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SYMPOSIUM ON ADJUSTED EARNINGS

INTRODUCTION AND OVERVIEW

LIFE INSURANCE COMPANIES AND THE ACCOUNTING PROFESSION

MR. J. THEODORE ARENBERG:* With all the current controversy about accounting principles and the accounting profession, it is not surprising to hear some insurance people ask why, since the accounting profession has not completely straightened out accounting in general, it should pick on the life insurance industry. After all, if the accountants have not attained perfection in other areas, why should the insurance industry be singled out for special treatment? The oil industry has its peculiarities involving alternative accounting and reporting practices. So does the shipping industry, and there are others. Why not eliminate these alternatives first? These are, of course, valid questions which deserve answers.

The questions posed, however, are largely attributable to a lack of understanding as to the degree to which the accounting and reporting practices of the industry have differed from those used by business enterprises in general. The accounting practices in the insurance industry have been in use for a longer period and have been more uniform than those of perhaps any other industry. Their long usage and uniformity stem from regulatory influence and regulatory concern with respect to serving the needs of only one, albeit important, segment of society, namely, the policyholders. This preoccupation with the policyholders has created a kind of tradition, or obsession, which has made it almost a sacrilege to suggest that the accounting and reporting practices followed may not adequately serve the needs of the owners, prospective owners, and possibly even management.

The fact is that these practices do not adequately serve the needs of all of the users of the industry's financial statements. It is just that simple. When some of your accounting is on a cash basis (and this is the case) and some of it is on an accrual basis overcharged with regulatory conservatism, the answers you get frequently are not meaningful and, in fact, can be downright misleading. Do not be deluded into believing that the peculiarities of regulatory accounting practices are just as sophisticated as the alternatives which exist in other areas of accounting and about which you

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read and hear much debate and criticism. The current debate and criticism involve questions which apply to financial reporting for all industries, including the insurance industry. There is no debate, however, about the simple principle of matching revenue with expenses incurred to produce that revenue; about using systematic and rational estimates where estimates are called for; about reporting all costs and expenses as charges in the operating statement; about reporting all assets in the balance sheet with appropriate valuation reserves provided, if necessary, out of charges to operations; or about recognizing that the tax benefit due to charges on the tax return which will be charged to a future period for accounting purposes requires deferral of the tax benefit. It will not be until you deal with these problems, and others, that you can enter the current accounting debate on an equal footing with other industries. Even then, you will find that there will be little progress if you point to the "other guy" as your excuse for not following sound accounting practices. This simply leads to all accounting principles sinking to the lowest common denominator and results in no improvement for the users of financial statements. The establishment of accounting principles is not a matter of a popularity contest. It is a matter of fairness in reporting.

It was as a result of concern with the question of fairness in reporting in 1932 that the term "accepted principles of accounting" came into general use in the reports of CPA's. In a letter from the president of the New York Stock Exchange to the presidents of listed companies, it was stated that auditors' reports should provide answers to the following questions:

1. Whether in the opinion of the auditors the form of the balance sheet and of the income, or profit-and-loss, account is such as fairly to present the financial position and the results of operation.
2. Whether the accounts are in their opinion fairly determined on the basis of a consistent application of the system of accounting regularly employed by the company.
3. Whether such system in their opinion conforms to accepted accounting practices.

As an outgrowth of this correspondence, there came into being the standard form of opinion which resulted from conferences in the early thirties between an Institute committee and a committee of the Controllers Institute of America, now known as the Financial Executives Institute. Certain revisions in the form of the standard short-form report were made in 1939 as a result of the McKesson and Robbins case. As a part of the revision, the word "generally" was inserted in front of the old phrase "accepted accounting principles," without any indication of the significance, if any, to be drawn from that change. Since then, however, it has come to be regarded as adding to the responsibility of CPA's for determining that accounting practices in use by a client really have substantial authority back of them. In 1934, as today, the possible guides in determining whether an accounting practice had substantial authoritative support consisted of the following:

1. The practices commonly found in business. Acceptance follows not from the mere fact that a practice exists but from the fact that experience of the business has demonstrated that the practice produces dependable results for the guidance of management and for the information of investors and others.
2. The requirements and views of stock exchanges as leaders in the financial community. Similarly, the views and opinions of commercial and investment bankers would be entitled to weight.
3. The dominant influence exercised by the regulatory commissions' uniform systems of accounts and accounting rulings on the accounting practices of the industries subject to their jurisdiction. The commissions sometimes depart from generally accepted accounting principles; in such cases, it may be necessary for the certified public accountant to make appropriate qualifications in his report.
4. The controlling authority of the regulations and accounting opinions of the Securities and Exchange Commission over reports filed with the commission. The commission and its chief accountants have demonstrated a high degree of objectivity, restraint, and expertness in dealing with accounting matters. The regulations and opinions issued to date are entitled to acceptance by their merit as well as on the basis of the statutory authority of the commission.
5. The authoritative support for accounting principles or practices constituted by affirmative opinions of practicing and academic certified public accountants. These may be found in oral or written opinions, expert testimony, textbooks, and articles.
6. Published opinions of the American Accounting Association and of the American Institute of Certified Public Accountants.

The AICPA regards the representative character and general acceptability of its opinions as of the highest importance, and to that end it has adopted the following procedures:

1. Before issuance, any opinion or recommendation is submitted in final form to all members of the Accounting Principles Board, either at a meeting or by mail.
2. No such opinion or recommendation is issued unless it has received the approval of two-thirds of the entire board.
3. Any member of the board dissenting from an opinion or recommendation issued under the preceding rule is entitled to have the fact of his dissent and his reasons therefor recorded in the document in which the opinion or recommendation is presented.

Before reaching its conclusions, the board is supposed to give careful consideration to prior opinions, to prevailing practices, and to the views of professional and other bodies concerned with accounting procedures.

Starting in 1939 and up through 1959, a total of fifty-one *Accounting Research Bulletins* were issued by the Committee on Accounting Procedures. (The first forty-two of these bulletins were restated in 1953 and reissued as *Bulletin No. 43.*) Since 1959, the APB, which superseded the Committee on Accounting Procedures, has issued a total of seventeen opinions, some of which modify previous bulletins or opinions. The authority of these bulletins and opinions rests upon their general acceptability. While it is recognized that general rules may be subject to exception, the burden of justifying departures from the opinions must be assumed by those who adopt other practices. To this end, in 1964, the council of the AICPA unanimously adopted recommendations requiring that departures from accounting principles accepted in board opinions be disclosed when the effect of such departures on financial statements is material. Therein lies the authority of *APB Opinions* as well as that of the *Accounting Research Bulletins* of the predecessor Committee on Accounting Procedures.

Quite naturally, the formal opinions of the APB and its predecessor committee carry the greatest weight with members of the AICPA in their determination of GAAP. The board made the following comment regarding the applicability and authority of its opinions:

> Underlying all Board opinions is the fact that the accounts of a company are primarily the responsibility of management. The responsibility of the auditor is to express his opinion concerning the financial statements and to state clearly such explanations, amplifications, disagreement, or disapproval as he deems appropriate. While opinions of the Board are addressed particularly to certified public accountants whose problem it is to decide what they may properly report, the Board recommends similar application of the procedures mentioned by those who prepare the accounts and financial statements.

It may be well at this point to distinguish between the role of the APB and the role of the AICPA Committee on Insurance Accounting and Auditing. The board has sole authority to make public statements regarding opinions on recommended accounting practices. There are about 116 committees which exist to give consideration to accounting problems in various areas. The AICPA Committee on Insurance Accounting and Auditing is one of these. In order to control and co-ordinate these activities, the board of directors of the AICPA adopted the following resolution:

WHEREAS, the Accounting Principles Board and the Committee on Auditing Procedure, herein referred to as "senior technical committee," have been delegated authority by the Council of the American Institute of Certified Public Accountants to make public statements in their respective areas of specialization in accounting; and

WHEREAS, many other committees, particularly those cooperating with government agencies and other bodies, are required to give consideration to accounting problems in their activities; and

WHEREAS, consistency in all public statements issued in the name of the Institute is obviously desirable.

Be it resolved:

(1) No committee shall make public statements on accounting matters not yet covered by recommendations or pronouncements of senior technical committees without prior review by the chairman of the senior technical committee authorized to make such decisions or by members of that senior technical committee whom the chairman may designate. The purpose of the review is to preclude public statements that may be inconsistent with those previously made or under consideration by senior technical committees.

(2) Subject to the limitation of paragraph (1), a committee may confer or correspond with any appropriate party about technical problems, existing standards, recommendations or pronouncements, of senior technical committees, and any other matters which the committee believes pertinent to the subject which it has under consideration.

The Committee on Insurance Accounting and Auditing has been assigned the following objectives:

1. To promote closer co-operation between governmental supervisory agencies, the insurance industry, and the accounting profession.
2. To promote the use of GAAP and reporting practices in the insurance industry by the preparation of industry audit guides.

When a guide is issued, it will bear the following type of notice to readers:

This audit guide is published for the guidance of members of the Institute in examining and reporting on financial statements of life insurance companies. It represents the considered opinion of the Committee on Insurance Accounting and Auditing and as such contains the best thought of the profession as to the best practices in this area of financial reporting. Members should be aware that they may be called upon to justify departures from the Committee's recommendations.

Now in 1967 when the AICPA insurance committee turned its attention from the property and liability industry to the life insurance industry, the general reaction went something like this: What is wrong with life insurance accounting and reporting? The present system of accounting and reporting was developed over the better part of this century. Why, then, this new concern with the propriety of life insurance accounting and reporting? Who are you "Johnny-come-latelies" who appear to be trying to impugn the integrity of the industry's long-established accounting and reporting practices, and why do you do so? Well, one might also ask who came up with the idea of increasing the reported earnings of a life insurance company by an amount equivalent to $20 for each $1,000 of insurance written, and, more significantly, why did he do so? These and other questions began to emerge when life insurance companies either chose, or were required, to have their financial statements accompanied by the opinion of an independent public accountant.

In 1945 there were only 473 legal reserve companies in operation, and about one-third of these were mutually owned. Since then, over 2,000 new companies have come into being, and many of these have begun to compete for the investor's dollar. The advent of the formation of new life companies, the attendant public offering of new life stocks, and the phenomenal growth in personal investing since World War II served to focus greater attention on an industry whose financial status and performance were hitherto regarded principally as the province of management and the regulators. These events and trends brought with them either the necessity or the desire to meet or achieve the standards of public reporting associated with business enterprises in general. As a natural result of these developments, the industry's exposure to the public accounting profession increased significantly. My purpose here, therefore, is to try to convey a better understanding of the considerations involved in financial reporting to the public when such reporting is accompanied by the opinions of independent public accountants. An understanding of these considerations is an essential and desirable prerequisite to a useful dialogue between the accounting profession and the life insurance industry.

It is, of course, equally essential that the members of the accounting profession have an understanding of the considerations involved in the preparation of financial statements based on accounting practices prescribed or permitted by the regulatory authorities. Because of the substantial public interest involved, insurance companies have been subjected to state regulation for many years. The various states have enacted numerous laws designed to protect the policyholders. Since an important underlying objective of these laws has been to maintain and protect the solvency of the companies, a conservative approach has been taken in prescribing the accounting to be followed. Balance sheets prepared under this approach reflect essentially the net assets that could be realized in liquidation (although with respect to bonds and mortgages the going-concern concept appears to prevail). This regulatory practice has been concerned with the best interests of the policyholders, because it conservatively reflects the ability of the companies to pay claims. Although there are some differences among the various state accounting regulations, there is, of course, a substantial degree of uniformity due to the influence and the recommendations of the National Association of Insurance Commissioners (NAIC). While the laws of many states prohibit the publication of financial statements on any basis other than that prescribed, it is believed that such prohibition does not generally extend to supplementary information.

It is our desire to facilitate an understanding by all parties of the extent, if any, to which prescribed accounting practices and generally accepted accounting principles conflict and to provide the basis for a mutually acceptable solution in dealing with the objectives of both approaches. First, a word about the AICPA Committee on Insurance Accounting and Auditing. The committee was created in 1957. During its existence, it has been composed of CPA's in public practice as well as those in industry. Most of the members of past committees as well as those of the present committee have represented public accounting firms actively engaged in the examination of financial statements of most of the life insurance companies utilizing the services of outside accountants. The primary responsibility of the committee has been to advise the public accounting profession as to the special problems in insurance accounting and auditing and to encourage CPA's to study such problems. In this connection, the committee became engaged in the preparation of an audit guide for life insurance companies. In essence, the purpose of the guide will be to assist the practitioner in following generally accepted auditing standards.

The historical background of the development of generally accepted auditing standards can be traced back to 1917. The evolution of these standards culminated in the adoption of a resolution by the membership of the AICPA in 1948. A discussion of this history may be found in the statement on auditing procedures published in 1963 by the AICPA Committee on Auditing Procedures. The resolution included a brief summary of the meaning of generally accepted auditing standards. These standards are divided into three groups, namely, general standards, standards of fieldwork, and standards of reporting. Of particular significance is the first standard of reporting, which states, "The report shall state whether the financial statements are presented in accordance with generally accepted principles of accounting." The independent auditor has a responsibility to his profession, the responsibility to comply with the standards accepted by his fellow practitioners. In recognition of the importance of such compliance, the Institute has adopted as part of its Code of Professional Ethics rules which support the standards and provide a basis for enforcement of them. Rule 202(e) of Article II of the AICPA's Code of Professional Ethics provides in part: "In expressing an opinion on representation in financial statements which he has examined, a member or associate may be held guilty of an act discreditable to the profession if he fails to direct attention to any material departure from generally accepted accounting principles."

The statement on "Auditing Standards and Procedures" contains a section dealing with regulated companies. This section reads in part as follows:

> The basic postulates and broad principles of accounting comprehended in the term "generally accepted accounting principles" which pertain to business enterprises in general apply also to companies whose accounting practices are prescribed by governmental regulatory authorities or commissions (such companies include public utilities, common carriers, insurance companies, financial institutions, and the like); accordingly, the first reporting standard is equally applicable to opinions on financial statements of such regulated companies presented for purposes other than filings with their respective supervisory agencies, and material variances from generally accepted accounting principles, and their effects should be dealt with in the independent auditors' report in the same manner followed for companies which are not regulated.
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> In instances where the financial statements of regulated companies purport to be primarily presentations in accordance with prescribed accounting regulations, the independent auditor may also be asked to report upon their fair presentation in conformity with such prescribed accounting. There is no objection to the independent auditors' report containing such an opinion provided that the first standard of reporting is also observed by the issuance of a qualified or adverse opinion as required by the circumstances.

It is against this background that the accounting profession has approached the problem of clarifying those differences, real or fancied, which appear to exist between prescribed or permitted accounting practices and those principles of accounting which pertain to business enterprises in general. Some have suggested that the accountants have intentionally set about impugning the integrity of the industry's traditional accounting and reporting practices. This, of course, is not the accountants' purpose, and it has been our objective to find a means of satisfying the most sensitive that no imputation of impropriety of insurance accounting principles is inferred or intended.

The question is whether the entire insurance accounting structure, which has its basic origin in the exclusive need to serve the regulatory process, can also be made to serve the basic interests of the owners, prospective owners, and creditors of life insurance enterprises as well as the public generally.

Life insurance financial reporting has, rightly or wrongly, been surrounded by an aura of mystery. This mystery has led to considerable speculation, for example, about the so-called "true" operating results of life insurance companies. While the responsibility for such speculation has largely been from outside the industry, the accountant believes that it is in the best interests of the industry and the public to examine the problem with a view toward eliminating many of the rules of thumb and misconceptions which have seriously detracted from the basic reliability of life insurance financial statements in general.

It is apparent that the responsibility for seeing that GAAP are used in financial reporting is the accountant's, if not the company's. It remains, then, to identify those prescribed or permitted accounting practices which are at variance with GAAP. To the extent that there are such deviations, an appropriate procedure for measuring their effect on financial position and results of operations must be determined, and, unless the financial statements can be appropriately adjusted by the company, the accountant must seek acceptable methods for disclosing the effect and expressing his opinion on the company's financial statements within the context of the standards adopted by his profession.

The profit or loss realized after any given block of business has run its course cannot be altered by any accounting or actuarial concepts. It will be the same whether determined under the traditional techniques developed by actuaries or determined under principles advocated by accountants. In developing asset shares, an actuary must make assumptions relating to expected interest, mortality, persistency, and expenses. The resulting calculation represents a reasonably sophisticated estimate of the anticipated economic result of selling a particular type of product. The actuary is not as critically concerned with the recognition of the annual incidence of the economic result as he is with the ultimate result. The accountant, on the other hand, is concerned about the recognition of the annual result because his responsibility must be fulfilled in terms of his opinion as to the fairness with which the annual result is presented. Thus the principal distinction between reporting on the basis of practices developed by actuaries and reporting on the basis of principles advocated by accountants is one of incidence. The accounting profession seeks only to reconcile the two approaches in a rational and systematic manner. It cannot, and does not, seek to change the ultimate result.

BACKGROUND OF THE PROBLEM OF REPORTING EARNINGS

MR. DALE R. GUSTAFSON: While nothing in the material describing the session this afternoon specifically identifies it as being related to life insurance, it is my assumption that we are dealing primarily, if not exclusively, with life insurance, and it is within that frame of reference that I have organized my thoughts on background.

