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CURRENT DEVELOPMENTS IN FINANCIAL REPORTING

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1. GAAP methodology: Reinsurance, purchase method of accounting

2. By-products of GAAP: Use of GAAP financials for management purposes and reporting, analysis of major product lines by source, focus on continued profitability of current products

3. "Loss recognition" versus "recoverability": When? How? What type of assumptions in general? Expense assumptions?

4. Actuarial functions characterized by conservatism which is "reasonable and realistic":

   Initial GAAP conversation "conservatism"

   Current practice "reasonableness and realism"

5. Results of current surveys of GAAP assumptions and methods

6. Disclosure of GAAP data in GAAP statements

7. Deferred tax in GAAP accounting

8. Impact of recent FASB pronouncements on GAAP

9. Current practice in evaluating materiality

10. Conceptual framework for statutory accounting

11. Statutory accounting for future taxes payable

12. NAIC Blanks Committee recommendations

13. Other current statutory reporting topics

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MR. J. G. FERNAND BONNARD: We are here to share our thoughts about the recent developments in financial reporting as they affect the life insurance industry.

MR. GLEN M. GAMMILL: I believe one word can summarize current developments in the financial reporting area for stock life insurance companies as they relate to generally accepted accounting principles -- refinement.

During the early years of the original conversions to GAAP, those associated with the GAAP concepts were in an environment where few hard rules existed and the technology was very fluid and dynamic. GAAP techniques and approaches for each of the lines and sub-lines of business were being developed "on-line" during the conversion process and utilized the few written guidelines which existed at that time, including the AICPA's Audit Guide.

Recently, the insurance community concerned with GAAP financials has begun to eliminate any technological gaps which previously existed. As a consequence, more and more energy is being channeled into the refinement of the techniques and methods previously employed. For example, the following refinements have been recently generated:

1. Interpretation 1-D: Purchase Accounting

   This interpretation issued by the Committee on Life Insurance Financial Reporting Principles of the American Academy of Actuaries addresses the actuarial considerations involved in computing policy reserves for individual life insurance policies acquired in a transaction which is to be accounted for under the "Purchase Accounting" rules described in Accounting Principles Board Opinion No. 16. The interpretation recognizes two alternate methods of accounting for policy reserves in a purchase accouting situation. The Defined Initial Reserve Method essentially utilizes an initial reserve taken as a predetermined amount and requires prospective valuation premiums (never to exceed the gross premium) using current actuarial assumptions with a reasonable provision for adverse deviation. The Defined Valuation Premium Method sets the valuation premium equal to the gross premium less a reasonable profit allowance for the risk assumed by the acquiring company. The purchase reserves under the latter method are equal to the present value of future benefits and expenses less the present value of future unloaded gross premiums, using current actuarial assumptions with a reasonable provision for adverse deviation. Of the two methods, the latter is being almost exclusively followed. Interpretation 1-D, although not yet "officially" approved by the AICPA, has substantial authoritative support from within the accounting profession. This Interpretation, in my opinion, has been one of the most beneficial issued by the Academy on GAAP methodology.

2. Interpretation 4-A: Reinsurance Ceded

   In April, 1974, the Academy's Committee on Life Insurance Company Financial Reporting Principles issued Recommendation 4, Reinsurance Ceded By Life Insurance Companies. Paragraph 4 of that Recommendation mentioned that the degree of materiality of reinsurance adjustments is such that most companies will be able to use simplified approaches in measuring the impact of reinsurance ceded on the GAAP financials. During 1977, however, the Committee felt that the practitioner had possibly used paragraph 4, particularly as it related to YRT reinsurance, to justify simplified approaches to the adjustment of reinsurance ceded without sufficient consideration as to the materiality of such an adjustment. This over reliance on paragraph 4 was mirrored by the responses recently summarized in the Survey of GAAP Practices distributed by the Committee to the Academy membership during 1977.

   Interpretation 4-A seeks to remind the actuary that there will be situations when special care should be exercised in considering the materiality of a simplified approach. The actuary is directed to pages 397-413 (especially page 411 for YRT) of Volume XXVII of the Transactions for further guidance on accounting for reinsurance ceded. While a vast majority of companies are currently using either the statutory reserve offset or some simple modification of that offset for GAAP purposes for YRT, the GAAP reserve when calculated with the YRT built into the calculation can, in many instances, be larger than that same GAAP reserve assuming no YRT reinsurance.

In addition to the Interpretations mentioned above, the Academy will soon release a Recommendation on Materiality. The Recommendation will discuss the application of the concept of materiality as it relates to actuarial aspects of the financial reporting of life insurance companies. The proposed Recommendation indicates that it is appropriate for the actuary to employ approximate methods and procedures when a more exact method would be of little significance to a potential user of the actuary's work. Highlighted in the Recommendation is a statement that the actuary generally need not "utilize methods or procedures which imply a degree of precision that is in fact unattainable", based on the circumstances surrounding the calculation. The proposed Recommendation will initially have three Interpretations as follows:

1. Typical Users - Opinion A-3, Transmittal of Actuarial Reports provides general guidance to the actuary in determining who his client is when acting in various roles. This Interpretation seeks to assist the actuary in determining the primary user of his work under various circumstances.

