLIAM G. POORTVLIET: The MSVR has two main purposes: it acts to cushion the surplus funds of life insurance companies against wide swings which could result from capital gains and losses on stocks and bonds, and it provides a mechanism for life insurance companies to set funds aside in advance to meet certain large losses which might occur in times of abnormal economic stress.

In view of the latter purpose, I would like to focus attention briefly on the fact that there are many other abnormalities which might result in large losses and against which an insurance company may wish to protect its policyholders by setting funds aside in advance. I am referring to those large losses which occur so suddenly as to be considered catastrophic or irreversible, not to the costs associated with gradual (and even steep) changes in rates of mortality, morbidity, interest, and other contingencies. Some of these costs may be caused by events which are extremely difficult to predict—very few foresaw the Great Depression or the wars of this century. Others may result from calculated risks taken in connection with experimental coverages. With regard to all such losses, a company must decide (*a*) how the costs may equitably be shared, (*b*) how funds to meet such costs will be developed and accounted for, and (*c*) how an appropriate level for such funds will be determined.

I believe that the current economic indicators are such that it is quite timely for a company to consider the MSVR and its other existing investment reserves in the light of their relationship to the totality of

funds required and that it would be well to complete such general considerations before isolating the MSVR in order to determine how it can most appropriately be treated.

However, by way of an immediate reaction to the merits of a specific proposal to include the MSVR with surplus funds, I would like to summarize a few of the questions that I believe require our consideration.

1. One of the purposes which the MSVR serves is that of cushioning surplus funds against fluctuations. Would not this purpose be defeated if such a proposal were adopted? This would no doubt be painfully obvious to those companies which are heavily invested in common stocks.

2. Would the inclusion of this reserve with surplus funds achieve what some hope it will, namely, a better understanding of our balance sheet, or would the substitution of an asset valuation offset device be even more meaningful? Are the regulatory authorities generally in favor of conservative asset and liability valuation and opposed to large surplus accumulations (as evidenced, for example, by the existence in some states of surplus retention limits side by side with conservative minimum valuation requirements)?

A mutual company's policyholders, whose rights are not involved with ownership, are primarily interested not so much in the amount of surplus funds as in all the provisions made by a company to ensure that it will be able to meet all of its commitments under a wide range of circumstances.

3. Would not the inclusion of the MSVR with surplus funds place an unfair additional restriction upon the management of companies in those states which have surplus retention statutes? Is it safe to assume that the laws in these states would be changed? (It has been suggested that alternatively companies might be permitted, through a change either in the statement "Instructions" or in the "Valuation Procedures and Instructions for Bonds and Stocks," to file statements showing the MSVR below the line in some states and above the line in other states. I am sure that many of us would agree that the resulting lack of uniformity in treatment would represent a very undesirable development.)

4. Is it not true that, while many accountants believe that the MSVR should be included with surplus funds to provide conformity with generally accepted principles, there is by no means universal agreement among accountants on this point?

5. Would not clarification of the nature of the MSVR and of the nature of some of the other items being discussed today be more appropriately handled by furnishing data outside the annual statement? The present format of the Annual Statement has been painstakingly de-

veloped, and, by and large, it has proved satisfactory. While I am sympathetic toward the problems of the stockholders and management of stock companies and also toward the problems of many financial analysts, I believe that in judging the merits of, and the necessity for, any change an indispensable consideration must be the extent to which the change would contribute to what is the primary purpose of the annual statement, that is, the protection of life insurance policyholders.

I, *B*. Should capital gains be reflected in earnings? Should there be a difference in the treatment of unrealized and realized capital gains?

MR. CHARLES M. BEARDSLEY: The annual statement has traditionally treated gains and losses on capital assets as direct adjustments to the surplus account rather than as increases or decreases in earnings for the current year as a part of the summary of operations. Just exactly how this came to be would be very difficult to trace, but I believe that there would be at least two primary factors involved.

First would be the fact that throughout much of its history the life insurance industry has been rather severely regulated with regard to the types of investment in which it may participate. Most states have had, until the recent past, close restrictions on the percentage of assets which a life insurance company may invest in common stocks. Equities are normally the capital assets most fruitful of realized and unrealized capital gains and losses.

Second, the summary of operations of the annual statement has never yet been designed to produce a highly realistic profit or loss figure for the year. The annual statement, as we all know, is mainly a complex formula designed to test a company's solvency. Primary emphasis is given to the balance sheet, and the summary of operations is definitely a secondary consideration. By laying down rules for the valuation of assets and liabilities, both on conservative bases, the regulatory authorities achieve their purpose of ensuring that a company's stated surplus funds will also be on the conservative side. I do not intend to debate this practice now, but merely wish to emphasize that the problem of whether or not capital gains should enter into earnings has probably not been given much attention by the NAIC in past years.

Traditional accounting, in contrast to specialized life insurance accounting, has always seemed to be more concerned with the profit and loss statement than with the balance sheet. It is not at all unreasonable, therefore, that certified public accountants, when requested to audit

life company statements, have (among other things) questioned the practice of omitting capital gains and losses from the current year's earnings. The typical footnotes appended to a life company audit include a paragraph such as this:

> The determination of net income is not affected by realized gains or losses on the sale or maturity of investments or by unrealized gains or losses reflecting a change in valuation of investments. Both realized and unrealized gains or losses are reflected directly in surplus.