I find it impossible to escape the powerful personality of Elizur Wright in discussing life insurance accounting and financial principles. Mr. Wright spent some time studying life insurance and the then bare beginnings of actuarial science in England in the early 1850's. He returned to these shores with the bare outlines of an idea that the financial stability and safety of the life insurance enterprise could be more surely controlled with a relatively simple but quite different reserve valuation concept.

It is from the thinking of this man, which was swiftly implemented in regulation and law in Massachusetts during the 1860's, that the basic concepts of statutory valuation and nonforfeiture bases and, in effect, solvency accounting developed. In very brief and perhaps oversimplified terms, this concept can be described as taking full cognizance of the long-term nature of the life insurance contract and setting up, by means of very simple minimum statutory reserve requirements, a financial reporting system that carefully and surely safeguards the policyholders' interests and the long-term financial stability of the enterprise. No lengthy arguments need be given in support of this thesis. The record of life insurance in the United States speaks for itself.

It has always been implicit in life insurance financial reporting that it is the balance sheet that counts. It has been generally axiomatic in actuarial and management thinking that the assignment of earnings to specific accounting periods is relatively meaningless and at best, arbitrary, and that it is present values and long-term considerations that are important in life insurance accounting.

If what I have just said is true, and over a century of time has demonstrated the excellence of balance-sheet accounting for life insurance, then what has changed?

I would submit that nothing of what I have said above has changed but that a number of new ingredients have been added that have produced new needs. I will list some of these new developments, nearly all of which are very recent in origin. None of them goes back to any significant extent prior to World War II.

1. Prior to World War II life stock insurance companies were almost all closely held, with very little stock being traded. During the late 1940's and early

1950's this situation began to change very dramatically, with the stock of a great many companies becoming widely held and publicly traded.

2. During this period of time there was (understandably) a growing dissatisfaction with the many widely varying rough rules of thumb being used to estimate the earnings or net worth of life insurance companies.
3. Much more recently, with the rapidly growing involvement of life insurance companies with diversification, it has become increasingly a problem to incorporate the earnings of life insurance subsidiaries with the earnings of other types of enterprises in consolidated statements.
4. The American Institute of Certified Public Accountants has been engaged for many years in developing audit guides for different industries in order to bring about uniform accounting among industries. As will be outlined in a little more detail later, our turn has come.
5. A number of life insurance company stocks are actively traded on the New York Stock Exchange. One of the Exchange's requirements is that all such companies must file with it financial reports prepared in accordance with generally accepted accounting principles.
6. Within the last five years a large number of companies have been required to make certain filings with the Securities and Exchange Commission for various reasons, including, most notably, public stock offerings and the establishment of certain types of equity subsidiaries. At the present time over 180 life insurance companies are required to file financial statements with the SEC in connection with a particular form.

It might seem at first glance that all six of the paragraphs immediately above deal entirely with stock life insurance companies. That is not the case, however, because a number of mutual companies with subsidiaries or certain types of separate accounts dealing with variable annuities or other types of equities are included in the over 180 companies just mentioned.

In a chronological sense it can perhaps be stated that the first event directly antecedent to our present situation was the assignment by the AICPA of the project of developing an audit guide for property and casualty insurance companies to its Committee on Insurance Accounting and Auditing sometime during the mid-1950's. It is my understanding that during its early consideration this committee at first contemplated also developing an audit guide for life insurance companies but then decided to do the two jobs sequentially rather than simultaneously. The AICPA issued the audit guide for property and casualty insurance companies in late 1966 and immediately assigned the development of an audit guide for life insurance companies to the same committee.

In early 1967 the American Life Convention and the Life Insurance Association of America established the Joint Committee on Financial

Reporting Principles for the express purpose of engaging in continuing discussions with the AICPA Committee on Insurance Accounting and Auditing in its development of an audit guide for life insurance companies.

These two committees have exchanged a great volume of correspondence and have met jointly several times each year since then. Throughout these years it has been apparent that there were a large number of very difficult problems to be resolved, resulting from the differing backgrounds and philosophies involved.

In early 1970 the articulation of the natural reserve technique brought almost immediate recognition from most of the people involved that it might well be an appropriate basis of defining the application of GAAP to nonparticipating life insurance issued by stock companies.

It was immediately apparent that what GAAP might imply for mutual life insurance companies was not a matter of direct and simple extension of the natural reserve technique, and in spite of much effort on the part of all concerned, there is today not a common understanding of how, if at all, the audit guide should be applied to mutual life insurance companies.

There are several other very important aspects of accounting that are far from satisfactory resolution, but I am assuming that these areas will be covered in more detail either by Messrs. Corbett and Lewis or in general discussion.

Meanwhile, to go back a few years chronologically, the Association of Insurance and Financial Analysts appointed a committee to work on the development of a uniform method of adjusting earnings for life insurance companies. Most of you are no doubt familiar with their method, which was the result of an enormous amount of work and has been used by a number of companies for one or two years. This method was severely handicapped in that the financial analysts realized that practical considerations limited them to the use only of information available in published statements. It is also my opinion that the method contains substantive theoretical actuarial errors, but that is another whole subject. Suffice it to say that it was perhaps as good a method as could have been developed within the severe constraints imposed.

It is obvious that the various insurance departments and the National Association of Insurance Commissioners have an inherent interest in this subject. In fact, the NAIC has an active interest and appointed a special subcommittee to deal with this area some time ago. An open meeting was held by this subcommittee in San Francisco, at which a number of formal statements were made by members of the NAIC as well as by representatives of individual companies and associations.

I have not mentioned in my chronological summary the activities of such bodies as the committee formed by the Conference of Actuaries in Public Practice, which was quite active in dealing with the financial analysts, and also the Joint Actuarial Committee of the several actuarial bodies, which has been extremely active since it was formed last fall and has produced a response to the AICPA exposure draft audit guide which can only be described as magnificent. I also assume that Mr. Corbett will either directly or indirectly say something about this.

Now, if I may, I want to turn for a few moments to matters of principle. If in the next few paragraphs I seem to be implying some criticism of the accountants, I want to be clear that I am not intending to single them out for special treatment. Actuaries, lawyers, and other professionals are often guilty of the same thing. It is just that accountants are easiest to talk about here today because it is GAAP that seem to be the crux of the matter. While there may already be lurking somewhere in the background genuine principles, they certainly cannot be articulated very readily from the statements that have been made recently about GAAP. It seems to me that it is more accurate to describe what has been going on as an attempt to cloak preferred practices with a mantle of respectability that they do not deserve by invoking the power of "principle."

It is only fair to state that, while I believe that life insurance accounting as it has developed is based upon some very sound underlying principles originally laid down by Elizur Wright, we have done a pretty good job of compromising principles for preferred practices as the years have passed.

While neither accountants nor actuaries or other insurance experts may find it easy to try to discuss principles rather than preferred practices, I submit that the stakes in this current controversy are so high that there is a grave danger of serious damage to the life insurance enterprise unless some significant attention is given to the real principles involved.

We seem to have so many principles floating around that each individual can readily find a set to support his own personal preferences. We have gradually reduced most of the various sets to acronyms. First, there is GAAP, for generally accepted accounting principles. Then there is SAP, or statutory accounting principles, also known as PAP, for prescribed accounting principles. Then, since the first of the year, we have been dealing with AGPAP, for audit guide prescribed accounting principles. Finally, someone suggested that, if the accountants and insurance people meeting jointly could come to agreement, the results could be labeled Committee Recommended Accounting Principles.

I made reference in my earlier remarks to the fact that traditional life insurance accounting places heavy emphasis on the balance sheet and that the assignment of earnings to consecutive accounting periods is an exercise in guesswork at best. It is perhaps not inaccurate to state that GAAP, as they have developed in practice in recent years, place very heavy emphasis on the income statement, with little importance attached to the balance sheet except as a means of reconciling consecutive income statements.

It is probably true that the natural reserve technique can do a relatively unbiased job of estimating the pattern of emerging earnings for a block of life insurance for consecutive accounting periods. However, whatever the façade of technical detail and theoretical proficiency, the very heavy element of future probabilities inherent in life insurance prevents one from lending much credence to this stream of earnings until the actual experience factors for a block of business have been largely determined.

I would suggest that one of the elements in the heavy emphasis on the earnings statement has resulted from the almost universal practice in the financial community of estimating the value of an enterprise by multiplying the earnings figure by a selected price earnings ratio. As a means of estimating the real value of an enterprise, this relatively crude technique must have developed largely because of the practitioners' total inability to apply probability and discount to the emerging experience of an enterprise. Uniquely, these techniques are at the heart of actuarial science, with the result that a properly constituted gross premium valuation calculation can give a pretty fair estimate of the real current value of an insurance enterprise. These considerations lead me to suggest (somewhat facetiously) that the most accurate way to determine adjusted earnings for a life insurance company would be to divide the gross premium valuation figure by the analysts' favorite price earnings ratio.

I would conclude only by repeating that I think it is time we started considering principles. So far, very little has actually been said about principles, although the word has been invoked almost continuously.

USES AND OBJECTIVES OF FINANCIAL STATEMENTS

MR. ROBERT L. POSNAK:* Accountants have never really defined the objectives of financial statements. To be sure, there have been attempts, primarily by concerned academicians, to establish a broad theoretical foundation for the preparation of financial statements. In October, 1970, the Accounting Principles Board of the American Institute of Certified Public Accountants issued a "statement" (which does not have the authority of an *APB Opinion*) which, among other things, attempted to

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articulate the objectives of financial statements. It is fair to say that these efforts, while shedding some light on the problem, have not been successful.

For one thing, it is difficult (and may be impossible) to obtain a consensus on the objectives of financial statements; financial statements are, after all, in the nature of an art form, and there are no immutable laws of nature applicable in the circumstances. Furthermore, existing accounting principles have grown somewhat like "Topsy" and are not particularly responsive to an ex post facto determination of objectives. Once established, accounting principles tend to perpetuate themselves; they do not yield readily to a series of propositions that may call their validity into question.

It should be mentioned at this point that the AICPA has appointed a high-powered study group to formulate a statement of objectives of financial statements. The committee's work will take about two years. Debate over the committee's conclusions will require a considerable period of time. Assuming that the committee's conclusions meet with acceptance, any significant modifications of accounting principles required to fulfill the stated objectives will probably take years. Meantime, the work of preparing financial statements must go on.

All this seems strange and somewhat confusing. Accountants have not defined the objectives of financial statements. But generally accepted accounting principles should rest on a firm foundation of fundamental objectives. They do not, which explains why they are difficult to establish and even more difficult to apply. This rather fluid environment has been accepted, sometimes quite grudgingly, by commercial and industrial enterprises because it constitutes their financial reporting tradition.

Quite understandably, the life insurance industry does not accept a "fluid environment" so readily because it constitutes no part of the industry's financial reporting tradition. The industry's financial reporting tradition derives from a set of financial statements whose objectives are quite obvious. Now the industry is being asked to prepare, in addition and at considerable cost, financial statements whose objectives are not so obvious. It is only natural for the industry to ask what such financial statements are for.

While it is true that the uses and objectives of financial statements have not been determined, the fact is that accountants do have some idea of what financial statements are for. This "idea" is in no small measure intuitive and often operates at the subconscious level. In a word, accounting is on the order of a cultural tradition. Patterns of meaning and significance are assimilated by accountants in the course of their training and experience and become, almost without their awareness, canons of their profession. Generally accepted accounting principles (basically an undefined term) constitute a kind of common law which draws its substance from this elusive "cultural tradition."

It is tempting to conclude that this is a pretty skimpy foundation for the preparation of financial statements, which play an enormously important role in an economic society. A moment's reflection, however, will suggest that substantially all professional activity (including the work of the actuary) is based upon a network of traditions, assumptions, and conventions which defy concrete expression. None of the professions is particularly well understood by the lay public.

Although the uses and objectives of financial statements cannot be neatly listed, it is certainly feasible at least to suggest a few of the factors and conditions which accountants take into consideration (explicitly or intuitively) when they prepare financial statements or render an opinion on them. First, accountants know, with some certainty, who uses financial statements. Second, accountants have some notion as to the needs of such users; however, it should be pointed out that the needs of users are really something of a mystery, even to the users themselves. Third, having some knowledge of users and their needs, accountants attempt as best they can to prepare financial statements which respond to those needs.

It might be helpful to list the principal users of financial statements and briefly discuss their apparent needs, which will perhaps give some indication of how they use financial statements. The means by which accountants attempt to serve the needs of users can then be outlined. Finally, the question of making life insurance company financial statements conform to the indicated pattern of financial reporting can be discussed.

All the discussion which follows—and for that matter the preceding discussion—has no official status. It merely represents one accountant's view of the dynamics of current financial reporting.

First, equity owners are primary users of financial statements. A distinction must be made between owner-managers (who must be presumed to have direct access to the financial information they need) and third-party equity investors (who do not have direct access to the information they need and who therefore must rely on the representations of others). This latter group of owners is discussed here.

Third-party equity owners have two conflicting needs. On the one hand, they need a report on the financial stewardship of management, because management has a fiduciary responsibility to the owners of the enterprise. Reports of financial stewardship are essentially historical and tend to emphasize conservative measurements of assets and liabilities and the changes therein during an accounting period.

On the other hand, owners also need financial information necessary for rational investment decisions. Such decisions are oriented to the future and theoretically are based in part upon realistic measurements of earning power.

Certain secondary users of financial statements mediate in behalf of owners. Such secondary users include security analysts and certain regulatory agencies such as the Securities and Exchange Commission and (to the extent that they have important responsibilities in the area of shareholder protection) state insurance departments. For the most part, secondary users are interested in the investment-decision aspects of financial statements.

Second, creditors are primary users of financial statements. Creditors include suppliers, commercial lending institutions, investors in debt securities, and the like. Secondary users (such as credit investigators and, with respect to debt investors, security analysts and the SEC) also mediate in behalf of creditors.

Creditors typically use financial statements to measure solvency, liquidity, asset quality, and cash flow and earnings available to service debt. These uses frequently conflict. Solvency, liquidity, and earnings are generally measured conservatively and as objectively as possible. Asset quality should ideally be measured in terms of current values, which inevitably introduces a degree of subjectivity into the measurements.

Third, customers (of whom policyholders are a variant) are important users of financial statements, primarily through the agency of regulatory bodies such as the NAIC, the FPC, the CAB, and so on. The needs of such regulators are definable in terms of solvency safeguards or rate-setting; in the latter case, rate regulation is often intimately associated with regulation of return on investment. For solvency measurements, conservatism is a primary consideration; for regulation of return on investment, uniformity and some degree of realism in valuation and income determination are necessary.

Fourth, management (including owner-managers) is, of course, a primary user of financial statements. Management needs financial information for planning and controlling current operations, for special decisions, and so on. Management needs the truth regardless of what the external financial statements report, and in many cases the "truth" involves a degree of subjectivity which is incompatible with the need to protect external users of financial statements.

Employees constitute a fifth important class of users of financial statements, primarily through the agency of labor unions. Financial statements are used in determining a fair division of profits between labor and capital. Earnings measurements are, of course, of prime importance. Measurements of financial position are also important, however, in determining the ability of a company to meet union demands. In union negotiations it goes without saying that management prefers its accounting to be on the conservative side, while labor prefers a more liberal set of financial statements.

Sixth, the general public uses financial statements. It is represented at various times by taxing authorities, economists, consumer affairs advocates, and others. Taxing authorities define accounting principles in their own way. Economists use financial statements in compiling national income accounts, performing macroeconomic analysis, and otherwise coming to conclusions which have vast implications for the economy. Economists would prefer to measure income in terms of a change in wealth. Measurements of economic "wealth" have very little relationship to existing accounting principles.

It is readily apparent, even from the foregoing highly simplified listing of users and their needs, that conflicts abound: history versus the future, income statement versus balance sheet, subjectivity versus objectivity, conservatism versus "reality," microeconomics versus macroeconomics, one vested interest versus another, and so on. The possible combinations of conflicts are staggering to contemplate.

The plain fact is that one financial statement will never serve the needs of all users. But one statement must, as a practical matter, be used, and one statement—referred to by accountants as a "general-purpose financial statement"—has evolved over the years. That statement is designed to serve the needs of owners and creditors primarily; it is assumed that the needs of other users will be served, if not perfectly, at least adequately. In short, owners and creditors are deemed to constitute the most important classes of users of financial statements, and general-purpose financial statements are oriented to the objective of serving their needs. Generally accepted accounting principles are therefore oriented to the needs of owners and creditors. Inevitable conflicts in use are resolved according to the accountant's best judgment. Accounting principles are typically flexible enough to accommodate the resolution of such conflicts.

How do life insurance companies fit this pattern? The needs of policyholders, creditors, and employees seem to be adequately served by the Convention Statement. Management has the power to draw up financial statements for its own use in whatever form it sees fit. With respect to taxation and the life insurance industry's roles as financial intermediary and risk carrier, the general public's interest is adequately served by the Convention Statement.

The conclusion is inescapable that the audience for general-purpose financial statements of life insurance companies is much more limited than is the case with respect to commercial and industrial enterprise. Thus the traditional assumption that financial statements prepared primarily for the use of owners and creditors will also serve the needs of other users is not entirely valid simply because the needs of other users are adequately served by the Convention Statement.

This is a subtle point but an important one. In the case of a life insurance company, a general-purpose statement becomes something less than a general-purpose statement, and the Convention Statement becomes something more than a special-purpose statement. Generally accepted accounting principles cannot have the clout they normally have. On the other hand, it is possible to be a little more specific in defining the objectives of general-purpose financial statements of life insurance companies, simply because there are fewer users to consider.

In the case of stock companies, the principal users of general-purpose financial statements would be stockholders, management, and the general public. The needs of stockholders of life insurance companies are equivalent to the needs of stockholders of commercial and industrial corporations. The needs of management and the general public are limited. As suggested earlier, management has the power to prepare such internal reports as it may require; hence management would use general-purpose financial statements primarily to measure company performance in relation to the performance of other companies—assuming, of course, that the companies used for comparison purposes are reporting on substantially the same basis. It was also suggested earlier that certain interests of the general public are well served by the Convention Statement. But the general public also has a legitimate interest in operating performance because life insurance companies are in the nature of public institutions. Operating performance might be measured better by general-purpose statements than by the Convention Statement.

While the balance sheet should never be slighted, the common denominator of the various users of general-purpose financial statements of stock life insurance companies is a need for a measure of the results of operations—the income and surplus statements. Fair presentation of the results of operations is probably the basic objective of general-purpose financial statements issued by stock life insurance companies. This does not mean that the general-purpose balance sheet can be ignored in favor of the Convention Statement balance sheet, because the general-purpose balance sheet would have important uses of its own. It does mean, however, that the emphasis in life insurance accounting shifts from balance-sheet valuations to allocations of revenues, costs, and expenses.

In the case of mutual companies, management and the general public have a need for general-purpose financial statements for the reasons discussed above. Some have argued that participating policyholders, as legal owners, also need general-purpose financial statements. But policyholders are not owners in the economic sense. Full development of this point is beyond the scope of this discussion; suffice it to say here that a mutual company, unlike a stock company, does not have a group of owners with traditional residual interests. Thus the objective of general-purpose financial statements issued by a mutual company should be to report the progress of the entity as an entity, not as a repository of owners' interests. Among other things, this suggests that all obligations to policyholders (including contingency funds, undistributed dividends, and other funds which are currently withheld for reasons of safety but which will ultimately be distributed to existing policyholders) should be recorded as liabilities. The resulting earnings and surplus are *entity* earnings and surplus; they do not constitute a measure of the residual interests of owners. No one can lay claim to them, directly or indirectly.

Whether this view will find favor remains to be seen. It does appear that, while GAAP are applicable to general-purpose financial statements issued by mutual life insurance companies, those principles should be applied in a manner which recognizes the unique nature of the mutual form of organization and the needs of a unique group of users.

It will be amply evident by now that the uses and objectives of financial statements cannot be stated with clarity. In the final analysis, the use to which a financial statement is put is a matter for the user to decide. All the accountant can do is render a fair presentation of financial position and results of operations. Indeed, "fairness" is perhaps the fundamental objective of general-purpose financial statements. Different users have different perceptions of fairness. Of necessity, then, the fairness of a set of general-purpose financial statements is ultimately a matter for the accountant's professional judgment.

OVERVIEW OF THE AUDIT GUIDE

MR. GARY E. CORBETT: I am particularly pleased by the large attendance at this meeting. It has been a little lonely at times in the past. A few years ago it was difficult to find another actuary to discuss this subject with. It is only with the active participation of many members of our profession that we are going to come up with appropriate answers in this area. Whatever answers do emerge this year or next are not going to be the final answers. There is going to be an evolving process, and I would like to encourage as many of you as possible to participate in this process.

My assigned subject is an overview of the audit guide. I assume that most of you are familiar with the audit guide, at least in general terms. I shall rather briefly give this overview and then go into more detail in two areas which will probably not be discussed elsewhere on the program.

What is the purpose of the audit guide? The Arenberg committee has stated the purpose in the preface to the guide:

> This Guide has been prepared to assist the independent auditor in serving his clients in the life insurance industry by describing those aspects of a life insurance business with which he should be familiar. [It is written for auditing accountants and not for the life insurance industry or for actuaries.]
>
> The first six chapters of the guide provide background information regarding the nature of the business and how it is conducted, the character and extent of regulation, and its effect on accounting and reporting practices. [These chapters are intended to provide only background. They do not delve into new or proposed principles.]
>
> Chapter VII deals with those accounting and reporting practices which are peculiar to the life insurance industry. Some of these practices are considered by the Committee to be a variance from accounting principles which are generally accepted for other industries. The Committee has attempted to deal with those practices and related auditing procedures.
>
> [The next paragraph, I think, is extremely important.] We expect that the Guide will be revised or supplemented from time to time as the need for refinement evolves in the application of the adjustments contemplated in Chapter VII or as the need for such adjustments is eliminated through changes in accounting and reporting practices prescribed or permitted by regulatory authorities. [None of us—not even the arrogant accountants to whom we heard a few speakers refer—have the temerity to suggest that in a two-year period anybody can possibly write out the accounting principles that will be proper for all time for the life insurance industry. All we can do—all anybody can do—is to make a start.]
>
> Chapter VIII discusses the types of auditors' reports considered appropriate under a variety of circumstances.

The first six chapters are of a general nature. It is probably not worthwhile to spend much time discussing them now. The Joint Actuarial Committee did not even submit a response to these sections. We did send in some comments that were forwarded to the Arenberg committee through the Farley committee. The role of the actuary is touched upon in some of these early chapters, but this subject is a specific topic for tomorrow's general session.

The seventh chapter is the heart of the guide, where the technical discussion is centered. As stated in the guide: "The purpose of this chapter is to discuss the differences which may exist between regulatory and generally accepted accounting principles and to set forth appropriate financial reporting in conformity with generally accepted accounting principles for stockholders, policyholders, and the public in reports prepared for other than insurance regulatory or taxing authorities."

In the accountants' opinion there are ten major differences. Two of them I will not discuss because they are going to be discussed by others. Recognition of revenue and costs is going to be covered by Jim Lewis later today. Deferred income tax, another extremely important area, is the subject of a panel tomorrow. There are five differences which I will only mention, since there is really not too much that can be said about them. One concerns special reinsurance agreements. The intent of the guide is to reflect the true effect of that reinsurance agreement in the statement. But there are so many different types of reinsurance agreements that it is probably impossible to detail in the guide exactly how each type should be treated. A second difference concerns the mandatory securities valuation reserve. The guide simply states that it is not a valuation reserve but should be regarded as an appropriation of surplus. Third, for nonadmitted assets, generally accepted accounting principles applicable to all industries should be followed. This may result in a nonadmitted asset ending up as an asset, or it may not. Fourth, the guide generally requires the use of the so-called equity method of accounting for investments in subsidiaries. The matter of reporting on consolidated financial statements is the last of these "minor" areas of differences. Apparently appropriate reporting depends on the relative size of the companies being consolidated, but the principles of *Accounting Research Bulletin No. 51* and *Accounting Principles Board Opinion No. 10* apply.

I have accounted for seven of the differences. The eighth has to do with participating policies. However, mutual companies are specifically not covered in the December exposure draft. There is a general feeling among actuaries that the natural reserve most-realistic-assumption approach is not appropriate for mutual companies. The Joint Actuarial Committee has suggested two possible approaches to the mutual company problem. One is a so-called co-operative enterprise approach which results in zero earnings in all situations. The second is called the entity surplus approach, which would classify as earnings any increase in general contingency funds. I do not propose to discuss the mutual company question further because it is not part of the present audit guide. Participating policies of stock companies are mentioned in the guide. We feel, however, that any final decision here must await a decision on the mutual company question because there should be some consistency between a stock participating operation and a true mutual company operation. We have tentatively concluded that the audit guide proposal to treat dividends as benefits is probably appropriate for stock companies selling a relatively small proportion of participating business.

This covers eight of the ten differences. I would be complying with my assignment merely to mention the other two and sit down. I would like, however, to spend some time discussing these other two. They are, I believe, very important and are not to be discussed elsewhere on the program. The first is the composition of equity accounts, a subject that I have expanded to encompass balance-sheet presentation, of which equity accounts are a part. The second is the recognition of realized and unrealized gains or losses on investments.

Let us turn to the first—statement presentation and relation of general-purpose statements to statutory statements. What does the audit guide propose? The increase in the deferred expense asset would affect the income statement, probably by reducing the actual expenses. Increase in reserves would be the increase in the natural benefit reserve rather than the statutory reserve increase. With a few other adjustments, the result would be net income that would be in accord with GAAP.

On the balance sheet deferred acquisition expenses would be shown as an asset. The liability for policyholders' reserves would be the natural benefit reserve. (The exposure draft as written at present states that these two can be combined, but my understanding is that the Arenberg committee has now decided that the expense portion must be shown as an asset and the benefit portion as a liability.) With a few other adjustments, surplus would then be in accord with GAAP. The difference between GAAP and statutory surplus would be identified and shown either in the equity accounts section of the balance sheet or as a footnote.

Statutory statements would remain about as they are today. Of course, it is not the accountants but the regulatory authorities who determine the content of the statutory statements. The Joint Actuarial Committee discussed extensively the differences between the two sets of statements. Basically, we do not believe that the continued existence of dual sets of GAAP and statutory statements is in the interest of the industry, of the stockholders, or of the public. We think that the existence of two sets of statements will be confusing and misleading. Our resolution of this situation is based on two assumptions: first, the statutory income statement is meaningless; second, the GAAP balance sheet could be misleading, in that it identifies as surplus those funds that must be returned for the protection of policyholders. Therefore, the Joint Actuarial Committee has recommended the following: basically a GAAP income statement and a statutory balance sheet.

The income statement would be the same as that proposed by the accountants, all the way down to the "Net Income" line. The line labeled "Net Income" would be identical with that proposed in the audit guide, but two lines would be added. The first would be a deduction from "Net Income" of the difference between statutory and net benefit reserve increases. The final line would be labeled "Increase in Surplus." This increase is not identical with statutory gain, primarily because the increase in the deferred expense asset has not been reversed out.

The asset side of the balance sheet would be identical with that in the proposed GAAP balance sheet, with deferred expenses to be shown as an asset, but the "liability for policyholders' reserves" would be the statutory reserves. (We actually should be considering not statutory reserves but reserves that have a very high probability of being sufficient to enable us to pay promised benefits. Many of us are finding that for term plans natural benefit reserves are considerably higher than statutory reserves. This result is primarily the effect of a select and ultimate mortality assumption.) The "liability for policyholders' reserves" could be broken down, showing on one line the natural benefit reserve and on the second line the difference between the statutory and the natural benefit reserve. The important difference, however, is that the entire statutory (or other conservative) reserve would be shown in the liability section of the balance sheet and not split between the liability and surplus section. Total surplus would be GAAP surplus reduced by the difference between the statutory and the natural benefit reserve. Any differences between statutory surplus and the surplus derived on this statement would be shown as restricted. One example is the surplus resulting from capitalizing acquisition expenses, which is not distributable to stockholders.

If this approach were adopted, the reserves used for the purpose of solvency tests and for the protection of policyholders (balance-sheet reserves) would be divorced from those used to derive earnings (revenue reserves). Thus we believe that it would not be necessary to anticipate losses in the revenue reserves but only in the balance-sheet reserves. Why do we take this, perhaps heretical, position? Basically, it is because we believe that losses resulting from experience worse than assumed are properly losses of the year of occurrence. As an example, consider interest assumptions. If 5 per cent rates are assumed, and interest rates drop to 3 per cent—and even if the outlook is for 3 per cent for some time—that gap, that loss of 2 per cent in interest each year, is properly a loss of each year. Another factor in our decision was the cyclical nature of interest rates; we know that they will decline, but we also know that they will recover. Once losses have been anticipated—for instance, by revaluing revenue reserves down to 3 per cent in the example I used—then, if interest rates return to 5 per cent, profits are going to be reported in those later years that we do not think are justified. The original assumed rate was only 5 per cent. Thus a break-even situation would exist.

Permitting a company to anticipate losses introduces an element of management of earnings which we find undesirable. A company could revalue in a year in which it had other significant losses, so that an additional loss would not look too bad. This company would then be relatively more assured of reporting higher earnings in the future. We believe that policyholders would be protected by the balance-sheet strengthening rather than the revenue reserve strengthening. We also have some hope that divorcing the two sets of reserves will result in more attention being paid to the adequacy of the balance-sheet reserves. Some companies that write almost all term business and hold statutory reserves are not, in my opinion, adequately providing for the protection of policyholders. Company management might be more willing to allocate this additional money for the protection of policyholders, if this increase were not going to be directly reflected in the earnings for that year.

The second major area that I want to discuss is the valuation of investments and the recognition of realized and unrealized gains and losses thereon. This is an actuarial concern because of the necessity of consistency between asset valuation and liability valuation. The Accounting Principles Board is currently considering the problems of accounting for marketable equity securities, such as common and preferred stocks. The different committees (Arenberg, Farley, and Winters) have taken positions on how investments should be valued and how changes in value should be recognized in the income statements of life insurance companies.

The Arenberg committee, in a February, 1969, statement, recommended that realized and unrealized gains should be reported together and in the long run be reflected in the income statement. Equity securities should be carried in the balance sheet at market value, but the Arenberg committee preferred some method which would credit or charge capital gains or losses to income on a basis which results in a rational and systematic recognition of the results of investing in marketable securities and which avoids giving undue weight to short-term market fluctuations. They proposed three methods of actually doing this—all approaches of the averaging type. The balance sheet would thus reflect market value, but the complete impact of a change in market value would not be reflected in the income statement in the year in which it occurred. It would be spread out in some manner.

The Farley committee, in May of this year, stated that for preferred stocks they would prefer to use the NAIC basis—cost if in good standing and market value if not. Common stock should be carried in the balance sheet at market value. Realized and unrealized capital gains and losses should be treated alike. So far their stand is identical with that of the Arenberg committee. The difference is that the Farley committee would like these realized and unrealized gains and losses to be a charge to surplus and not to go through the income statement. That is their preference. If the APB decides that these gains and losses must be reflected in the income statement, the Farley committee wants them as a separate and distinct part of the income statement, not labeled as income. Their third preference is for charging such gains and losses to income on some averaging basis, a proposal similar to that of the Arenberg committee.

The Winters committee did not address itself intensively to this question. We satisfied ourselves by pointing out the need for consistency between asset and liability valuations and by supporting an amortized cost basis for bonds. It is the bond problem that particularly concerns me. I think that it deserves much more consideration than it has been given. The current APB hearings are restricted to the problem of equity securities. They do not touch upon bonds. If we use amortized cost for bonds—and nobody, so far as I know, is suggesting that we do not—we do avoid the problem of unrealized capital gains or losses; however, we still have realized gains or losses arising from the sale of a bond. Let me give an example of a problem that I can see arising here. If we invest today in twenty-year bonds at 7 per cent, and five years later, when interest rates have dropped to 5 per cent, we sell them and reinvest in 5 per cent fifteen-year bonds, our net return over the twenty years does not change. The combination of the capital gain on sale plus interest payments will be exactly sufficient to cover the original assumption of 7 per cent per annum. Current accounting practices, however, require us to report losses in years 6–20, since we are receiving only 5 per cent as opposed to the 7 per cent assumption, and perhaps to report a large profit in the fifth year, depending on whether the capital gain goes through the income statement or through the surplus statement. Whichever it does, there is a distortion of the true earnings of a life insurance company. In my opinion this situation must be corrected by allowing us to spread this capital gain, or loss in a converse situation, over the remaining term of the original investment. Such a spreading would be quite analogous to the treatment of equity securities that was suggested by the Arenberg committee. I would urge all of you to consider this problem.

PHILOSOPHY OF MATCHING COSTS AND REVENUES

MR. W. JAMES D. LEWIS: The central concept of the audit guide and of my remarks today is that, to produce a generally acceptable earnings statement, revenues and costs should be matched. With this concept few of us would argue. However, translating the concept into figures on an earnings statement involves many philosophical, theoretical, and practical considerations.

I would like to start my discussion of these considerations by making the obvious comment that the ultimate earnings of a block of nonparticipating individual life insurance business are a definite amount and in no way depend on the reserve system. Once the last policy in the block has terminated, the accumulated earnings are the sum of the gross premiums received plus the sum of the investment income earned less the sum of the amounts disbursed for claims, withdrawal benefits, and expenses. However, during the currency of the block of business, the reserve system controls the incidence of the emergence of the earnings and thus is the instrument by which the objective of revenue and cost matching period by period is achieved.

Let us therefore consider the concept of revenue and cost matching. How should we define revenue? Is it premium income? Is it premium income plus investment income? Could we define revenue as premium income plus investment income less all or a portion of the reserve increase, on the theory that the reserve increase is revenue which should be deferred to future periods to match with the costs anticipated in those periods? What are the costs associated with the life insurance product? How do we match? Do we start with whatever definition of revenue we adopt and match costs to that revenue? We could do it the other way around, starting with costs and then adjusting the revenue to match the costs. What is matching anyway? Does it mean, for instance, that, starting with revenue, we adjust the costs so that they represent a constant percentage of the revenue in each period? Or will a more generalized type of matching be suitable?

These questions serve to indicate that the concept of matching revenue and costs bristles with problems and that each distinct answer to the questions raised results in a different reserve system and hence in a different incidence of earnings over the lifetime of a block of life insurance business.

Generally speaking, for a typical block of life insurance business, the income to the company precedes, in time, the outgo. A notable exception to this general rule is in the first year, when acquisition expenses are likely to exceed income. However, apart from the first policy year, income tends to precede outgo. Thus, under any concept of matching, we will either anticipate costs or defer revenue, depending on which is matched to the other. In either case the matching is achieved through the reserve system.