The implication is, certainly, that if we were to follow generally accepted accounting principles, capital gains and losses for the year would be included in the summary of operations rather than in the surplus account on page 4 of the Annual Statement.

It is very interesting to note that, when the NAIC committee drew up the Annual Statement of Separate Account Business, one of the most important differences in the design of this statement was inclusion of capital gains and losses directly in the total investment income. In other words, with respect to this item, the Annual Statement of Separate Account Business does follow generally accepted accounting principles. One of the things which I hope our later discussion will bring out is whether or not there are valid reasons why the two types of annual statement should differ so widely on this one point.

Even though capital gains and losses appear in the summary of operations of the Annual Statement of Separate Account Business, by the time the results of the Separate Account Statement are combined with the life company's regular statement, such gains and losses are reflected only in the surplus account—just as are the life company's other capital gains or losses, if any.

All things considered, I favor the way in which capital gains and losses are handled now. At this point in time I would not like to see the regular Annual Statement modified to include capital gains and losses in the summary of operations unless a completely honest attempt is made to redraft the entire Annual Statement in order to have it all conform to generally accepted accounting principles. Even then I would hope that the basis on which it would be done might prevent earnings from fluctuating wildly in response to market conditions and would prevent management from having unacceptable discretion to "manage" the flow of published earnings.

Regardless of my personal preference, however, we must recognize that decisions to purchase, retain, or sell securities are not based solely on coupon returns, or dividend returns, or rent returns. They may be very

largely influenced by the prospect of capital appreciation. A common stock yielding 3 per cent and appreciating 6 per cent may be a much better investment than one yielding 6 per cent and appreciating 3 per cent. A high-yield bond with a considerable risk of default may be a poor investment. Yet we have no way of reflecting the appreciation of the common stock in current earnings or in the numerator of the interest rate. What appreciation we do record shows up as an increase in the denominator of the interest rate calculation with a consequent penalty on the interest rate; and the high-yield bond that goes sour does not make the interest rate go down. One result of deficiencies of our accounting is that management investment decisions may be unfavorably influenced against the interest of the company; an excellent stock having a high price/dividend ratio may be shunned because of its effect on the published interest rate.

It would be helpful, therefore, if there were some mechanism by which capital gains, and losses, could be reflected in earnings.

Reflection of realized capital gains in earnings is not a new concept. It is customary in manufacturing and commercial fields to include realized capital gains in earnings, because assets subject to gain are usually small in relation to total assets. Such assets are normally carried at cost (or market, if lower). Any realized gains tend to be comparatively small in amount and comparatively rare in frequency. For such companies the accounting treatment takes appropriate cognizance of the fact that capital gains are minor and incidental. When they are no longer minor and incidental, as is often the case with life insurance companies nowadays, it would seem that we need better accounting treatment.

Whatever accounting recognition may be given to capital gains in life companies, both realized and unrealized gains ought to be considered together, as complementary parts of a whole rather than as separate and unrelated issues. Granting our assumption that capital gains constitute a very material objective of investment policy, there should not be an artificial pressure upon management to realize those gains in order to have them recognized in earnings. For example, management could improve earnings by the simple device of selling an appreciated asset on the open market and then immediately repurchasing it. Furthermore, if a stock bought many years ago at 100 has appreciated to 150 as of the end of last year, management should not record an earnings of 30 from selling the stock this year at 130; on the contrary, they should show a loss of 20, since an asset worth 150 at the end of last year has been disposed of for 130. It follows, therefore, that realized and unrealized capital

agins should be treated on a consistent and logical basis and not as unrelated issues.

We must also consider the interplay of capital gains and the MSVR. If the MSVR is intended as a cushion against stock market fluctuations, it is appropriate that some part of capital gains should be credited to it and only the remainder credited to earnings. Like a bad debt reserve, it should absorb some of the benefit of favorable years and correspondingly absorb some or all of the loss in unfavorable years. If this approach is to be followed, it would argue that all of the increments and decrements to the MSVR should be divided into a portion which will affect current earnings and a portion which will increase or decrease the cushion against fluctuations and act as a stabilizing influence.

One suggestion that has recently been made is that, for insurance companies, the earnings from dividends on common stocks should include not only the dividends received but also the difference between earnings of the owning company, as is now commonly done with respect to the undistributed earnings of a majority-owned subsidiary. This could also be thought of as a process whereby the value of common stocks is written up or down each year to reflect undistributed earnings. It would follow that the difference between market values and the written-up book value on stocks owned would then constitute a class of capital gains for which it would be appropriate to credit or debit the MSVR.

This new approach has been drawn to the attention of the C.P.A.'s and some of them have expressed considerable and favorable interest in the idea. It is my understanding that they are discussing it, or will discuss it, within the ranks of AICPA.

The practical problems may not be as difficult as they appear. There are computer services which register both distributed and undistributed earnings for publicly quoted stocks and which can supply companies with figures of undistributed earnings for their portfolios. There would probably be a practical problem involved; because of different fiscal years for the issuing companies, and because of the time lag in getting undistributed earnings as of the end of a calendar year, it might be possible only to write up, and credit to earnings, the last available data prior to the close of the life insurance company's statement. The lag thereby created in getting undistributed earnings of stocks owned into the earnings of the owning company should not be a serious practical problem. A similar problem exists with respect to the undistributed earnings of majority-owned subsidiaries and does not seem to cause any serious practical difficulties.

Another reason for opening up this subject of the reflection of capital

gains in earnings is that more and more of our companies are, for one reason or another, finding that their financial statements have to be consolidated with those of noninsurance companies. The process will inevitably be one of adding apples and oranges together. Consequently, its solution should be approached on a logical basis with due regard to the propriety of the statements of each component of the consolidated result.

MR. BITTEL: At the time the present form of the Annual Statement was adopted in the early 1950's, provision was made for showing net realized capital gains in the summary of operations on page 4 as part of net investment income and net realized capital losses as a deduction therefrom. No instructions were given as to how this item was to be calculated, but each company was required to include with the statement an explanation of how any amount shown was determined. Because of unsatisfactory experience with this procedure and the lack of any uniformity on the part of companies reporting amounts in this item, the present form of reporting was adopted for all companies.

The current requirements in this connection show the correct calculation of realized capital gains or losses, including amounts reflected in prior years' statements, as a footnote in Exhibit 4 of the statement without any requirement that this amount should be reflected in the current year's accounts. This treatment is necessary because of inability to reach any agreement on how the portion of such realized capital gains or losses reported in previous years' statements could be incorporated in the current statement without, in some instances, showing ridiculous results for the current year. In general, there appears to be agreement that there should be a difference in the treatment of unrealized and realized capital gains, but no suitable or practical method has been devised for reflecting such treatment in the annual statements.

It should be noted that such a separation does appear in the fire and casualty annual statement blank although, even in this blank, the amount reported as realized usually reflects only that portion of net aggregate gain or loss applicable to the current year.

MR. FREDERICK S. TOWNSEND: The principal argument for including capital gains in the income account is that some companies intentionally sacrifice higher yields in return for potential capital gains. A secondary argument is that some companies realize consistent capital gains from year to year. However, such experience is difficult to project into future years.

I do not favor including capital gains in the income account. Dividend income and interest income are amounts which are recurring and directly a part of annual earnings. Capital gains reflect a change in book value rather than a stable, recurring earnings figure.

The inclusion of realized capital gains in the income account has tempted some noninsurance corporations to acquire control of insurance companies with large unrealized capital gain positions. The idea is that the parent corporation can "manage" its earnings by realizing capital gains in any amount and by any incidence it so desires. A prudent investor should be aware of the portion of annual earnings represented by capital gains.

One minor consequence of including capital gains or losses in earnings is that some managements will be reluctant to take capital losses and thus may retain deteriorating (price and earnings) common stocks in their portfolios rather than dispose of them at a loss.

II, *A*. What accounting adjustments have had to be made by companies registering with the SEC? By companies seeking to be listed on the New York Stock Exchange?

MR. GATHINGS STEWART: The form and content of financial statements required to be filed with the SEC are specified in Regulation S-X. Regulation S-X deals with certification by independent certified public accountants and with the rules of general application required for all types of companies. Article 7-A of this regulation deals specifically with financial statements of life insurance companies. In its basic form, Article 7-A allows for the use of the Convention Annual Statement figures with a rearrangement and retitling of the various financial items involved. Reconciliation of the net income statement to "generally accepted accounting principles" is not required in a financial note as it is in the case of fire and casualty companies.

The rearrangement of the balance sheet and income items seems to present no particular problems. However, certain additional information is required which is not shown in the NAIC Convention Annual Blank. For example, the amount of surplus allocated to participating policies and not available for dividends to stockholders must be shown as a separate item in the surplus section. Also, the surplus section of the balance sheet calls for a division into (1) paid-in surplus, (2) surplus arising from revaluation of assets, (3) other capital surplus, and (4) earned surplus—appropriated and unappropriated. If the company cannot furnish these four divisions of surplus, it is required to show in a financial note an analysis of surplus since organization. This analysis must show, among other things, the following: (*a*) the total income after income taxes, (*b*) cash and stock dividends, (*c*) paid-in surplus, (*d*) realized and unrealized gains on investments and other assets, (*e*) increase in reserves on account of change in valuation basis, (*f*) nonadmitted items, and so on. In the income statement the net income allocated to participating policies must be shown.

It is interesting to note the SEC treatment of the MSVR. This reserve is not treated as a liability, nor is it treated as a part of the surplus account. Instead it is left in No-Man's Land as a separate item in the balance sheet.

In financial notes certain additional information is required by the SEC as follows:

1. The general policy of the company in determining dividends and profits allocable to participating policies.

2. The current year's addition to the "policyholder surplus account" as defined in the Internal Revenue Code applicable to life insurance companies and also the total accumulated amount thereof.
3. The amount of federal income tax on unrealized capital gains.
4. Detailed information about the reserve liabilities in a manner similar to Exhibit 8 of the Convention Blank.
5. Information concerning the book value of assets and also information regarding nonadmitted assets.