Which reserve system is used must depend on the use to which the resulting earnings statement is put. That is, it depends on the groups of people who use the earnings statement, be they shareholders, policyowners, or management. Mr. Posnak, here on the panel, indicated in a most scholarly paper earlier this year that "accounting principles, like actors, need an audience to survive." To the extent that reserve systems influence the earnings statements of life insurance companies, his remark is equally valid for these systems. A reserve system which produces earnings which are inconsistent with the company's earnings philosophy as expected by shareholders or policyowners, or as expressed by management through its rate-making concepts, would appear to me to violate reserving principles.

It is instructive to consider for a moment or two how matching of revenue and costs has been achieved by a number of reserve systems considered in recent months. First, of course, is the natural reserve system of the AICPA audit guide. Here revenue is defined as premium income. Costs are defined as operating expenses, withdrawal benefits, and claims less interest earnings. The deduction of interest earnings is accomplished through discounting. Costs are matched to premiums by leveling them over the premium-paying period using most likely estimates. This leveling produces a natural reserve premium, and the anticipated earnings in any period are the difference between the gross premium charged and the calculated net premium. Anticipated earnings are then a constant proportion of the premium income and cease at the end of the premium period.

This system has the merit of simplicity. It does not, however, produce earnings which are consistent with the management philosophy of a company which has instructed its actuarial staff to provide for profit in some less simple way—say, as a percentage of expected claims or of invested funds or of both. It provides for no earnings after the first year on single premium contracts or on other contracts once they are paid up, beyond those earnings which arise from actual deviations from expected. In the Confederation Life Assurance Company's Canadian operations, where we have been active for a century, one out of seven contracts now in force is paid up. Accordingly, this restriction of natural reserve earnings to the premium period could have serious disadvantages.

Finally, the natural reserve system tends to front-end the earnings to a greater extent than a full consideration of the potential future risks implicit in life insurance would appear to justify. I will deal with this aspect more fully a little later, and at this point I would simply like to state that in my own view this early anticipation of earnings is a serious theoretical flaw.

A second approach could be developed by defining revenue as premiums plus investment income. Costs consisting of expenses, claims, and surrender benefits are matched to this definition of revenue using the most likely assumptions. At this point a choice appears in how we match. Do we want costs to be a uniform percentage of the combined premiums and interest? Or would we be satisfied if we said that costs are to be matched to revenue as x per cent of premiums plus y per cent of investment income? The latter approach presents some advantages in simplifying the calculations, since we can construct a net premium and reserves using most likely assumptions for all factors except the interest rate, where a rate y per cent less than the most likely is used; y can be chosen to result in a sensible valuation interest rate and not one involving four or five decimals. Earnings are then expected to emerge partly over the premium period as a constant percentage of the premium and partly over the entire contract period as a percentage of the interest earnings.

This system would tend to appeal to many. It is simple. With many company statements showing that roughly 30 per cent of income is investment income, it seems natural to define revenue as total income including interest. Also, this system tends to solve the problem of single premium and paid-up contracts. As would be expected, it tends to defer earnings as compared with the natural reserve method, and the extent of the deferral can be changed by altering the matching weights in relation to the two revenue components, premium and interest. However, this method also has drawbacks. It would seem strange to many company managements, being in the life insurance business to pay claims, and perhaps constructing premium rates to provide for at least some earnings related to the life insurance claim risk, that they should be constrained to have their earnings emerge along with premium and investment income.

This leads to a third method, which is to define revenue as premiums plus investment income less reserve increase. Some simplifying assumptions and a little algebra will convince you that this is equivalent to a reserve system based on more conservative assumptions of interest, expense, withdrawal, and death rates than those felt to be most likely. The amount of anticipated earnings will emerge as a linear compound of the anticipated premiums, investment income, withdrawal costs, claim costs, and expenses. The parameters of this linear compound can be chosen by the actuary to reflect his judgment as to the degree of risk implicit for his company and for the product under consideration.

This more general approach to matching revenue and costs has received a great deal of study by the Joint Actuarial Committee on Financial Reporting as the "release from risk" reserve system. It occupies a central position in that committee's response to the audit guide.

The original concepts of the system were developed by Richard Horn in his work with the Joint Actuarial Committee. At almost the same time an only slightly less general approach along very similar lines was put forward to the ALC-LIAA industry joint committee by Harvey Wilmeth as the "per cent completion of contract" reserve method.

The more general Horn or "release from risk" system is extremely powerful and includes all the others mentioned, including the natural reserve system, as special cases of the concept of revenue-cost matching. It also sheds considerable light on the whole subject of the nature of the life insurance operation and hence on the accounting structure necessary to reflect that operation.

Basically, the method starts from the recognition of the uniquely probabilistic nature of life insurance. Contracts are entered into today which provide guarantees for the future. These guarantees are provided in the face of future risks of variability on the levels of interest earnings, mortality, withdrawal rates, and expenses. For each such component of future risk a probability distribution exists which represents the nature of and degree of variability implicit in it. This variability is built into the reserve system by basing the reserves on assumptions which reflect the degree of risk associated with each assumption. For instance, if a full actuarial consideration of the variability of the mortality risk leads to the conclusion that provision should be made for 105 per cent of expected or most likely mortality levels, then this higher rate is used in the reserve system. If, as time goes on, the expected mortality is realized, then the extra 5 per cent flows out into earnings. The important consideration is that the release to earnings occurs as the risks provided against are converted, with time, to historical fact.

The matching of revenue and cost is achieved by deferring through the reserve system a portion of the revenue to match the period costs. The extent of the matching with each component of cost depends on the variability provision associated with the component.

The generality of the system does permit the actuary to adopt a reserve basis which reflects the degree and nature of the risks his own company faces. Thus the basis could depend on the current size and financial strength of the company, its market, its product range, its sales mix, its investment policy, its distribution system, and many others. All of these can and will influence the degree of risk a company can assume while guaranteeing its perpetuity and hence also influence the valuation basis to be used and the period earnings.

The audit guide natural reserve is a special case of the "release from risk" reserve system, occupying an extreme position at one end of the system's range. The extreme position is that in which no account is taken of future risk and variability, so that natural reserves rely on the most likely values alone. A corollary to this is that all other special cases of the "release from risk" system do defer earnings to later durations than does the natural reserve. This was the reason for my earlier criticism of the front-ending of earnings implicit in the natural reserve system. Such a front-ending of earnings in the face of uncertainty as to the future would appear unwise, particularly in cases in which the variability due to market or sales mix may be large and the current financial strength of the company marginal.

Last month the Joint Actuarial Committee on Financial Reporting released a response to the audit guide that does include a complete development of the "release from risk" system and shows its application and resultant reserves for a number of plan-age cells and for a model company. It also compares the consequent earnings with those arising from other valuation methods. You are all urged to study the theoretical appendixes to the report if you have not already done so.

One final remark. So far our emphasis has been on nonparticipating business. The "release from risk" method may well have applicability in the future consideration of adjusted earnings for mutual companies. A characteristic of mutual companies is that they do face an additional element of risk. Because it is expected that each dividend class will be self-supporting and will not have to rely on the earnings of other classes, the actuary must establish risk factors in his assumptions appropriate to this concept of isolated dividend classes. This line of thought may well justify mutual company valuation standards which depart little from statutory standards except for the amortization of acquisition expense. The "release from risk" concept is so general that it may well prove to be a unifying factor as we approach the problem of adjusted earnings for participating business. Speaking personally as an actuary for the Confederation Life Assurance Company, a mutual company which has seen its ranking in *Best's* jump from forty-fourth place in new sales in 1968 to twenty-fifth place in 1970, I would view such a change in our valuation and accounting techniques with considerable favor.

MR. W. HAROLD BITTEL: The foregoing comments present the views of an actuary who has actively participated in the yearly revision of the prescribed statement form and in the review and analysis of the statutory financial statements of life insurers for more than twenty-five years and who recognizes the need for and the desirability of having supplemental data which will provide a more realistic picture of the operating results and earnings of such companies. No criticism is intended of the efforts of those actuaries and others who have worked diligently with accountants in recent years to develop analytical methods which produce results comparable to those sought by accountants for other clients through the application of their generally accepted accounting principles (GAAP). These methods have been documented and fairly presented in the proposed AICPA audit guide, although many corrections and clarifications of the latest exposure draft are needed. It will be unfortunate, however, if only one method of adjusting earnings, the use of natural reserves, is deemed acceptable by the Accounting Principles Board, as seems indicated, and if no acceptable adjusted balance sheet, such as one based upon a gross premium valuation, is advocated.

My quarrel is not with what has been proposed in this connection but with the underlying assumption that these methods produce results, in the case of life insurers, which satisfy the accountants' objectives of financial accounting and financial statements, as defined by their own Accounting Principles Board, either those objectives classified as general or those described as qualitative. It is my contention that we, as actuaries, now have to challenge the results of such calculations and adjustments as not being a proper or even an acceptable presentation of the true earnings or condition of a life insurer because they do not measure up to these APB objectives. This may place us in an extremely awkward position in our relations with accountants, but it is my hope that, once the accountants realize and comprehend the extent of and the misleading nature of these inadequacies in the results produced by the application of their GAAP, they may be receptive to our alternative proposals.

There is one very important characteristic of the various factors used to determine the price of our product that was not pointed out to the accountants, or, apparently, even considered, when it was agreed that *any* GAAP would be appropriate for such long-term obligations. This is the fact that each of these factors is subject to cyclical trends of such magnitude that any presentation which does not disclose the effect of such trends on the current operational results is not only meaningless but actually misleading and even deceptive. Accountants contend that, while yearly variations in these factors do affect the adjusted earnings, when GAAP are used, there is no serious distortion because the results using the original assumptions will still be appropriate and conform to their objectives. Unfortunately, this is not true! These cyclical trends, such as that currently being experienced in interest rates, can make a tremendous difference in the operating results when natural reserves, as proposed in the exposure draft (December, 1970), are used for adjusting earnings. These differences would vary by individual insurer because of different proportions of term business and of various types of investments and would, in many instances, be of such size as effectively to conceal serious current variations in other factors such as mortality and withdrawals. In any event, the distortions and inadequacies inherent in adjusted earnings on this or any other comparable basis are so serious that we, as actuaries, should firmly oppose their use, unless, as will be described later, there is a comprehensive analysis of the actual sources of such earnings as compared with those expected on the assumptions used; this analysis should be prepared and certified to by a qualified actuary, as a supplement to or as a part of such a presentation.

The adjustments of the balance sheet resulting from the use of the natural reserve concept, as proposed in this latest exposure draft, are, in my opinion, even more misleading and worthless. Unfortunately, there seems to be no practical way of developing and presenting supplemental data that would make such an adjusted balance sheet of any value whatsoever. The theory behind the development of these adjustments, which are designed to bring life insurance accounting into conformity with GAAP, seems logical and reasonable, except that the basic concepts underlying such theory do not exist in the products sold by life insurers. As pointed out earlier, this is because of the long-term nature of most of the contracts and the unpredictable cyclical trends of considerable magnitude affecting all the factors that determine the cost of this long-term product. The adjusted balance sheet, when natural reserves based upon the original assumptions in the contract premiums are used, reflects the earnings to date on this theoretical basis plus the additional earnings, or minus the losses, that have arisen from the variations to date in the actual developed experience as compared with that assumed and less distributions to stockholders. This, I contend, is a completely meaningless statement which shows an accumulated surplus somewhere between that obtained on a statutory basis and that reflecting the value of the business currently on the books. The latter adjusted surplus is, to me, the only kind of adjusted figure that could have any meaning or significance whatever to the person using this information to make decisions.

Consequently, the adjusted statement produced by the application of GAAP not only fails to provide the information needed to make decisions but actually provides information that is misleading, in that the user is led to believe that it has some meaning and significance. As indicated above, there appears to be no practical method of preparing an analysis of such data which would disclose the effect of these inadequacies, such as would be available in the case of the adjusted earnings. Consequently, we have, in my opinion, no alternative to reasoned but adamant opposition to the presentation in any form of any balance-sheet adjustments based upon the use of natural reserves as proposed in this audit guide.

It is not clear to me why there must be an adjusted balance sheet when our objective seems to be adjusted earnings. Actually, it would be possible for an estimate of the additional accumulated earnings to date resulting from the use of natural reserves to be obtained from the data appearing in my proposed analysis of the increase in such reserves which produces the desired information on the actual sources of current earnings. As previously indicated, the only adjusted balance sheet that would provide any useful information to the user would be one based upon a current gross premium valuation, using the actuary's best estimates of the future levels of the various factors involved. This, obviously, provides the information which those using these adjusted financial statements are seeking in one form or another, and, when this information is combined with a meaningful analysis of the sources of earnings, the user has all the information that can be obtained from such a source on which to make his decisions. This does not mean that I am advocating yearly gross premium valuations. However, I do maintain that, if any adjusted balance sheet is to be shown as an estimate of the current condition of the life insurer, it must be prepared on some basis other than the use of natural reserves in the form proposed by the audit guide. Obviously, a full disclosure of the assumptions used in the preparation of any such adjusted balance sheet would be an essential part of such a presentation.

There are two possible approaches to this problem in our current negotiations with the accountants on their proposed audit guide. Both of these involve a concerted attack on the appropriateness of GAAP for the preparation of financial statements for life insurers that will conform to the accountants' own general and qualitative objectives of financial accounting and financial statements, as defined by the APB, to which, I think, all accountants would subscribe regardless of any differences of opinion there may be on the specifics of promulgations by this board. We must convince the accountants that, in the case of life insurers, there is a need for something more than statements prepared in this manner, "for those using such statements, particularly owners and creditors, in making economic decisions and in evaluating management's effectiveness in fulfilling its stewardship and other managerial responsibilities." The quoted language is paraphrased from paragraph 73 of chapter 4 of *Accounting Principles Board Statement No. 4*. These are all fundamental concepts of proper financial presentations which are not carried out in their proposal and which can be provided only by an actuarial analysis of the kind described in the following paragraph.

One approach would be to try again to convince the accountants that something more than their usual form of presentation based upon GAAP is needed in the case of life insurers and that these additional data should be included as part of the statement to which an accountant attaches his certification, with a reference to, and recognition of, the qualified actuary responsible for them. These data, to be prepared and certified by a qualified actuary, would consist of an analysis of the sources of current gains and losses in essentially the same form as that used in the gain and loss exhibit before these comparisons were deleted in the mid-1940's. At that time, these ratios and comparisons, relating to gains or losses from mortality, gains from interest, gains or losses from loadings, and gains or losses from other sources, were not meaningful because they were based upon statutory standards rather than upon the assumptions used for calculating premiums and values. Their deletion was due to the misuse of these comparisons in competition between insurers. However, now that data will be available on a realistic basis through the use of natural reserves, these comparisons become very significant and actually provide the only practical means of obtaining the kind of actuarial analysis needed to understand and make use of the adjusted earnings. A separation of the earnings into the portions arising from the cyclical trends and from the random fluctuations of the various factors would be very useful in this connection. It cannot be emphasized too often that these methods have no applicability to balance sheets based upon natural reserves and that, while the adjusted reserves for the previous year and for the current year would be used for this analysis and can be compared with the statutory reserves for such periods, no presentation of an adjusted balance sheet, as such, on this basis is contemplated or should be permitted under any circumstances.

The other approach is based upon the same premise—that the accountants' usual form of presentation based upon GAAP does not provide adequate information in the case of life insurers and that supplemental data, prepared by a qualified actuary, are needed to carry out the accountants' own objectives of financial accounting and financial statements. This would require the recognition by the accountants that it is not possible by the use of GAAP to provide, in the case of life insurers, information of the same kind and quality as that provided for their other clients and that, accordingly, supplemental data are needed and must always accompany these financial statements. The accountants would be able to give unqualified certification to such financial statements, including adjusted earnings by a method acceptable to them, as being prepared in conformity with GAAP, with a reference, in their final audit guide or in their certification, or in both, to the additional requirement of a supplemental actuarial analysis which is needed to understand and to use effectively the certified financial data. Again, this would not include an adjusted balance sheet, as such, on this basis, under any circumstances. As previously indicated, the only kind of adjusted balance sheet that would provide useful information would have to be based upon a gross premium valuation using current assumptions as to the future trends of the various factors used for calculating premiums.

I am hopeful that this approach will be found acceptable by the NAIC through the subcommittee which is currently studying this matter, since none of these proposals is designed to alter or in any way supplant the statutory annual statement for life insurers or the prescribed methods for its completion. The one question that probably will be the most difficult to resolve is that of the abandonment of our traditional cash value floor for these calculations. I do not feel that such a requirement is essential, or even desirable, in calculations of this kind, since it would effectively conflict with the concept of expense recognition inherent in these principles. Furthermore, I am convinced that it is proper in calculations of this kind to consider the probability of surrender as one of the estimated future contingencies being evaluated.

MR. ROBERT L. PAWELKO: What are earnings? I feel that a stockholder views earnings as consisting of two separate parts. The first portion is the dividend income that he earns. The second part is the change in the net worth of the corporation. Why can't we use a gross premium valuation to depict this? One thing that concerns me from the department of insurance standpoint is that one-third of the companies operating in the state of Illinois have neither the expertise of Associates or Fellows of the Society of Actuaries nor the expertise of CPA's who are members of national firms. I fear that the natural reserve approach could easily lead to stock manipulation. The gross premium valuation, in my opinion, will not lead to manipulation. Perhaps the "release from risk" method would be acceptable. My main question is why we cannot use a gross premium valuation which accurately shows the net worth of an insurance corporation.

MR. GUSTAFSON: There is a very important, intrinsic difference between the natural reserve and the gross premium valuation. The gross premium valuation is in the frame of reference of present values. It is a balance-sheet figure. The natural reserve is oriented to the stream of earnings. Insofar as GAAP require an emphasis on the stream of earnings, the natural reserve technique is more suited to their purposes. The use for life insurance enterprises of the gross premium valuation, suggested by Bob and by others, may well give us a more accurate figure on the net worth of an enterprise, but it does not fit the way the real world is working.

MR. PAWELKO: Then what are earnings?

MR. POSNAK: One of our accounting publications (which constitutes a substantial authoritative support) states that earnings are a computed amount, a residual that remains after GAAP have been applied to the individual items that enter into the determination of earnings. More to Mr. Pawelko's point, a gross premium valuation does not seem to provide a suitable measure of earnings relative to earnings measurements in other industries. The gross premium valuation lies somewhere between traditional "GAAP" earnings and a going-concern valuation. The going-concern value would render the price-earnings multiple obsolete, but the use of the going-concern value would conflict with some of the more fundamental postulates of accounting, such as objectivity and conservatism. Meantime, it is necessary for investors to determine their own going-concern values by applying a multiple to a measurement of earnings that is based on a generally accepted set of principles—that is, generally accepted for all industries. A gross premium valuation would seem to fall short of satisfying the criterion of comparability with other industries.

MR. ARENBERG: I am appalled that Mr. Pawelko expressed concern about new young life companies and suggested the gross premium valuation method for reporting profits. He is criticizing us because we are anticipating profit in the natural reserve method, but now he is telling us that he would like to see all earnings anticipated in the year the business is sold.

MR. PAWELKO: From a state insurance department viewpoint, we have six hundred life insurance company annual statements on hand. It would be easier to compare companies using current-day assumptions than to use all the myriad assumptions of the past. I feel that the gross premium valuation method using current assumptions provides a much better vehicle for analyzing statements.

MR. RALPH P. WALKER: Does the natural reserve concept either defer earnings or accelerate earnings, depending on how your experience differs from that which was assumed at the time of issue?

MR. CORBETT: Any differences from assumptions are reflected in earnings for the year in which the differences occur. Acceleration and deceleration are relative terms. To the extent that you use dissimilar assumptions, you are going to get dissimilar incidence of earnings, because the difference between actual results and expected results will vary. For example, if you think renewal expense factors are going to increase because of inflation, the increase should be built into the natural reserve factors. This is especially true if you assume an inflationary level of interest. Thus, if you assume fairly high continuing rates of interest, your expense factors should be increased, since many of us feel that such interest rates cannot come without a continuing inflationary trend. Alternatively, some feel that grading the rate of interest to some fairly low ultimate level will offset the inflationary trend. They would then use the profit resulting from the extra interest earnings to approximately cover the increased renewal expenses, if inflation did continue.

MR. WALKER: I agree! Both actuaries and management have been rescued by the interest rates in the last twenty years. The point that I am trying to make is that no matter when the actual figures start differing from your assumptions, no change is made until you make a gross premium valuation.

MR. CORBETT: Yes; there is no change until a deficiency actually results.

MR. WALKER: In effect, you are assuming uniform profit until all future profits are eliminated.

MR. CORBETT: No; you would have decreasing profits because the gap between the actual and the anticipated expenses has been increasing.

MR. WALKER: But the point is that you are taking out any profits which you might have had in future years and bringing them back into early years under those circumstances.

MR. CORBETT: To the extent that you did not anticipate the future expenses and should have, you are not reserving properly and would be, in retrospect, front-ending profits.

MR. POSNAK: It has been stated several times that total profits are the same regardless of the reserve system. I am a little confused on this point because, so far as I can tell, only the present values of profits are the same. The accumulated total is the same only if profits are retained. If they are distributed as recognized, then the reserve system would have a direct effect on total profits. Is that correct?

MR. CORBETT: It is the act of distribution itself that is then affecting total profits. To the extent that you consider earnings on retained profits, what you say is true.

I am going to quote from an article written by Mr. Posnak some time ago which pertains to the definition-of-earnings problem that Mr. Pawelko raised and to certain of Jim Lewis' comments: "The province of accounting is to allocate revenues, costs, and expenses. Profit recognition is only a derivative of this process. Proper application of this concept of matching revenue with related costs and expenses is a primary objective of accounting. Creating a particular pattern of profit is not an objective of accounting." Therefore, earnings are not defined in accounting. You do not develop a system of matching costs and revenues based on what sort of earning pattern it is going to create. While there may be proper debate as to the process of matching costs with revenue, once the matching is done profit is merely the result.

I would like to extend this comment and give a brief historical background on the natural reserve and whether it front-ends earnings. The natural reserve concept did not evolve from trying to produce a certain pattern of earnings, that is, a pattern of earnings that were a level percentage of the gross premium. It evolved from substituting relatively current assumptions for statutory reserve assumptions. At one time there was a proposal to substitute only current interest assumptions. The natural reserve simply resulted from substituting current, or rate-manual, assumptions with respect to assumptions for expenses, interest, mortality, and withdrawals. The fact that anticipated earnings emerge as a constant percentage of gross premiums is a result of the natural reserve system. It was not a condition employed in its derivation.

MR. JOHN M. BRAGG: My concern is that unjustified capitalization of expense will occur if conventional expense factors are used in the determination of natural reserves. This is because conventional expense factors contain provision for overhead in the first year. The capitalization of overhead is not justifiable. Expense factors, which would give proper natural reserves, consist of full maintenance expenses plus only those acquisition expenses which are permitted by the audit guide. Factors of this nature might be called functional expense factors. My discussion of Mr. Pharr's paper compares the capitalization of expenses resulting from conventional and functional expense factors and attempts to show the degree of overcapitalization which results from the use of conventional factors. Would the accountants and actuaries on the panel be willing to comment on this point?

MR. ARENBERG: This gentleman is absolutely correct in his observation. This merely reflects a weakness in the manner in which the accountants have expressed themselves in the audit guide. The last thing in the world we want to do is capitalize period costs, which is what I infer when you use the phrase administrative costs or overhead. We have tried to avoid a cookbook approach to defining acquisition costs because there are other areas in accounting where we have the same problem. For example, manufacturing accounting has this problem in terms of the definition of manufacturing overhead. I agree with the point that Mr. Bragg is making, however. We need to clarify what is acceptable for capitalization in the guide.

MR. CORBETT: We can discuss such areas as reserve systems and whether investment income should be part of revenue, but all of these have a very minor impact on earnings compared with the effect of capitalizing 150 per cent of the first year's premium as opposed to 90 per cent. I agree with Jack in his paper of some years ago that the marginal expense approach to pricing is probably the most sound. The problem is that we do not use it. Most of us build into our premium structures expense assumptions which include a portion of the overhead. To the extent that the reserves are to reflect the cost assumptions of the actuary, I suggest that overhead expenses should be included. I also recognize that there is some debate that they should not. One practical problem of using only marginal or functional costs is that you will capitalize a different amount of cost depending upon the type of marketing arm of the company. If the company is primarily a brokerage company paying 120 per cent total direct first-year commission or overrides to an agent, the full 120 per cent is capitalized. Another company which might be paying 80 per cent commissions but which has very extensive agency development costs, financing, and the like, which might be classed as overhead, is allowed to capitalize only 80 per cent. This is a problem that would have to be resolved before we could use a strictly functional cost approach.

MR. WILLIAM H. CROSSON III: Companies holding statutory reserves on the net level basis have been faced with a problem arising from the fact that they have to charge all their expenses in the year in which the expenses accrue. This has caused quite a hardship, particularly on small or new companies. Accordingly, modified reserves were developed. The definition of a natural reserve which is being discussed is that of a net level reserve. Thus, to secure the proper matching of revenue and expenses, it is necessary to spread acquisition costs over some period. What I would like to suggest is the possibility of modified natural reserves. Such reserves could be defined by reducing the natural premium in the first year by an amount such that the difference between the first-year and renewal natural premiums is equal to the acquisition expense. Accordingly, you would no longer need to defer the charging of the acquisition expense.

MR. EDWARD H. COLTON: I think it would prove a tremendous service to both the auditor and the company if the auditor were urged not to interpret what is in the published audit guide. My suggestion is that the audit guide stipulate that the auditor refer to the committee whenever there is any doubt as to the guide's intent.

MR. ARENBERG: There are practical limitations as to the extent to which fifteen of us can deal with 78,000 auditors in the field. Your point is well taken. I would regard this as part of the evolution of the guide—the need to supplement it and define it as we go along.

MR. J. F. FRANÇOIS VACHON: Can the natural premium reserve approach produce a reserve which is lower than the cash value, and, if so, should not the cash value be shown instead of the lower reserve in order to be consistent with other financial institutions who show their deposit liabilities in full?

For example, if I show earnings which are higher than they would otherwise be, because I am assuming that not all the policies that could be withdrawn will be withdrawn, then is this situation not comparable to that of a bank which, instead of showing as an expense the full amount credited to depositors in a year, shows only the increase in the discounted value of the withdrawals as it anticipates them, on the assumption that not all those who could withdraw their deposits at any given time will do so, and thus redistributes interest charges and reports earnings earlier than it would otherwise?

MR. CORBETT: The answer to your first question is "Yes." The natural benefit reserve for permanent policies can be either more or less than the cash value. In the early years it will generally be greater than the cash value, while in the later years it can be less than the cash value. This variation is primarily a function of the ultimate interest level assumed. If you use in your natural benefit reserves a graded interest rate that reaches an ultimate rate which is close to the cash value rate, there is not going to be a great deal of difference between the cash value and the natural benefit reserve. Your second question was whether the natural benefit reserve should ever be permitted to fall below the cash value. The cash value floor has been considered by all three committees: Ted's committee, the industry committee, and the Joint Actuarial Committee. It has been discarded by all of them as violating the going-concern concept of measuring earnings. A cash value floor introduces a liquidation concept. Withdrawals are just as probabilistic as mortality. They are a contingency and should be provided for by actuarial contingency factors just as we provide for mortality. There are many practical arguments for a cash value floor, but all three committees felt that a cash value floor was not in accord with generally accepted accounting practices.

MR. POSNAK: The analogy between a cash value and a bank deposit has been vastly overdone. From a very practical standpoint, if we should go to a cash value floor, I think the industry would be obliged to value bonds at market. Under these circumstances, many companies would be insolvent. If a going-concern assumption is used for bonds, it seems only proper to use it for cash values, too.

MR. RALPH H. GOEBEL: What do you classify as acquisition cost? In Northwestern National's premium calculation we assume that 80 per cent of the branch-manager salary and many other costs are first-year costs. Now I gather that these would all be period costs.

MR. POSNAK: I do not think that a branch office company or a mail-order company is at any disadvantage compared with a brokerage operation or a general agency company. The basic problem is one of cost accounting and equalizing among the various types of sales organizations. Companies which have done some good functional cost work—including agency activity analysis—will not have any particular problem in identifying costs that can be associated with the production of specific units of new business. I call this association the principle of essential linearity—that is, the principle that acquisition costs should bear an essentially linear relationship to production. An underwriting department's expenses would qualify under this principle, an issue department's expenses would qualify, certain field supervisory and managerial expenses would qualify, but the president's salary would not qualify. There are no hard and fast rules. If the fundamental notion of linearity is followed, then there should be no substantial difficulty in making rational and reasonably conservative allocations.

MR. JOE B. PHARR: Although it has been suggested by the Joint Actuarial Committee that selection from a number of definitions of revenue reserves be permitted in applying generally accepted accounting principles to life insurance financial statements, I strongly favor a definition of revenue as equal to premium income when this definition is used in conjunction with reasonable actuarial assumptions typically inherent in gross premium calculations. Although these actuarial assumptions are usually viewed as realistic, in practice the assumptions are conservative, particularly in the areas of the net investment rate and mortality assumptions. This in effect ends up spreading earnings over a period of time beyond the premium-paying period. The pattern of earnings which emerges tends to follow the definition of revenue as equal to premium income plus investment income and is also related to the "release from risk" method in that there are margins in the net investment rate and mortality areas.

The use of a natural reserve concept in which revenue is equal to premium income and in which assumptions used to compute the natural reserves must be those actuarial assumptions inherent in the gross premium calculations greatly reduces communication problems between accountants, actuaries, management, and investment analysts and keeps the natural reserve calculations on a relatively simple basis by avoiding the complexities and/or necessity of successive approximations found with the use of the reserve systems in which revenue is defined as equal to premium income plus investment income, or with the per cent completion of contract method, or with the "release from risk" method.

RESPONSES TO THE AICPA DRAFT

MR. DANIEL F. CASE: In 1966, after several years of work, the American Institute of Certified Public Accountants Committee on Insurance Accounting and Auditing published its audit guide for property and casualty insurance companies and turned its attention to developing an audit guide for life insurance companies. During the preparation of the property and casualty audit guide there had been little effective communication between the AICPA committee and the property and casualty insurance business. The CPA's recognized this to be an unfortunate situation, and they decided to avoid it if possible in developing the audit guide for life companies. At about the end of 1966 they approached the American Life Convention and the Life Insurance Association of America with the idea of engaging in a dialogue which would help them to develop a sound audit guide. The ALC-LIAA established the Joint Committee on Financial Reporting Principles to study accounting principles and to engage in discussions with the CPA's.

The ALC-LIAA joint committee spent its first few years becoming convinced that the CPA's were really determined to establish a set of generally accepted accounting principles (GAAP) for life insurance company financial statements and that those principles would differ from statutory accounting practices. The joint committee thereupon left Consciousness I and entered Consciousness II. On this level of awareness it found itself dealing with various pieces of the annual statement, such as acquisition expenses, nonadmitted assets, and the mandatory securities valuation reserve. At this stage of the game, in 1969, the CPA's were talking in terms of setting up acquisition expenses as an asset, transferring some nonadmitted assets to admitted assets, moving the mandatory securities valuation reserve below the line, and making a few other piecemeal adjustments of that sort. In this way they would obtain an adjusted earnings figure and an adjusted balance sheet.

Piecemeal adjustments of the type I have mentioned seemed simple enough; but when it came to adjusting the reserves to a more "realistic" basis, say, and adjusting for the effect of lapses, it began to seem that some of the adjustments depended on others and that it was difficult to know which one to begin with and whether you were coming out at the intended place when you finished. It seemed that an integrated approach was desirable. Thus it was that the joint committee, and the AICPA as well, entered Consciousness III.

As you all know, the integrated approach which offered itself was the so-called "natural reserve" method. Two of the early students of natural reserves as a tool for adjusting earnings were Gary Corbett, a Fellow of the Society, and Robert Posnak, a CPA with the firm of Ernst and Ernst. At a joint meeting in the spring of 1970, the AICPA committee, with the concurrence of the ALC-LIAA joint committee, embraced the natural reserve method. One further point of agreement at that time was that natural reserves did not always have to be at least equal to the cash surrender value. It was felt that to set an arbitrary "cash value floor" would accelerate the amortization of capitalized acquisition expenses and distort the pattern of adjusted earnings. The analogy with savings bank deposits appears not to be valid, since cash surrender is only one of various possible dispositions of a life insurance policy. Provided that suitable lapse rates are employed in the natural reserve calculation, it seems correct not to impose a cash value floor.

It may be noted that "natural reserves," as defined in the exposure draft of the audit guide, are not precisely the same as the natural reserves described in classical actuarial literature. It may also be noted that the exposure draft permits the piecemeal approach as well as the natural reserve method but that it specifies, with respect to certain of the piecemeal adjustments, that they should be made in a manner that is consistent with the natural reserve method.

At about the time that the natural reserve method was being adopted, it became apparent that the involvement of mutual life insurance companies was, potentially, very deep. During the summer of 1970, an ad hoc group of mutual company representatives began to seek out the basic nature of GAAP for mutual life insurance companies. In September, 1970, a subcommittee of the ALC-LIAA joint committee, called the Subcommittee on Accounting for Participating Insurance, was appointed to investigate accounting for the participating insurance not only of mutual companies but of stock companies as well. This subcommittee carried on the work of the ad hoc group and subsequently arrived at the position which the joint committee submitted to the AICPA committee in March, 1971. For mutual companies this position is, basically, that the company undertakes to furnish insurance at an eventual cost which depends on emerging experience, and that in order to assure with a high probability that a given class of policies will not have to be subsidized by other classes, the company must hold reserves on that class at a level which will be adequate under any adverse conditions which may reasonably be expected to occur. The amount of these reserves may be redetermined from time to time as actual experience emerges, but it will always be based on "reasonable floor assumptions" as to future experience rather than on the so-called realistic assumptions underlying natural reserves. This type of reserve held by a mutual company has been named by Robert Posnak the "policyholder reserve." Usually it is considerably larger than would be a natural reserve determined for a similar block of nonparticipating policies by the method described in the December, 1970, exposure draft. It may also be larger than the statutory reserve.

In exposing the December, 1970, draft, the AICPA committee listed several "conditions of exposure." One of these was that the AICPA committee reserved its conclusion as to the applicability of Chapters VII and VIII of the exposure draft to mutual companies. In effect, there has been no exposure of Chapters VII and VIII as they would apply to mutual companies. Accordingly, the joint committee has recommended that drafts of Chapters VII and VIII applicable to mutual companies be developed and exposed for a reasonable period. Incidentally, the joint committee is composed of nearly equal representation of mutual and stock companies and is unanimous in its support of the mutual company position. The joint committee's position on accounting for the participating business of stock companies is similar in some essential respects to the description in the exposure draft.