Certain schedules are also required, but much of this information can be satisfied by filing the Convention Annual Statement.

While it is true that Article 7-A of Regulation S-X does not explicitly require information about adjustments to generally accepted accounting principles, this question will be raised in the required certification by the independent accountants. Accountants have insisted that differences from generally accepted accounting principles must be discussed in their financial notes. These differences include (1) reference to the fact that acquisition expenses are charged in the year incurred and are not amortized over a period of renewal years; in the case of established companies, the accountant may feel that there is no material difference involved in the treatment of acquisition expenses and therefore may make no comment on this item; (2) comments regarding the NAIC method of valuing assets—for example, use of market values for common stocks; (3) reference to the fact that the MSVR is not treated as appropriated surplus; (4) reference to the fact that realized capital gains and losses are not included in the income statement; (5) comments regarding the NAIC concept of nonadmitted assets; (6) reference to the fact that reserve strengthening is a direct surplus charge rather than adjustment to past or future income statements; (7) references to the possibility of deferred taxes for items where the accounting practices in the financial reports are different from the treatment of these items in the tax return. A specific example of this relates to the use of modified preliminary term reserves in the financial reports and the use of the net level election in the tax return. This question will be covered later today.

The above differences from generally accepted accounting principles, as I have stated, if shown at all, appear as financial notes to the life insurance company statement. I am not aware of any attempt to adjust the income statements and balance sheets of life insurance companies for these items in SEC filings. You will be interested to know that dialogue between the American Institute of Certified Public Accountants and the life insurance industry is currently taking place regarding generally accepted accounting principles. The life insurance companies are represented by an ALC-LIAA Joint Committee on Financial Reporting.

MR. CHARLES M. BEARDSLEY: What is the situation when a noninsurance holding company becomes involved?

MR. STEWART: When the life insurance company is part of an affiliated group and is a subsidiary of a noninsurance holding company, the question of consolidated financial statements may arise. If a consolidated statement is prepared for the entire group, the adjustments to generally accepted accounting principles will be directly reflected in the income statement and the balance sheets. These adjustments may reflect, for example, restatement of common stocks to cost, reclassification of the MSVR to surplus, inclusion of realized capital gains as income, and the exclusion of minority interests. The question of the exclusion of income and surplus allocable to participating policies and not available for dividends to stockholders will also arise.

The second part of question II, *A*, relates to accounting requirements for companies seeking to be listed on the New York Stock Exchange. It is my understanding that the Exchange does not attempt to prescribe the exact form or detail of the financial statements. It is expected that statements to stockholders and the public will be reasonably informative and that the accounting policies of the company will conform to accepted practices. This means that the basic accounting comments made about SEC requirements would also be applicable in the New York Stock Exchange reporting. In the listing application much information is required beyond the normal financial reports.

There is one accounting requirement of the Exchange which goes even further than the SEC has seen fit to prescribe. This is the requirement for the publishing of quarterly statements of earnings. Interim financial statements must be certified, but the certificate may be made by the company's principal accounting officer.

II, *B*. What changes in the treatment of nonadmitted assets are necessary if life insurance companies are to follow generally accepted accounting principles?

MR. JOSEPH C. NOBACK: The excluded assets are those reported in Exhibit 14. They include such items as furniture, fixtures, equipment, amounts receivable from agents, agents' debit balances, and miscellaneous accounts receivable.

The treatment of these asset items in the current Association Blank dates back almost one hundred years. This treatment dates back to

the early days of life insurance in this country. Perhaps at this point it is pertinent to note that the first Convention Blank adopted in 1875 made specific provisions for a set of not-admitted assets. Apparently in those days the statement-makers thought that this was a perfectly acceptable practice. In those early days—in the 1860's and 1870's—a few small companies apparently engaged in some very sharp practices in completing their annual statements for the commissioners. From all accounts these companies reported unconscionable amounts in some of these asset items. As a consequence, when the commissioners uncovered these practices and concluded that they were not in a position to control them through their own audit, the decision was made to exclude these items completely. There is every likelihood that some of these men realized that these assets could be proper ones for a life insurance company to hold. However, the feelings ran so high that not only were the items excluded from the Association Blank but, in addition, the excluded assets were specifically spelled out in the statutes. These statutory exclusions were reinforced and expanded from time to time in the ensuing years.

These assets, therefore, are excluded from the balance sheet because of practices that occurred many years ago, because the Association Blank calls for these deductions, and because there are statutory requirements to be satisfied.

A great many changes have occurred in the business community during the last fifty years. Accounting and auditing are much more sophisticated than they had been. The practice of depreciating furniture and equipment is widely recognized. Consequently, there is good reason for feeling that the present requirements are somewhat outmoded.

A few years ago the laws of several states were amended to permit companies to report electronic data-processing equipment as an asset at a reasonable value. This principle applies to desk calculators and other equipment. Perhaps that legislation should have been broadened enough to eliminate all the "asset not-admitted" items.