As you all know, questions have been raised concerning the appropriateness of the natural reserve method for the determination of GAAP earnings (of a stock company, say). If actual experience approximates the experience which was assumed in the calculation of the natural reserves, GAAP earnings by the natural reserve method will emerge more or less in proportion to premiums received. It has been pointed out that this method, especially in the case of single premium insurance, involves a "front-ending" of expected profit. This fact itself is regarded as a disadvantage by some observers. If, however, the assumptions used in the calculation of the natural reserves are on the liberal side, then I think that most observers would agree that the incidence of emerging GAAP earnings will be concentrated too far forward in the lifetime of the particular block of business.

The joint committee is aware of the potential pitfalls involved with the natural reserve method. The committee has recommended to the AICPA committee that (1) the natural reserve method be considered as an acceptable method located at one end of a range of acceptable methods, the others of which would involve a later incidence of expected profit, and (2) the assumptions used in calculating natural reserves should contain a margin of conservatism, chosen with due regard to the long-term-risk nature of the typical life insurance policy.

The joint committee has submitted a statement on deferred tax accounting. The principal points made in the statement are as follows:

1. Taxes which may be payable in the distant future should be discounted both by interest and by the probability of payment.
2. Permanent differences between GAAP and prescribed accounting should be distinguished from temporary differences.
3. Recognition should be given to differences which arise because of a change in the fundamental tax position of the company at the time the adjustments reverse.
4. There are parts of the adjustment for which it is not appropriate simply to substitute GAAP figures in place of figures used in the tax return.
5. Any proposed adjustment methods should be carefully field-tested before they are adopted.

MR. SAMUEL H. TURNER: Three members of the Joint Actuarial Committee deserve special recognition: Bob Winters, the chairman, for his inspiring and effective leadership; Gary Corbett for "fathering the natural reserve concept" as a means of achieving a reasonable matching of revenues and costs in accordance with GAAP; and Dick Horn for developing the "release from risk" reserve system, of which the "natural reserve" method is one special case.

Since copies of the Joint Actuarial Committee's recent response to the AICPA will be available shortly through the Society, and since several of the topics covered in the response have been (or will be) covered during other parts of this meeting, my comments will be directed to three items: a profile of the Joint Actuarial Committee; a brief description of the organization and general content of their response to the AICPA; and a summary of certain of the findings and recommendations contained in the response.

The Joint Actuarial Committee was formed in December, 1970, by the four North American actuarial bodies (the American Academy of Actuaries, the Canadian Institute of Actuaries, the Conference of Actuaries in Public Practice, and the Society of Actuaries) to focus actuarial participation in the current examination of actuarial aspects of the AICPA audit guide exposure draft. More generally, the committee was to focus continuing actuarial participation in the application of GAAP to life insurance operations.

The committee's membership currently numbers fourteen, including a liaison representative from the Casualty Actuarial Society. Of the remaining thirteen members, twelve are members of the Society of Actuaries, four are members of the Canadian Institute, four are members of the Conference of Actuaries, and all thirteen are members of the American Academy. By employer, committee members represent state insurance departments, investment firms, actuarial consulting firms, mutual life insurance companies, and stock life insurance companies.

On May 14, 1971, one day before the close of the announced exposure period, the Joint Actuarial Committee submitted its response to the AICPA on its exposure draft of "Audits of Life Insurance Companies." This response contains 148 pages. It is, in large part, a commentary on the seventh chapter of the audit guide draft. As noted yesterday, the committee's comments on the first six chapters were submitted through the ALC-LIAA joint committee.

Before noting some of the findings and recommendations contained in the response, let me briefly review its organization and general content. There are eight sections in the main body of the response, which account for 84 of the 148 pages.

Section I is, as might be expected, the "introduction." It covers the Joint Actuarial Committee, the place of the actuary in life insurance, the scope of the response, and a summary of comments and recommendations.

Section II, "Basic Considerations," discusses the probabilistic nature of life insurance operations, the role of investment income, and responsibilities to our various publics.

Section III, "Statutory Accounting," in essence supports the continuing need for financial statements prepared in accordance with statutory accounting principles.

Sections IV–VII are directly related to the application of GAAP to life insurance companies. Section IV considers nonparticipating individual life insurance; Section V considers participating individual life insurance; Section VI considers other lines of business; and Section VII considers "other implications," such as deferred taxes and asset valuation.

Section VIII is entitled "The Actuarial Role in Financial Reporting of Life Insurance Companies." Barry Watson will discuss the Joint Actuarial Committee's response in this area, as well as that made directly by the American Academy.

There are three appendixes to the response, which account for the remaining 64 pages. Appendix A sets forth the development of the "release from risk" reserve system and contains demonstrations of special cases of this system. Appendix B describes and presents the results of the research conducted by the committee. The primary objectives of our research were to explore alternative reserving methods; to demonstrate relative patterns of earnings generated by these methods for selected plans and ages and for a model company; and to demonstrate sensitivity of earnings to changes in certain underlying assumptions.

Over two hundred plan-age analyses and twenty-five company models were calculated in the course of our research. Data for several of the reserving methods finally selected are illustrated in Appendix B. It may be noted that our research demonstrated that variability of earnings due to changes in underlying assumptions is considerably greater than variability of earnings due to differences in reserving methods. Appendix C presents considerations and other commentary regarding participating individual life insurance issued by mutual companies.

In the remaining few minutes available, I will summarize some of the comments and recommendations presented in the response.

1. The committee endorsed the "release from risk" concept as a generalized and unifying reserve system which accomplishes a reasonable matching of revenues and costs. Although this system was mentioned by Jim Lewis yesterday in his remarks during the concurrent session, several points seem worthy of comment here. The essence of the system is a recognition of the probabilistic nature of life insurance, embodying not only recognition of expected values but also recognition of the likelihood that actual values may adversely vary or deviate from those expected. Period earnings under this system represent the periodic release of each of the "risk provisions" in the underlying reserve system (with respect to interest, mortality, withdrawal, and expense) plus any "gain from loading" in excess of such provisions. "Risk provisions" represent the differences between actual experience (or realistic estimates of such experience) and experience assumptions underlying the reserve. Because of the generalized and unifying nature of the "release from risk" reserve system, it is hoped that it will be applicable to lines of business other than nonparticipating individual life insurance.

2. The committee recommended that a range of reserve methods, within specified limits, be permitted. We regard the audit guide "natural reserve" method as producing the most rapid emergence of earnings that should be permitted, and this represents one limit. At the other end of the proper range of methods within the "release from risk" system is the "per cent completion of contract" reserving method, under which the reserve net premium is equal to the gross premium.

3. We recommended that reserve assumptions be "locked in" both ways, in contrast to the position in the audit guide exposure draft that assumptions would not be changed should actual experience emerge better than that assumed but would be changed should actual experience emerge significantly worse than that assumed.

4. We recommended that companies be permitted to show unamortized acquisition expenses either separately or in combination with the benefit reserve component. This is contrary to the AICPA committee's current position requiring separate presentation.

5. The committee asked for an exposure period for audit guide provisions

applicable to mutual companies and indicated a preference for the "entity surplus" approach, if only one method is permissible.

6. We asked that the audit guide not prescribe accounting for lines of business other than individual life insurance, pending further study. We also stated our opinion that a satisfactory result can be achieved initially by statutory accounting plus amortization of acquisition expenses where material.

7. We recommended that probability and interest discounts be permitted, but not required, in accounting for deferred tax.

MR. CHARLES B. H. WATSON: The role of the actuary has been referred to frequently during this symposium, as one area in which the Joint Actuarial Committee felt considerable concern over the thrust of the AICPA audit guide.

Recognizing the primary role which the American Academy of Actuaries is intended to play in the field of professional recognition, the Joint Actuarial Committee on Financial Reporting referred this specific topic to the board of the Academy for response. This response took the form of a four-page letter to the AICPA committee, signed by H. Raymond Strong as president. Since the letter was carefully drafted by a committee headed by Jack Moorhead and was discussed at length by the Academy board, it does represent an official response from the board. The response of the Joint Actuarial Committee does contain a section dealing with the role of the actuary. However, because the thrust of this section is essentially the same as that of the Academy response, I shall refer directly only to the Academy letter.

Before discussing responses to the problem, we need to describe the problem itself and, in particular, how this problem arises from the accountants' view of their own profession. Most of the references to the role of the actuary have dealt with the need, the essentiality, of having actuarial judgment applied in the choice of the factors that go into determining the reserves and other actuarial elements of the life company statements. Hence there is a desire to have alternative methods and factors permissible under the audit guide. Put dramatically, the question at issue is the responsibility of the actuary for the adequacy of life company reserves.

Up to the present, this responsibility has been recognized by and large without much question by the accountants. Often this recognition has been given explicitly by a reference to the actuary in the scope paragraph, or sometimes in the opinion paragraph, of the auditor's statement.

The scope paragraph describes the data and tests that the auditor has made, and here the auditor might state that he had referred to the work of a qualified actuary. The opinion paragraph contains the auditor's statement that, in his opinion, the earnings of the company are fairly presented; it is here that GAAP must be referred to, if a "clean" opinion is to be given. Obviously, if the auditor said in this paragraph that he had relied on the statement of an actuary as to the correctness of the reserve liabilities, it would be a very important recognition of the actuary's importance.

In the view of the audit guide, it is too specific a recognition. It is the view of the AICPA that, for GAAP to apply, the auditor must satisfy *himself* as to the appropriateness of all aspects of the statement, including the reserve liabilities; otherwise, the auditor is not rendering a whole opinion, and implicitly not a clean one.

From this point of view, the actuary should be considered in the same light as any other expert an accountant might consult—a petroleum engineer to measure gas reserves or a gem expert to assess the inventory of a jewelry store—and any reference to the actuary in the opinion paragraph is, in the memorable word of Chapter VIII of the audit guide, "gratuitous." If the auditor is satisfied with the reserves, he can give a clean opinion on his own; if he is not, he cannot get off the hook, philosophically or legally, by dragging in an actuary.

This is not to say that accountants do not recognize the importance of actuaries in the life insurance business or would want to do without them. Every accountant the Joint Actuarial Committee has talked to has made this very clear and has stated that he and his firm would continue to rely on actuaries. But they do not want to say in the auditor's statement that they have done so.

Moreover, the audit guide does not prescribe to the last detail what the auditor must do. It is, after all, the auditor's own responsibility and judgment that stand behind his opinion. Hence the guide does not at any point require that the auditor consult an actuary. In a number of places it states that the auditor "may find it" desirable to consult an actuary, and that is all.

The Academy response bases its comments on the premise that "public interest demands (*a*) that an opinion by a qualified actuary be obtained on the actuarial items in life insurance company financial statements, and (*b*) that the nature of the opinion of such actuary be made known as part of any published statement." From this premise, it builds up to two major recommendations: first, that the audit guide make clear that the auditor should, as a part of his audit procedures, obtain the opinion of a qualified actuary as to the actuarial items; and, second, that the audit guide require that the scope paragraph reveal that such an opinion has indeed been obtained. The Academy submission also recommends some additional specific language to make clear the need of the auditor to obtain the services of a qualified actuary in specific circumstances.

For a definition of a qualified actuary, it refers to that appearing in *Accounting Principles Board Opinion No. 8:* "Membership in the American Academy of Actuaries, a comprehensive organization of the profession in the United States, is generally considered to be acceptable evidence of professional qualification."

We are somewhat hopeful that a recommendation along these lines will be accepted. It has become clear that any attempt to obtain a reference to the actuary in the opinion paragraph would be doomed to provoke a long, exhausting, and ultimately uncertain battle, and a clear audit requirement of an actuary's opinion combined with a reference in the scope paragraph would seem to be a satisfactory substitute. Needless to say, even such a solution will bring its own problems in train. For one thing, it may now be necessary for some companies to acquire direct actuarial guidance when previously they could rely on indirect assistance.

More important, the whole question of independence is still left up in the air. The accounting profession demands that the auditor be completely independent of the company he audits, even to the point of owning no stock in it, and in general the auditor, to the extent that he adheres to GAAP, will require the same independence of the experts he consults. This, on the surface, would seem to require that the auditor obtain the opinion of an independent actuary as to a company's reserves rather than that of the in-house actuary. In fact, this is the case for many companies whose statements are audited today; an independent firm of consulting actuaries in effect audits the work of the company actuaries. If this is to be the future practice with respect to audited statements, it will not be surprising if some of the larger companies, and some of the smaller ones, view it with something less than unbridled enthusiasm.

Still, the entire picture must be kept in view. If GAAP is to come to the life insurance industry, and it seems as sure as corn growing in Iowa, then the auditor is going to be expected to satisfy himself as to the validity of the reserves. It should be the goal of our profession to make certain that in doing so he relies on the opinion of a qualified actuary. As to whether the actuary is the company actuary or an independent consultant, that decision is the prerogative of the auditor, and there seems to be little as a profession that we can do about it. There may be other pressures, but they will be outside our professional calling.

MR. ROBERT C. WINTERS: I am going to talk for a few minutes about where we seem to be headed for the future. Where do we go from here?

I would like to start by voicing a minor sense of dissatisfaction with the label which has become attached to this process, the label "adjusted earnings," which is also part of the symposium title by derivation. I think that this is an unfortunate term, for two reasons. First of all, it suggests a concentration on earnings, which overemphasizes the earnings report. What we are really talking about is the financial statements of life insurance companies, not just the earnings report. Second, the term suggests that we start with numbers that are somehow improper and adjust them so as to remove those improprieties. Since the typical starting place is statutory numbers, and since I am unwilling to acknowledge that they are improper, at least for their purpose, I tend to rebel at the notion of our having to adjust them. I suggest that what we are really talking about is approved financial reporting for life insurance companies. This raises two questions: who does the approving, and what gets approved?

Now, clearly, in looking at life insurance reporting, we are basically talking about the reserve system. There are many other elements involved, but at the heart of all of this is the reserve system. Therefore, we come to the question of who is going to be in the business of approving the reserve system and what kinds of reserves they are likely to sanction. Let me first go over quickly two fairly recent entrants which I think will drop out of the field. Those are the financial analysts' systems and some of the proprietary systems. All these systems share the severe limitation of relying wholly on statutory numbers. Although they include some fairly ingenious procedures to overcome that initial liability, I do not think that they are likely to survive, once there is in the field an earnings-oriented system which is not saddled with this initial difficulty. This brings us down to two obvious "who's" in the approving business, and one not so obvious. The two obvious ones are, of course, the insurance commissioners and the accountants. The less obvious one, I suggest, is the actuaries.

Touching briefly on the National Association of Insurance Commissioners, there is, as has been mentioned, a subcommittee of the NAIC working on the question of how the states should react to the exposure draft and to the impending development of statements prepared in accordance with GAAP. This subcommittee is scheduled to report at the June, 1971, NAIC meeting in New York. It is a little premature to guess exactly what they are going to cover, since they are still exchanging views on just how they should propose that the NAIC deal with this development.

Nevertheless, I think that some of the dimensions of what they will say are clear. For one thing, they will certainly stand vigorously by the statutory balance sheet as the proper solvency test. I also think that there is a reasonable chance that they will sanction alternative earnings reports. No one has any great affection for the summary of operations as being a fully reliable and meaningful earnings report for a life company. I think, however, that it is much less likely that the subcommittee will go for a separate balance sheet. Harold Bittel of the New Jersey Insurance Department has presented, very well and very persuasively, in a paper submitted as part of the material for this symposium, the case for a single balance sheet even though there may be more than one earnings statement. In his paper he argues, among other things, that, if we are going to go to a realistic earnings system, a system which really purports to present earnings on a basis that ought to be relied upon, it should be accompanied by an analysis of gains by source. A major argument for this requirement is that, once people start believing in the earnings, they may become misled by such things as a company's covering current mortality losses with high current investment earnings. An investor who, unaware of the fact that he is counting on continuation of current investment yield, believes those earnings as a reasonable basis for projecting the future is likely to be unhappy in the end. Gary Corbett touched briefly yesterday on how we might work toward a single balance sheet serving as a link between two somewhat different earnings statements. I do not think that this development is right around the corner, but I think that there is room for the accountants to move a little bit away from their classic theory on the linkage between balance sheets and earnings statements as far as the liability side is concerned, and perhaps for the NAIC to permit a slightly extended use of nonadmitted assets in Exhibit 13 as a basis for reconciling the asset side of a single balance sheet.

Let me turn now to the accountants, the other obvious "who" in the field, operating both for themselves and as delegates of such other approvers as the Securities and Exchange Commission and the New York Stock Exchange. I think that we can anticipate, as Ted Arenberg indicated yesterday, that we will see a published audit guide issued this year, including coverage of mutual companies, but probably not effective or required for 1971. This suggests that I hold the view that we can find a satisfactory resolution of the mutual company issue, and I think that we can. Some regard that as optimistic, but we have discovered a lot of common ground between the accountants and the industry representatives, and I think that there is a very good chance that we will find enough more to reach what might be termed a mutually satisfactory resolution. This raises the question of what reserving methods the AICPA will sanction. I think it is clear that the published version of the guide will continue to sanction the kind of expected value adjusted or natural reserves that were described in the exposure draft. The real question is whether they will also sanction additional methods, and I think that they should for at least three reasons.

One, which has been alluded to, is that the choice of assumptions underlying the calculation of reserves for any particular method is, in many cases, much more powerful in its effect on the outcome than the reserving method itself.

Perhaps more important, on a somewhat short-range basis, I suggest that we need to have a range of reserving methods in the field for several years simply because we do not know enough about what any one kind of natural reserves will do to life insurance company earnings. I suggest that there has been no satisfactory research of sufficient scope for us to rely on it as a demonstration of what really happens. There are really only two ways to do this kind of research. One is to go back historically and look at what would have happened to many companies in many kinds of situations. That has not been done, and I do not think it is going to be done, even assuming that the data were available, which is itself unlikely. The other approach, of course, is to permit a thousand flowers for a few years—to have a number of methods applied by companies in being to their actual situations. Then, at the end of a period of two, three, or five years, we can take a look at whether or not we need a single method and, if we must zero in on a single method, find the best one at that time on the basis of some demonstrations and facts.

Finally, I think that more important for the long term than the need for better understanding of the possible reserve systems is a need for flexibility in accounting procedures. As Jim Lewis mentioned yesterday, we need sufficient range in our accounting to reflect the variations in the actual circumstances of individual companies in the risk-taking enterprises in which they are engaged.

Currently, the accounting profession is being pushed rather hard in two opposite directions on this matter of flexibility. There is a growing cry by knowledgeable outsiders that the accounting profession is becoming too rigid. The president of the AICPA last January called a meeting of a relatively small number of prominent members of the profession to examine whether there might not be some fire where there is all this smoke. They have appointed two high-level committees to look into the operations of the Accounting Principles Board and the way in which accounting opinions are developed and to dig into the question of what the objectives of financial statements really are. The other pressure on accountants is toward ever greater uniformity, with less scope for "imaginative accounting." It seems to me that, although the difficulties which the accounting profession has encountered recently in a number of other industries may force them into a more rigid format for the accounting for most industries, I do not think that is necessary for life insurance, and I do not think so because of the existence of the third "who" that I mentioned.

Whereas the accounting profession is a rather diverse group, a dispersed collection of some forty thousand individuals in commercial practice, there is in the actuarial profession a single, closely knit group with a reasonably uniform educational standard whose special province, whose special area of competence, is exactly the key issue in life insurance accounting: reserving. Therefore, it seems to me unnecessary to extend into the life insurance area the kinds of rigidity, the idea of the same dose of medicine for everyone, which may be necessary in other industries. That position, in turn, suggests that there is a responsibility for actuaries to serve professionally, both individually and as an organized body of professionals, in developing, articulating, promulgating, and codifying the proper ways to go about preparing life insurance company earnings and other statements, and the proper reserving bases. At the same time we should probably move somewhat more in the direction of the self-discipline that the accountants now seek. Presumably this would mean, for the Academy, more extensive activity in the area of guides to professional conduct and disciplining membership; for the Society, more work on the content of reserve systems for life statements; and, for the Casualty Society, perhaps a parallel responsibility in connection with the casualty blank. In terms of our discussions yesterday morning, this seems to be a reasonable responsibility of the actuarial profession to users of financial statements, and one which we might well fulfill in conjunction with the accountants. I have every confidence that we will.

MR. HARLOW B. STALEY: The role of the actuary who is assisting with an audit is a function of the role of the auditor. It may be true that, if the auditor chooses to hire an actuary as an independent expert, the in-house actuary will be displeased. However, he is in the same position as the in-house accountant whose work is reviewed by the auditor.

It should be remembered that it is the company that should select from among alternative acceptable methods and do the calculations. If there are competent accountants and actuaries who have done this work, with explanations of what they have done, then the work of the auditor, with or without his outside actuarial expert, will be greatly reduced. If not, the outsiders may be making financial statements and not merely auditing them. Then who will audit the auditors?

If the auditor decides that the in-house actuary is not independent, then doesn't it follow that a company's regular consulting actuary is not independent, either? Of course, CPA firms are often in the position of providing other services in addition to auditing, including not only financial analysis but also a variety of management consulting services. Doesn't this tend to decrease their independence?

It has been stated that it is difficult to predict the effect of adjusted earnings in various situations and for a variety of products without actually performing the calculations. If results are unpredictable, then the test of the reasonableness of the results cannot be used with much assurance. This will be especially true for a company that is making the adjustments for the first time, and this makes it particularly important for the work to be done and checked by separate people.

It is still necessary that the company accountants and actuaries know what the auditors will accept. However, each must take full responsibility for the correctness of the results.

DEFERRED TAX CONSIDERATIONS

1. How are deferred tax accounting principles applied in companies other than life insurance companies?
2. In what ways might deferred tax accounting principles applied elsewhere be inappropriate for life insurance companies?
3. What deferred tax proposals are contained in the AICPA exposure draft?
4. What modifications have been suggested by the Joint Actuarial Committee on Financial Reporting? The ALC-LIAA Joint Committee on Financial Reporting Principles? Others?

MR. ALAN RICHARDS: The need for the allocation of deferred taxes in general accounting arises because of the existence of "timing differences." Timing differences arise when the income shown in the financial statement is not the same as the income reported on the tax return. If the financial statement income is greater than taxable income, accounting principles require that a deferred charge be made against income in an amount equal to the current tax rate multiplied by such difference. The requirement of such a deferred charge arises from the general objective that any expenses (including tax expenses) reported in an income statement for a specific period should be matched with the revenues and other expenses reported for that period.

Examples of transactions which may give rise to deferred taxes include the following:

1. Instalment sales wherein profits are recorded at time of sale and reported for tax purposes when instalments are received.
2. Use of accelerated depreciation in tax returns as opposed to straight-line depreciation in financial statements.
3. Deduction of research and development costs in tax returns which are actually capitalized and amortized in financial statements.

A deferred tax credit may arise when tax return income is greater than financial statement income. For example, the estimated costs of product warranty contracts are recorded in accounts at the date of sale and deducted in tax returns when later paid. Another example might be organization costs which are written off in the financial statement when incurred but are amortized over a period of years on the tax return.

The operation of a deferred tax charge can probably best be illustrated by the use of the simple numerical example shown in Table 1, which traces the accounting and tax effects of profits of a million dollars on instalment sales in each of the years 1967 and 1968.

The basic authority for deferred tax accounting is *Opinion No. 11* of the Accounting Principles Board. The AICPA exposure draft of the proposed audit guide for life insurance companies states: "Tax allocation principles as set forth in APB Opinion No. 11 must be followed when computing adjusted earnings for a life insurance company." If you wish to read that *Opinion* in full, you will find it in a handy little booklet entitled "Accounting for Income Taxes: An Interpretation of A.P.B.

TABLE 1

INSTALMENT SALES, 1967 AND 1968

1967:	
Pretax accounting income	$1,000,000
Less gross margin in uncollected instalment sales, year end	200,000
Taxable income	$ 800,000
Taxes payable (48 per cent less surtax exemption)	$ 377,500
Deferred charge (48 per cent of $200,000)	96,000
Total income tax expense	$ 473,500
1968:	
Pretax accounting income	$1,000,000
Plus gross margin on prior year's sales collected in current year	200,000
Taxable income	$1,200,000
Taxes payable (48 per cent less surtax exemption plus 10 per cent surcharge)	$ 626,450
Amortization on deferred taxes set up in prior year (credit)	(96,000)
Income tax expense	$ 530,450

Opinion No. 11," by Donald J. Bevis and Raymond E. Perry. This contains a great deal of useful background information and can be obtained directly from the American Institute of Certified Public Accountants, 666 Fifth Avenue, New York, New York 10019. Table 1, which demonstrates how *Opinion No. 11* is to be applied in a simple case, was taken directly from that publication.

It is implicit in the recognition of timing differences that they will ultimately "reverse" and that the deferred taxes in the balance sheet will be amortized to tax expense. In the illustration the amount of $96,000 was set up as deferred taxes in 1967 and added to the taxes payable of $377,500 in order to obtain the total income tax expense of $473,500. In the following year the amount of $96,000 was "reversed" and deducted from the tax payable in calculating the total tax expense.

Opinion No. 11 also recognizes so-called permanent differences. These arise from transactions in which there is no subsequent reversal of the difference between tax and book income, and in such cases no deferred charge or credit is required. For example, tax-exempt income and nondeductible political contributions would both cause differences between book and tax income which are permanent and have no deferred tax consequences.

Opinion No. 11 also discusses three possible ways in which calculations of deferred taxes may be made and presented in the financial statements. These are the "deferred" method, the "liability" method, and the "net of tax" method. The *Opinion* specifically prohibits the use of any method but the deferred method. As we shall see, this has significant implications for the application of deferred tax theory to life insurance companies.

The "deferred" method is essentially retrospective in nature. Deferred tax charges or credits are calculated for each timing difference in the year in which it arises at the rate of tax current for that year. Such deferred taxes are then accumulated in the balance sheet from year to year without interest and without regard to whether the total amount bears any precise relationship to the taxes which might ultimately become payable when the timing difference is reversed. In other words, the deferred method is income statement-oriented rather than balance sheet-oriented.

The "liability" method on the other hand, is balance sheet-oriented and is prospective in nature. Deferred taxes in the balance sheet are labeled as liabilities (or assets) rather than as deferred credits (or deferred charges). A liability for deferred taxes is computed at the rate of tax expected to be in effect when the timing difference reverses. Any changes in the tax laws which affect the probable amount of deferred tax to be paid in the future may be reflected as adjustments to the liability.

The "net of tax" method requires deferred tax accounts to be shown in the balance sheet as reductions of the appropriate assets and liabilities.

The Joint Actuarial Committee and the ALC-LIAA committee have argued that the use of the deferred method is inappropriate in the case of life insurance companies. They favor the liability method. Other commercial transactions extend over relatively short periods of time, and the distortions which might be introduced through the use of the deferred method as a result of subsequent changes in tax rates or tax laws would normally not be important. However, life insurance transactions extend over long periods of time, and the ability to make adjustments, implicit in the liability method, would appear to be an absolute necessity. Furthermore, the federal tax law for life insurance companies is extremely complex and is likely to cause the imposition of quite different amounts of tax when timing differences reverse than was contemplated when they originally arose. Above all, many timing differences will turn out not to have been timing differences, after all, but permanent differences. It is possible to conceive of a situation in which an otherwise healthy company becomes technically insolvent solely through the presence of redundant deferred taxes on its balance sheet!

The two committees also believe that deferred taxes should be discounted for the probability of payment when deferred tax principles are applied to life insurance companies. This is at present prohibited by *Opinion No. 11*. Such probabilities might be determined from projections of the companies' business. This will not be an easy task, but it must be tackled.

One other way in which deferred accounting principles as enunciated in *Opinion No. 11* might be inappropriate for life insurance companies relates to discounting deferred taxes for the length of time which is likely to elapse before they actually become payable. The *Opinion* specifically prohibits discounting. The ALC-LIAA committee and the Joint Actuarial Committee have agreed that such future tax payments should be regarded as actuarial liabilities just as, for instance, benefit payments are, subject to discount at some appropriate rate of interest.

A simple illustration of this might be a bond purchased at a discount, assuming a yield of 8 per cent and coupons of 5 per cent. There will be a substantial amount of discount to be accrued to maturity. Under the scientific method of accrual, those accruals at discounts will be set up in such a way as to level out the gross yields from year to year. The strict application of *Opinion No. 11* will require that each accrual of discount be charged with 25 per cent, the capital gains rate each year, even though no capital gains tax is actually payable until that bond matures. The committee would instead take each 25 per cent of the deferred tax against the accrual of discount in the proper year and in turn discount that for the balance of the life of the bond. This has the effect of producing a very small deferred tax accrual in the early years of the bond, gradually increasing to a greater amount in the later years.

Finally, the use of the liability method is a must for the life company. It is something we have to impress very strongly upon the accountant because the whole nature of our business is such that we could not live with a situation in which redundant deferred tax accruals cut into net worth or vice versa. Regardless of the use of discounts for probability payments or discounts over time, it is fairly obvious that the liability method would make these problems much easier to live with because we could make adjustments from year to year, at the end of each year on our view of the future.

MR. ROBERT L. LINDSAY: I will briefly review the AICPA audit guide position on deferred taxes and the response of the ALC-LIAA committee to this portion of the audit guide, and I will then summarize the response of the Joint Actuarial Committee on Financial Reporting.

The following is a summary of the positions taken in the AICPA audit guide:

1. The tax allocation principles set out in *APB Opinion No. 11* must be followed in computing adjusted earnings. This is the dominant phrase.
2. Differences between financial statement reserves and "tax basis" net level premium reserves would require tax reallocation. Presumably this is now being done in Phase II calculations where a company has made a section 818(c) election.
3. Tax allocation adjustments must be made for any other significant differences between adjusted financial statements and basis upon which the company determines its taxable income. Since *Opinion No. 11* would be followed, no adjustments would be needed for items which are considered to be permanent differences.
4. Theoretically, a company should recompute its federal income tax liability for each year beginning with 1958, using section 809(f) limitations, operations loss deduction rules, and so on. Practically, an approximation to the amount of the tax allocation account at the start of the period when generally accepted accounting principles (GAAP) were adopted may be permitted.
5. Shareholders' surplus and policyholders' surplus accounts would be recomputed using all Phase III tax rules. If a distribution to shareholders were made which exceeded the recomputed balance of the shareholders' surplus account, appropriate provision would have to be made for a Phase III tax liability even though no Phase III tax liability was shown in the tax return filed by the company. It is our understanding that the AICPA committee may modify its views on Phase III tax accounting and may not require this recalculation.
6. The audit guide says that no deferred tax need be provided for any balance in the recomputed policyholders' surplus account except where payment of such tax is imminent or where the account exceeds the limit set forth in the Internal Revenue Code. Here again, the final audit guide may be changed. *Opinion No. 11* exempts the tax return policyholders' surplus from tax allocation accounting.
7. The audit guide mandates the disclosure of the recomputed "policyholders' surplus" account, together with the taxes which would be payable upon distribution to shareholders, if material. This disclosure would be made as notes to financial statements.
8. Finally, deferred taxes should be provided when necessary for unrealized gains or losses on investments.

The response of the ALC-LIAA committee may be summarized as follows:

1. The main point is that *APB Opinion No. 11* is not entirely appropriate for the life insurance business as it may be for the usual commercial concern. This is because of the complex and variable-effect taxing formula applicable to life companies. Thus tax projections are needed in order to determine the appropriate provision for taxes on an adjusted earnings basis.
2. The committee contends that original timing differences may not result in the payment of additional federal income tax in the future when such differences reverse. Thus what may appear to be timing differences are, in effect, permanent differences. If a company can so demonstrate, then it should not have to provide for deferred taxes. Mathematical models or other techniques should be used to determine the appropriate tax liability.
3. Application of GAAP to tax accounting should not result in any change in aggregate taxes incurred over a period of time but only in the period in which they are reported.
4. The disclosure of "shareholders' surplus" and "policyholders' surplus" accounts recomputed under GAAP should *not* be made, since these do not represent reality and would confuse readers of the financial statement. They are legal tax memorandum accounts only and are not used for accounting purposes.
5. The committee argued that taxes which may be payable in the distant future should be discounted both for interest and for the probability of payment.
6. Literal compliance with *Opinion No. 11* will produce deferred tax credits on the balance sheet which are greatly overstated and are therefore erroneous and misleading. Under the audit guide the deferred tax account for companies which never have to pay such taxes might increase indefinitely.
7. The ALC-LIAA committee suggested that full deferred taxes should not be set up for unrealized gains or losses on investments. The example was given of the reason a life insurance company buys bonds at a discount. The main reason is that the yearly accrual of discount is not currently taxable. If GAAP required a full capital gains tax liability to be set up on each annual accrual of discount, this might discourage companies from pursuing a course which is to their economic advantage. No set of sound accounting principles should produce such a result. Taxes applicable to the accrued bond discount should properly be provided at present value of amounts due in the future.
8. The committee suggests guidelines which are fairly comprehensive and speak to the four basic tax situations. The ALC-LIAA committee proposed that any prescribed adjustment methods be carefully field-tested before they are adopted.

I will now present a summary of the response of the Joint Actuarial Committee on Financial Reporting.

The recommendations of the Joint Actuarial Committee were generally along the lines of the ALC-LIAA committee response. We recognized the theoretical desirability of the discount and probability techniques and our preference for the "liability" method for tax accounting. We developed some fairly good arguments for its use. Pragmatically, we recognized the position of the AICPA committee and also some of the difficulties in applying a discount and probability approach. We therefore suggested some simple guidelines to be contained in the audit guide, with the auditor being given considerable discretion to act within these guidelines.

Before discussing our suggested guidelines, it would be useful to consider the AICPA committee position on this subject. This committee is under considerable pressure to promulgate an audit guide which would be effective this year. Tax adjustments must be made if earnings adjustments are to have any meaning. The AICPA committee cannot turn its back on the *APB Opinion*, although it could recommend that certain of the opinions be reviewed by the APB. This review, however, takes time, since the opinions are to be applied to all industries and not just to life insurance. Therefore, the AICPA committee will undoubtedly come up with guidelines which do not conflict with *APB Opinions*. The Joint Actuarial Committee concluded that a strong argument should be presented for the theoretical discounting approach, with the hope that it would be adopted at some point, but we felt that we should also suggest reasonable guidelines which might be acceptable to the AICPA committee.

At the start, let me make a rather obvious remark: no set of guidelines can be developed to cover all situations and all companies. Therefore, the guidelines should permit reasonable flexibility. Elaborate and expensive calculations should not be required. To force these on all companies would be unreasonable.