I believe that serious consideration should be given to the inclusion of all a life insurance company's assets in its balance sheet. Of course, the amount reported should be a reasonable value. The fact of the matter is that those which are currently included in Exhibit 14 are, by and large, relatively small in relation to the entire assets of the company. It seems to me that any potential abuse can be prevented by setting forth specific guidelines in advance and then following this up with a reasonable audit procedure.

One of the main benefits to be derived from the elimination of these not-admitted assets from our statement form is that it would make the

Association Blank more readily understood by the general public and more acceptable to the accounting profession. I would go even further and suggest at this time that an effort should be made in the near future to revise our Association Blank and in the process to eliminate all reference to not-admitted assets. This would mean the elimination of the "market over book" entries as separate items in the printed form of the Association Blank. It would also mean the elimination of "overdue interest and rent." This could be achieved by recasting Exhibits 3, 13, and 14.

This change would not alter the Association values actually reported on the asset page for bonds, stocks, mortgage loans, real estate, or interest due and accrued. Only the procedure by which these items are computed and reported in the exhibits would be modified. The procedure to be followed has already been adopted in the Canadian Life Blank.

The modernization of the Association Blank should not be undertaken lightly. However, the criticism generated by the accounting profession with regard to not-admitted assets is a fair one. Our practices do not follow their "generally accepted accounting principles."

If a change is to be made, a great deal of work will be required because, as matters now stand, the life insurance industry must comply with the statutes of the several states. As a consequence, before the Association Blank could be changed, it would be desirable to amend the not-admitted-asset statutes of several states.

III, *A*. Are life insurance reserves too conservative to reflect accurately earnings and net worth? If so, what methods could be used to eliminate the overconservatism?

MR. GATHINGS STEWART: The question of the conservatism of life insurance reserves is a relative one and depends on one's viewpoint. For example, put yourself in the shoes of the following interested parties: (1) the insurance department, (2) the policyholder, (3) the stockholder, (4) the security analyst, (5) the independent accountant, and (6) the company's actuary. All may have different viewpoints.

The insurance departments and the policyholder are certainly interested in solvency. The stockholder and the security analyst are more interested in a realistic appraisal of net income and its past and future growth. Current experience as to interest rates and mortality weighs heavily in their thinking. The actuary and the independent accountant must take a balanced view, keeping in mind the long-term nature of the insurance business and the need of providing for contingencies.

With these various viewpoints in mind, there are several items which are worthy of consideration.

1. Interest and mortality levels are always in the process of changing. What about the reserves on existing policies? The question of whether interest assumptions are too conservative on an old block of business cannot be considered separately from the method of valuing bonds and mortgages. If, as an extreme example, a closed block of fully paid policies is valued at 3 per cent and if the matching assets have been invested in amortized bonds and mortgages averaging a 3 per cent yield and reasonably matching in maturity the anticipated payouts from the policies, the liability assumption of 3 per cent may be appropriate, regardless of whether the current yield on new bond issues may be 5 or 6 per cent. It is not reasonable to talk of conservatism in a reserve interest assumption without knowing the character of the corresponding assets.

2. There is the question of preliminary term reserves versus net level reserves. This raises the whole question of the amortization of acquisition expenses and their relationship to the reserve basis.

3. The appropriate amount of surplus cannot be divorced from the level of the reserves. If less conservatism is used in reserve valuations, should the level of surplus be higher? What about the surplus limitation for mutual companies? Should this be raised if less conservative reserve bases are used?

On balance, I believe the reserve systems required by law have worked

well. They have changed from time to time to meet changing conditions. They are flexible as to interest assumption and allow the option of preliminary term or net level reserves. Reserve strengthening is permitted and encouraged where appropriate. It seems unrealistic at this time to attempt any major changes in these systems for the purposes of the Convention Annual Statement. This does not mean, however, that a concept of adjusted earnings is not a valid one for security analysts and stockholders.

The projection of future interest and mortality rates is a matter of judgment, and it is the prerogative of any analyst or stockholder to exercise this judgment. There is also validity in looking at the relationship of acquisition expense to the reserve basis used. This is a question that both the accountants and the analysts are considering and an area where actuaries can provide some basic guidance. For example, should we go one step beyond preliminary term valuation and calculate adjusted reserves as being equal to cash values? This assumes that cash values would be close enough to serve the purposes of dealing with acquisition expenses for life and endowment policies. It should only be necessary to do so for issues of the last ten or twenty years, grading the amount from the cash value at the end of the first year to the statutory reserve at the end of ten or twenty years. The result might be a very useful figure for the analyst of a stock insurance company.

Some analysts have suggested that life insurance reserves should be revalued to a current interest rate, using the formula in the income tax law. Apart from the approximations involved in the rule of thumb, this suggestion is an oversimplification of the problem. First, it does not consider the parallel revaluation of assets. Second, it is hardly conservative to assume that a current market evaluation of interest rates will necessarily hold for the future lifetime of a block of insurance business. The mere fact that typical valuation interest rates are lower than typical company portfolio yields, which in turn are lower than typical yields available on new investments, does not necessarily prove that reserves are unduly conservative. Third, it might produce reserves which are lower than the cash values.

MR. FREDERICK S. TOWNSEND: With respect to the adequacy of reserves, it is up to management to see that its underwriting practices make the mortality basis of their reserves adequate. Ignoring the mortality aspect, I believe that the incidence of reserves is too conservative to reflect accurately earnings and net worth.

Reserves are conservative to the extent that they exceed cash surrender

values, which are demand liabilities. The excess of reserve over cash value liability may be due to (*a*) CRVM reserves exceeding minimum cash values, (*b*) the use of net level reserves where CRVM reserves adequately cover cash value liabilities, or (*c*) reserves being maintained at a lower interest rate than the corresponding cash value liabilities.

This conservatism could be corrected by changing page 4, line 17, of the NAIC Convention Blank into two lines: line 17A, "Increase in Aggregate Cash Value Liabilities," and line 17B, "Increase in Excess of Reserve over Cash Value Liabilities." "Earnings for Industrial Life" (col. 2) and "Individual Life" (col. 3) could be more accurately represented by the sum of lines 33 and 17B.

Unlike the Committee on Adjusted Earnings of the Association of Insurance and Financial Analysts of New York City, I do not believe that reserves should be adjusted to reflect current interest rate levels. Such restatement of reserves ignores demand liabilities and could result in aggregate reserves (as adjusted) which are less than aggregate cash value liabilities.

III, *B*. Should increases in reserves as a result of a change in the valuation basis be charged to earnings?

MR. STEWART: In NAIC accounting it has been traditional to charge reserve strengthening directly to surplus. I believe the theory would run something like this. The new reserve basis is more appropriate under current conditions, and, therefore, future profits will emerge in a more proper fashion on the revalued basis. The surplus is therefore adjusted, taking into account the new reserve basis. Since NAIC accounting has historically put more emphasis on the balance sheet than the income statement, it apparently has not been thought necessary to restate previous years' income.

Many independent accountants view changes of this kind in a different light. Their emphasis is on the all-inclusive income statement and the accuracy of accumulated earned income at any point in time. A direct charge to surplus, in their thinking, would improperly bypass the income statement and therefore violate "the clean surplus theory." The question then arises as to the proper way in which to adjust the income statements. There seem to be three possible approaches:

1. Restatement of prior years' income. *Opinion 9 of the Accounting Principles Board of the American Institute of Certified Public Accountants* deals with restatements of this kind. I understand that the AICPA Committee on

Insurance Accounting is examining *Opinion 9* to determine whether it is applicable to the reserve-strengthening process.

2. A charge against income in the year in which the reserve strengthening is determined to be necessary. If the increase is material, it would be identified as an extraordinary, nonrecurring charge for the year.
3. Amortization of the reserve strengthening over a reasonable period of years with an appropriate charge to future income statements. This is the approach used in determining the gain from operations under the 1959 Life Insurance Company Tax Act.

I have mixed emotions about which of the three methods might be preferable. The choice of method could well depend on the type of reserve strengthening involved. For example, if reserves are strengthened to provide a different interest assumption, how would the increase to past or future earnings be allocated? After all, the interest rate change may have been a gradual one. If current earnings are charged, the complex allocation problem is avoided. On the other hand, from the point of view of displaying a trend of earnings, it would seem better not to charge all the strengthening to the current year.

Revaluation to a net level reserve basis might be better handled by a restatement of past earnings.

Amortization of the strengthening over future years is more consistent with income tax treatment, but we should remember that income tax treatment does not necessarily dictate good financial-reporting practices. All in all, I would say that this question will require a great deal of study on the part of all of us.

MR. TOWNSEND: Most companies record "increases in reserves on account of a change in valuation basis" as a surplus charge through Exhibit 8A. These are usually nonrecurring charges. However, some very large companies do have programs under which such reserve increases recur annually and are charged to earnings through page 4, line 17. Examples of this include (*a*) reserve bases being strengthened in the year in the year in which policies become fully paid up and (*b*) conservative reserve bases being adopted in the year in which annuity settlement options are elected.

MR. JOHN S. MOYSE: The consensus of opinion seems to be that reserve strengthening should be charged to earnings if it is a recurrent matter but to surplus if it is a one-time matter.

Two similar items are the increase in nonadmitted assets and federal income tax payments for prior years. Increase in nonadmitted assets is a

surplus item and does not go through earnings according to the format of our Annual Statement; however, it would appear to be more correct accounting to put this item through earnings, especially if recurring.

With respect to federal income tax, if a company is continually underpaying this item and then making surplus charges on tax payments which relate to prior years, a strong case can be made for putting these tax payments through earnings rather than through surplus.

III, *C*. Should the liability for policyholders' dividends be limited to dividends earned up to December 31?

MR. JOSEPH C. NOBACK: The title of liability item 7 of the Association Blank reads: "Provision for policyholder dividends payable in the following calendar year. . . ." This title is clear and unequivocal. It states that each company which has participating insurance in force at the end of the year must report the total of all the dividends which are payable or will be paid to these policyholders during the following calendar year. This liability requirement has the advantage of creating uniformity of treatment among the various companies. Furthermore, this uniformity dates back some sixty-six years, to 1903. That was the year in which this item first appeared among the liabilities in the Association Blank. Since that date all companies have been required to report a full year's dividends.