The guidelines which we suggested are as follows:

1. Each company would recompute its tax, using revenue and costs from its general-purpose statement.
2. No tax recalculation would be necessary for those differences between taxable income and GAAP pretax income which are attributable to permanent differences.
3. A recomputation of "shareholders' surplus" and "policyholders' surplus" should not be required. No Phase III tax adjustments should be made.
4. An alternate method of tax adjustment should be permitted but not required. A conservative discounting for the time and probability of tax payment may be used which also recognizes the appropriate tax phase at time of payment.
5. Deferred federal income tax should be provided when necessary for unrealized capital gains or losses on investments.
6. Any balance-sheet deferred tax credits or charges arising from the use of the

"deferred" method should be periodically reviewed for appropriateness. This guideline would prevent carrying a deferred credit or charge on the books forever.

We also suggested that the audit guide would be more useful if it contained clear examples of permanent and timing differences. Items which do not require recalculation include the following:

1. The "company's share" of tax-exempt income.
2. The life insurance and pension plan reserves used in Phase I calculations. This also applies under Phase I to reserves adjusted by section 818(c) election.
3. Any prepaid expense asset should not require a change in asset base referred to in section 805(b)(4).

One very sticky question pertains to section 809(d) deductions which are used in determining the gain or loss from operations. Should the amounts which are used in the actual tax return be considered as permanent differences and therefore not be adjusted for changes in other items affecting the gain or loss from operations? This may be appropriate for the small business deduction and any operations loss deduction. Should the deductions for dividends to policyholders, 2 per cent of certain accident and health and group life premiums, and 10 per cent of the increase in reserves for certain nonparticipating contracts be frozen?

If we assume that the operations of a life company will continue on a going-concern basis and that its tax position will not change materially in the future, it would seem more appropriate to restate these last three deductions on a GAAP basis. This is a practical solution which is intended to give the desired results.

Let us examine the possible impact of this approach.

1. A company which is currently taxed only in Phase I and which has substantial unused deductions (because of sec 809[f] limits) would probably show little, if any, change in its incurred taxes on a GAAP basis.
2. If GAAP accounting produces a smaller gain from operations than that used in the original tax accounting, the amount of deductions used would be reduced accordingly.
3. Companies which are taxed on their gains from operations do not generally have unused deductions. The full amount of deductions has been applied in determining their incurred tax on a tax-accounting basis. Therefore, no recalculation of section 809(f) limitations is necessary. There are some cases in which the use of GAAP income in place of tax-basis income changes the company's pro forma tax situation from one phase to another. In such an event it would be prudent to examine the company's tax projection to determine the appropriateness of any adjustments.

Again, I would like to emphasize that our intent was to determine practical guidelines for auditing purposes which would avoid costly adjustments but which would produce reasonable results. Each company's tax position should be carefully examined, however, to make sure that adjustments are appropriate.

MR. JOSEPH R. PICKERING: Have you considered what happens when a company has restated earnings, as we did last year end, and has used the deferred method for setting up deferred taxes, and then sometime in the future it becomes permissible to use some other method? What happens then to the difference between the two?

MR. LINDSAY: I am just guessing, not being an accountant, but I imagine that it would be just an ordinary item in that year. You might then adjust your prior year's earnings accordingly.

MR. JOSEPH T. BROPHY: We are a stock company writing participating and nonparticipating business. As of last week we converted our statements for the last five years to a GAAP basis, and at present they are being audited. The question that concerns us is the interpretation for deferred taxes. As background: In 1966, 1967, and 1968 we were in a Phase I situation. We list dividend deduction and nonparticipating and group deductions. In 1969–70 we were taxed in Phase II. Our first approach in trying to interpret the audit guide was to go back and try to recalculate our tax in 1966, throwing in the numbers that emerged, so that there was very little increase in our tax on that basis because we used up the deduction. When we analyze the implication of this in the future, because we feel that in 1972 we are going to be back in a Phase I situation, we feel that this produces an inadequate tax. In other words, we are setting up not too much in taxes but too little, and it causes us some concern in trying to get a resolution of this.

In a given year we measure the difference between our GAAP and tax bases, which for simplification is the increase in the capitalized expenses less the difference between our tax reserve and our GAAP reserve. We break that down by year of issue. In other words, in 1970 we say that there is an adjustment from GAAP to tax of $2,000,000 because of business written in 1970, and we apply a tax rate, say 48 per cent or whatever the current tax rate is, and then we are able to amortize or watch that deferred tax write itself off in future years because the natural expense reserve will decrease to zero, and the difference between the section 818(c) and our statutory reserve will eventually disappear. Similarly, in 1970 we have a deferred tax for issues in 1969, a deferred tax for issues in 1968, and so on. Under this approach we are able to assure ourselves that the deferred taxes will be written off because we can identify them with the year of issue. We feel that we should, however, in the application of the current tax rate to the given year, use the full tax rate, because, when these earnings emerge or these expenses are written off, they are going to be taxed in a Phase I situation in the future. We are having some controversy with our auditors on this, and I appreciate any thoughts you have on it. It makes a very substantial difference in the trend of our earnings and the impact that it will have on our earnings in the future.

CHAIRMAN H. EDWARD HARLAND: Could we make sure that that there is no problem in the terminology used here? You mentioned being taxed in Phase I in the future. What do you mean by Phase I?

MR. BROPHY: I guess it is taxable investment income less $250,000. We will lose the dividend deductions and so forth.

MR. RICHARDS: If I understand your situation, you are essentially looking at your situation on a prospective basis. It makes a great deal of sense, but, as far as the auditors are concerned, they are required to apply *Opinion No. 11* in the present circumstances, which says that you look at things on a retrospective basis. Each year you calculate the timing difference for that year, apply the appropriate rate for that year, and accumulate these deferred credits. Now, I am not sure of this, but perhaps it is a little easier to convince the auditors that you should set up more taxes—I believe you said that you thought you should do this—than to set up less than the deferred credit account; but, regardless, *Opinion No. 11* says that you do not look forward, you look backward.

MR. BROPHY: Where is the principle of matching revenue expenses and taxes? Is that academic as far as *Opinion No. 11* is concerned?

MR. RICHARDS: *Opinion No. 11*, as I understand it, was a practical attempt to apply the principle of matching so that it would work for almost any business. It probably does work for almost any business except the life insurance business, and the principle of matching, in my opinion and the opinion of the committee, would be better served if we could use the liability method. At the moment *Opinion No. 11* says thou shalt not use the liability method.

CHAIRMAN HARLAND: Perhaps a point worth noting here is that *Opinion No. 11* did pass in the Accounting Principles Board by a really quite narrow margin, in spite of the fact that the board members were not thinking of the life insurance industry at the time they considered the question. My personal view is that, had they been thinking of the special problem of the life insurance companies at that time, *Opinion No. 11* would probably not have come out as it did. If that view is correct, it could suggest that the Accounting Principles Board might reconsider its stand on *Opinion No. 11*, but this may not happen in time to take effect before the audit guide.

MR. RICHARDS: There are, incidentally, some dissenting opinions which make quite interesting reading.

MR. JOHN C. FRASER: I must say that I am quite appalled by this situation. There is an Alice in Wonderland quality, of course, about the deferred tax method that is proposed by the accountants. On the other hand, I am sympathetic to their point of view, because, when I look at the alternative of, in effect, asking them to accept a projection of earnings to go into the current operating statement, I can see where their hangup would be. This tax law, as we all know, is incredibly complicated even when it is applied to the current year on the basis of tax figures, and when you start talking about projections and changes in phases and everything else, it becomes almost incomprehensible. I have not fully developed this idea, and I am not sure that it is right, but it occurs to me to ask why, if we could get the accountant off this requirement that everything be set up gross rather than net, we could not build into the natural reserve or "release of risk" reserve, or whatever is being used, a provision for taxes in a way which is comparable to the way we have built it into other elements? Surely anybody who is truly studying gross premiums on any kind of scientific basis must be in some way making provision or estimate or whatever you want to call it of the federal income tax impact on his profit, and it would seem to me that this sort of thing could be built right into the revenue reserve. Of course, such a provision would result in emergence of profit on a net aftertax basis to the extent that they were adjusted, but it seems to me that it might get around a lot of our problems, because I am afraid that I cannot visualize either this deferred tax method or the liability method as really being effective. I would appreciate it if you could explain the "net of tax" method; I do not know whether this is what they had in mind or what.

MR. RICHARDS: I have spent very little time on that because I thought that the main controversy lay between the deferred method and the liability method; but, very briefly, the "net of tax" method simply says that you state every item net of tax. You do not show the tax separately in the balance sheet. We had a discussion about whether it would be possible to do what you are suggesting by building the federal tax into the natural reserve calculation or the "release of risk" method of calculation. My hangup essentially is that the natural reserve calculations are made for individual blocks of business, whereas the tax calculation, as the law is written, is essentially done on an aggregate basis, and it may produce different results. I cannot prove this; I just have a feeling that it can and would produce results entirely different from those you would get by building the tax calculation into the natural reserve.

MR. FRASER: If that were true, you would be admitting that your rate structure is deficient.

MR. RICHARDS: Probably few of us are able to build any very sophisticated measure of federal taxes into our premium rate-making, even though we may try. That is probably what it comes down to.

MR. BARTON BURNS:* I have been dealing with deferred taxes for some fifteen years, and I think that I can explain a little bit about this alternative method, which really has no significance. This is strictly a balance-sheet approach which was discarded some years ago in the days when I first began to deal with deferred taxes. It was common to set items up on the balance sheet net of tax when we had some of these timing differences, but the only effect of *Opinion No. 11* on this was to say that you could not do that—that you have to set the liability up gross and set up an asset for the anticipated tax benefit, and then that liability flows through. I am scared to death, however, by some of the implications of what Mr. Brophy was talking about. If we look at the financial statements of the companies that actually presented their statements in accordance with GAAP in 1970, we notice that most of these companies were in Phase II, and it looks as if the way they computed their deferred tax liability in the income statement was to take 25 per cent of the timing difference. They assumed that half of this was ultimately going to go into policyholder surplus and that the other half would eventually result in tax to the company. They have apparently taken the same approach on the balance sheet, where it seems to me that they have adopted the liability approach for computing the balance-sheet effect of the deferred tax element. As a practical matter, going back to 1958 and recomputing the tax for every year, when we cannot possibly recompute our adjusted earnings for each of these years going back that far, is horrendous. Thus

* Mr. Burns, not a member of the Society, is a CPA with Ernst and Ernst.

we are left with the alternative of actually setting up a liability of 25 per cent of our timing difference—in effect the difference between the reserve and the deferred acquisition cost. Suppose, however, that we do this with a company that has been consistently in Phase I and anticipates that it is going to be in Phase I, and then we do as Mr. Brophy has done, that is, we set up an amount related to these timing differences which are going to phase out over a period of time, so that we throw up a liability on the balance sheet and bring it back into income over a period of years. The possibility of these two alternatives scares me as an accountant, and I am afraid that I face one very real possible situation in which this could have a dramatic impact on earnings over a period of years.

MR. JAMES MELVILLE: Even if we could do what Mr. Fraser was talking about to take care of the tax on the timing difference created by adjusted earnings, we still would have to solve the deferred tax implications of the eight or nine other accounting differences that are listed in the audit guide, and the amount of money involved in the tax on unrealized gains could be significant. Then we would have a neither-fish-nor-fowl situation.

I have a question for Mr. Richards: How can the deferred method create a redundancy in the liability?

MR. RICHARDS: I can give you a very simple example. The illustration that we went through on the instalment sales related to 1967 and 1968. If we had taken 1968 and 1969 or 1969 and 1970, we would have been involved in setting up a deferred credit which would have included a 10 per cent surcharge, yet this would be on a timing difference which would mature or reverse in a later year in which there would probably be no surcharge. Meanwhile, the balance sheet would be distorted.

In the case of a life insurance company, that could occur because of the immensely complex nature of the law. I emphasized earlier that I was not talking about life companies in discussing the way in which *APB Opinion No. 11* applies to nonlife companies. But the above example will give you a clue to how that sort of thing could happen in a life company. I think you would need to go through some numerical examples to get the feel of things—to see that, when a company moves from any one of the four typical situations to another one, you could get these redundancies.

I would like to follow up on what John Fraser was saying about building the taxes into the natural reserves. On further reflection, I mentioned that I could see an inconsistency here between the way in which natural reserves are calculated as they relate to individual policies or blocks of business and the way in which taxes are calculated in the aggregate, so perhaps that is not too inconsistent. Perhaps we have an analogy here, wherein the assumption is the individual calculation and the actual experience is the aggregate calculation, and you might find larger variations between those two than, for instance, you find between assumptions and actual experience of death claims; but this approach might hold some promise.

CHAIRMAN HARLAND: The possibility of an insurance company's tax situation shifting from time to time from one basic position to another is, of course, what makes this whole question so much more complex for our industry than it is for most other industries. John Fraser mentioned the "net of tax" approach as a possibility; again, John, you work for a company that manages to stay safely in Phase I last year, this year, and every year, and for such a company there may be some real possibilities along the lines you mentioned. I am not sure whether a company that moves occasionally from one position to another, as my company does, would be very happy with the results obtained by something like a lock-in assumption similar to those that would be used for expenses, withdrawal rates, interest, mortality assumptions, and so on, in the natural reserve calculation. You did assume, did you not, something like a lock-in of original assumptions?

MR. FRASER: I still get back to the basic point that, if you are really talking about these issue assumptions and you really believe all this "most likely" nonsense, you have got to be saying somewhere that you made some kind of provision, implicitly or explicitly or whatever, for, if not a lock-in, at least a possibility that you could go to another phase or what have you. Now the problem related to that is that the revenue reserve approach is intended to be before tax, because, if it is not, it is not producing the proper before-tax revenue. If it is before tax, it is in effect assumed that no taxes are payable, and, if it is assumed that no taxes are payable, then clearly the assets are overstated; it seems to me that that implies something about taxes and the discounting of taxes, and it may in effect be a justification for the interest-discounting effect. I have not thought this one through, but clearly what seems to be said here is that these revenue reserves are on a before-tax basis; it has never been clear, however, in what I have read anywhere whether they are before or after taxes.

MR. LINDSAY: The revenue reserve calculations are before tax.

MR. BROPHY: I would like to second what John Fraser has said about building tax provisions into the asset share. We are disturbed by our tax situation, and this is an alternative that we have been looking at. We feel, John, that it can be done, and it can be done whether you go into Phase I, Phase II, or back. I think that we can work that out. That seems like an acceptable approach to us.

CHAIRMAN HARLAND: A question has occurred to me, and I have not yet found anyone who has been able to answer it for me. The APB has defined generally acceptable accounting principles, and an official pronouncement of the APB constitutes a generally acceptable accounting principle. They say that other things can create GAAP, including a substantial body of authoritative opinion or practices. Now what would you say to a situation that might be created wherein there would be a pronouncement of the APB, such as we have in *Opinion No. 11*, and a substantial body of authoritative opinion to the contrary? I do not know whether that is even a possibility in the eyes of the APB, but the Joint Actuarial Committee has studied the question of deferred tax accounting methods and has suggested that the liability and discounting method is more appropriate to our industry. This is a considered view of the actuarial group. It has widespread support in that group. Would that satisfy the definition of substantial authoritative opinion? If so, are the auditors entitled to use whichever principle suits them, or is it possible that the official ruling of the APB overrides any possible conflict? Could somebody enlighten us on that?

MR. BURNS: The problem is likely to be that, even though *Opinion No. 11* is not changed and there is room for latitude in the audit guide in the interpretation of *Opinion No. 11* because of the inherent difficulties, if we have 250 companies that are publicly reporting their earnings to shareholders under GAAP and, let us say, 150 of them are audited by a dozen accounting firms, it is quite likely that we are going to get 250 different interpretations of the way to account for deferred taxes; I do not think that you are going to get anything that approaches general acceptance. If the actuaries can come up with a sound approach that will be adopted by enough companies, I think it has a chance. I am very pessimistic about there being enough unanimity among most of the companies reporting their earnings that you will be able to say that anything is generally accepted.

MR. JOHN T. GLASS: I would like to pose the question of a reversal of the general situation which we have been discussing, namely, that earnings are increased and there is a possibility of payment of more taxes. What if the situation is the opposite? Can we take credit, so to speak, for reduction in taxes?

MR. LINDSAY: I think that would be reasonable. Of course, you saw the restrictions on operations carried forward that you now have, which is expressed in *Opinion No. 11*, but it would be reasonable.

MR. BURNS: To get back to Mr. Brophy's point and his approach to this immediate question, I can see a real possibility of this happening in a great number of companies that have been in a Phase I or Phase II situation that suddenly see expenses creeping up and see their interest income creeping up. They have built the combination of these two into their calculations; as a result we are going to see many more companies going permanently into a Phase I situation, and these deferred tax credits that have been built up over this period of years may very well have some justification for coming down during the period when they are in Phase I only. Again, this scares me.

CHAIRMAN HARLAND: You are suggesting that this shows the importance of periodic reviews of the deferred tax items in the balance sheet to see whether they are sensible.

MR. ALAN B. GOLDBERG: The last gentleman was scared a few times, and I guess I am, too, about another question. We talk about tax planning. I think that by tax planning we mean the careful watchfulness over tax dollars which are real tax dollars as they affect the company and stockholders. Now, if we are to adjust taxes in this fairyland of reported earnings rather than taxable earnings, does this mean that we are in for a period of tax planning toward reported taxes rather than paid taxes, and is it possible that we would be swayed to improper tax planning for appearances when it is not real tax dollars that we are planning for or against?

MR. RICHARDS: I hope that we will not be swayed by such considerations. The problem of tax planning is now so fantastically complicated that, if we superpose on taxes that are paid the problems of planning for deferred taxes too, we will have a real monster on our hands. I do not deny that this might happen.