The fact that this requirement has been consistent, uniform, and of long standing does not necessarily make it immune to discussion or debate.

In 1937 J. B. Maclean raised a number of questions about this item in his book *Distribution of Surplus*. He discussed the statement requirement from the point of view of ordinary insurance and from the point of view of the three-factor method of distributing divisible surplus. He noted that part of the dividend allotted to any policy is the amount of excess interest earned on the reserve during the period from the previous policy anniversary to the anniversary in the year in which the dividend is paid. "If that is so, it would be logical . . . that the dividend liability as of December 31 should be reduced by the amount of surplus which it is assumed (in the dividend scale) will be earned in the following calendar year and prior to the respective policy anniversary or, say, roughly during the first half of the calendar year." At that time Maclean concluded, "The usual practice, however, is to ignore the fact that part of the cost of the new dividend will be met from surplus earnings after December 31 and the effect is

therefore that, from this point of view, there is in the financial statement . . . an overstatement of the liability for dividends."

On the other hand, the argument can be made that, once the board of trustees has declared that a dividend scale will be adopted, it has declared that the amount of the dividend will be paid and must therefore be allotted out of earned surplus, that is, surplus earned by December 31 of the statement year. Therefore, it is a real liability and *not* contingent upon earnings from December 31 up to the policy anniversary. According to this view, it would appear that the liability for the full amount of the dividends is just as real as the liability for shareholder dividends declared by the board but not yet distributed.

Immediately the question comes to mind of how this view would apply to a company having a dividend year which is not a calendar year. In those cases dividends have not been declared for the full calendar year, only for the remainder of the current dividend year.

A strong argument for not setting up the full year's dividends can be made by considering small blocks of policies and seeing how the present requirements apply to them. For example, for those ordinary policies dated December 1 with premiums payable monthly, it is apparent that not more than one-twelfth of the dividend payable in December 1 of the ensuing year can actually have been earned or accrued. This would apply to all three elements in the three-factor formula—mortality, interest, expense. On this basis the liability for a full year's dividend, as currently required, is an overstatement.

Perhaps one of the most powerful arguments for reporting the full amount on a uniform basis is the fact that at the present time Internal Revenue Codes recognize the present liability. As matters now stand, the full amount of the dividend set aside as of the end of the calendar tax year is considered as a liability for the purpose of determining incurred dividends for the year.

A further argument can be made with reference to the amount of the dividend liability if we consider the problem in group insurance. This point applies especially to the group term coverages for life, disability income, hospital, surgical, and so forth. In the case of those lines of business, the dividend payable at the end of the policy year is in accordance with a formula adopted by the board. The actual amount payable, however, depends, among other things, upon the experience of the policy during the period from December 31 to the end of the policy year. In other words, the dividends, to a particular group, will depend on three elements: (1) the experience of that group, (2) the credibility of that group, and (3) the experience of its entire class of group policies. Therefore, the liability

at year end should be limited to the amount actually earned or accrued from the last renewal date, to December 31. As we understand it, some group companies do modify item 7 on the liability page to this extent; that is, with regard to their group business they report an estimate of the amount actually accrued to December 31.

It would appear that, on balance, the policyholder dividend liability should be set up for the full calendar year, except in those cases where group cases are involved. The primary reason leading us to this conclusion is uniformity.

MR. W. HAROLD BITTEL: The Annual Statement itself does not impose any requirements as to the period for which a liability for dividends payable in the following year must be set up, although it does require that provision be made for all such dividends declared by the board of directors or trustees prior to the year end. Some states have requirements for this period. Where a company does not declare such dividends for the entire following calendar year, a line is provided for setting up a liability for amounts not yet apportioned, although there is no requirement that any such amount be set up as a liability.

There does not appear to be any doubt but that the amount reported as not yet apportioned can be limited to dividends earned up to December 31. In other words, this amount need not be more than the earnings for the year of the statement applicable to such dividends.

While provision for all dividends declared prior to the year end and payable in the following year, including those contingent upon the payment of a premium, must be made in the statement, it should be noted that these are estimated amounts and that there is no prohibition of an adjustment of this liability to approximate the amount which it is expected will actually be paid out in the following year, using any modifications that may be justifiable. Generally, companies do not make such modifications, but there does not appear to be anything in the statement or the instructions therefor which would prohibit such adjustments.

IV, *A*. Should liabilities be established for

1. Federal income taxes on unrealized capital gains?
2. Deferred Phase III taxes?

How should the amount of these liabilities be determined?

MR. CHARLES M. BEARDSLEY: My first reaction in attempting to speak on this question is to ask a further question: Are we talking about the possibility of establishing mandatory liabilities for all life companies or about discretionary liabilities on the part of individual companies? There is quite a difference in the two concepts!

Where a known liability exists, which is measurable within reasonable limits, a life company should be obligated to make provision for it. This is why page 3 of the Annual Statement is filled with items. They cover nearly all of the mandatory liabilities applicable. There is no prohibition against including additional amounts if a company deems them to be appropriate.

Do federal income taxes on unrealized capital gains and deferred Phase III taxes meet the test of being known liabilities measurable within reasonable limits? Frankly, I do not believe that they do. I would be most reluctant to suggest that they be listed as separate items on page 3 or that they be required parts of the total liability for federal income taxes.

Does this mean that I deny the possible existence of such liabilities? Of course not. It only means that I believe they are not an integral part of the Annual Statement's primary emphasis on establishing *current* solvency. They would, however, assume much more importance if the Annual Statement were to be prepared by using generally accepted accounting principles throughout—where attention becomes focused upon earnings rather than upon current solvency.

Let us assume that the reason for this question is as a response to the objection raised by certified public accountants that no provision is made in the current summary of operations for potential taxes which should be charged against current operations but may not actually be paid out for some years yet to come. Clearly, if we were to establish a liability for deferred Phase III taxes, for example, we could process the change in the liability from one year to the next through the summary of operations. This would accomplish the purpose of making a charge to the current year's earnings.

How to determine the amounts of any such liabilities seems quite

elusive—particularly in the case of unrealized capital gains. There is no actual tax until the gains are realized, an event which may never happen.

Would not one approach be to assume that all net unrealized capital gains will be realized in the following year? At least this would have the virtues of simplicity and conservatism. The liability could be the amount of net unrealized capital gains multiplied by the tax rate applicable to any increment in taxable income, as determined from the company's preceding tax return. The change in liability from one year to the next could be included in the incurred federal income taxes on line 32B of the summary of operations. The most serious objection to this approach would seem to be that a heavy change in liability would be incurred in the year when it was first established. This might be alleviated by setting up the liability gradually, over, say, a period of five years.

Establishing a liability for deferred Phase III taxes would seem to require a projection of the policyholders' surplus account as well as a projection of three other items, the largest of which can trigger the transfer of amounts from the policyholders' surplus account to the shareholders' surplus account: (1) 15 per cent of life insurance reserves at the end of the then taxable year, (2) 25 per cent of the amount of life insurance reserves accumulated between the end of 1958 and the then current date, or (3) 50 per cent of the net amount of premiums received during the then current taxable year.

This projection would help us estimate the length of time it will be before there is a transfer from policyholders' surplus to shareholders' surplus. Let us further assume that at the end of that period of years all of today's policyholders' surplus will be transferred at the same time. By applying the tax rate to the amount of policyholders' surplus and an interest discount to the product, we could establish a present value of the deferred Phase III tax liability. It undoubtedly would not be perfectly accurate; but the change in liability from year to year would probably be quite representative.

MR. F. G. REYNOLDS: In principle, a liability (or an asset) should be held for unrealized capital gains (or losses). However, the determination of an accurate liability would be difficult if not, for practical purposes, impossible.

Most of the questions in this regard are being generated by a review of the large, unrealized capital gains that exist in many companies' stock portfolios. To establish this liability properly, however, a complete review of the bond and mortgage portfolios would also be necessary. While it

would be reasonably possible to obtain a figure for the bond portfolio, the problems associated with a revaluation of the mortgages are much more difficult. Each mortgage would have to be classified as to the degree of risk associated with it. Then, each year it would be necessary to determine a prime rate of each class of security, and, finally, to recompute the present value of each mortgage.

Because of the rise in bond and mortgage interest rates over the last twenty years and because of the relative importance of bonds, mortgages, and stocks in most companies' portfolios, it is entirely reasonable to expect that the result of all this work would be an asset and not a liability.

MR. FREDERICK S. TOWNSEND: With respect to federal income taxes on unrealized capital gains, I believe it is unnecessary to establish such a liability. Astute managements will offset realized capital gains with bond losses.

As for deferred Phase III taxes, I find many companies footnoting their balance sheets to indicate the amount of the policyholders' surplus account and then stating something like the following: "This amount has not been subjected to current income taxes but, under certain conditions which management considers to be remote, may become subject to income taxes in future years."

One well-known company, a writer of noncancellable disability income insurance, is paying Phase III taxes. The full liability for Phases I, II, and III is charged against earnings, but the annual report to stockholders does identify the portion of the taxes arising from Phase III.

IV, *B*. Where an 818(c) election has been made, revaluing preliminary term to net level reserves, should there be a liability for deferred federal income taxes?

MR. BEARDSLEY: In general I will take about the same position in answer to this question that I took with respect to question IV, *A*. I would hesitate to introduce a specific liability for this item in the Annual Statement Blank. However, one cannot deny that the 818(c) election creates a deferred-tax situation which cannot be ignored currently from the viewpoint of generally accepted accounting principles. Again, the main problem involved is what the incidence of tax over the years will be.

At the end of any year it will be known how much actual reserve and how much revalued reserve are in force. By assuming a persistency scale,

one can project the amounts of insurance and the corresponding reserves into the future, say, for twenty years. On a closed block of business such as this, it can be expected that the annual increase in revalued reserves will be smaller than the annual increase in the corresponding preliminary term reserves. This difference in annual increases represents how much smaller a tax deduction the company will receive each year. By summing the present values of these differences and multiplying the total by the applicable tax rate, one could obtain a figure representative of the deferred-tax liability.