2. Quantitative Considerations - The Committee received many thoughtful responses to the Recommendation and particularly to this Interpretation. The exposure draft contained specific references to percentages which might be used to evaluate materiality, but then warned that such tests have not been found to be totally reliable. The final version of the Interpretation will not provide specific quantitative guidelines.

3. Qualitative Considerations - The final Interpretation related to the Recommendation on materiality stresses that the actuary must make judgments on materiality based on the best information available and that it is manifestly improper to fault decisions on materiality on the basis of "hindsight".

The Committee on Life Insurance Company Financial Reporting Principles is currently considering the possibility of adding three more Interpretations to Recommendation 1 concerning the areas to be considered by the actuary in choosing assumptions for GAAP purposes relative to mortality, morbidity, lapse and interest.

Last year the Committee released the results of a survey of GAAP practices which was sent to 125 U. S. stock life insurance companies who employed two or more members of the Academy. Based on the responses recorded by the survey, I would summarize the results as follows:

1. Most companies indicate no apparent deficiencies on current issues.

2. Loss recognition tests have not been performed by the majority of the companies since their original conversion to GAAP.

3. A majority of the companies utilized their own experience to a large extent in setting assumptions for GAAP relative to interest, lapse and expense. The tendency to defer to intercompany experience in the mortality/morbidity area was generally indicated.

4. On all assumptions, the companies tended to use implicit rather than explicit provisions for adverse deviation.

5. Appropriate GAAP interest rates to be used for a non-participating whole life policy issued in 1977 averaged approximately 6-1/2% initially graded to 4-6/10% at about the 30th policy duration. Based on my experience, these average rates would be roughly 1/2% higher than the typical average graded pattern used by most companies on their initial GAAP conversion for new issues in 1971-73.

6. In response to whether or not certain expenses were being deferred for GAAP purposes, the following expense items were split rather equally between those companies deferring and not deferring: subsidies to agents, general agents and managers, fringe benefits to agents, home office agency supervision and home office sales promotion costs.

7. In response to the methods employed to defer acquisition costs, roughly two-thirds used the factor method as opposed to the worksheet method. Virtually all companies responding used interest in their amortization procedures.

8. A majority of the companies indicated that they were holding some multiple of the extra premium related to substandard business. This response was probably due to the immateriality of the substandard issues relative to the entire insurance portfolio.

9. A substantial majority indicated that the following classes were not adjusted from their statutory basis for GAAP purposes: reduced paid

up, extended term, disability-active, disability-disabled and accidental death benefit.

10. About one-third of the actuaries responding did not provide an actuarial report to the company's management in accordance with Recommendation 3 documenting GAAP assumptions and methods employed.

11. Virtually all the companies appeared to utilize approximate techniques in adjusting for the effects of reinsurance ceded on the yearly renewable term basis.

12. Use of the mean reserve with individual life premiums recognized in revenue when due was the most popular response in the premium recognition section of the survey.

Based on my experience, I see many significant trends emerging from or related to the GAAP financial reporting area.

1. The refinement of methods and approaches (e.g., YRT reinsurance ceded treatment) consistent with a more rigorous consideration of materiality will begin to emerge.

2. Further clarification and development in the purchase accounting area due to an era of increased acquisition activity in the life insurance industry.

3. Wide acceptance and increased confidence level in GAAP financial concepts relative to:

   a. measuring profitability of existing products

   b. designing new products

   c. measuring the company's performance relative to predetermined objectives and analyzing earnings by source (interest, lapsation, mortality, morbidity, and expense)

   d. assistance in forming a judgment as to the value of an insurance entity being considered for acquisition.

4. Increased use of non-traditional, non-actuarial approaches in certain GAAP areas, for example the increased use of the worksheet method for the amortization of deferred acquisition costs.

MR. WAYNE KAUTH: While GAAP financial reporting for life insurance companies has stabilized somewhat over the past few years, there are a number of fairly recent situations that are causing some concern, consternation, and grumbling -- with definite overtones to the actuarial profession. These areas are:

1. The SEC, AICPA, and FASB activities

2. Segment reporting - past, present, and future

3. The status and activity regarding GAAP for mutual life companies

4. Activity associated with:

   a. Audit committees

   b. The NAIC

      -- Development of NAIC statutory accounting practices

      -- Casualty reserve certification

   c. SEC deficiencies

   d. Life policy confirmations

   e. Audit partner rotation

   f. Life company investment accounting

   g. Interim reporting

The accounting profession has a number of different types of pronouncements, the most important of which are FASB statements, APB opinions, and AICPA publications such as Audit Guides, Statements on Auditing Standards, and Statements of Position. In addition, the SEC promulgates its own accounting rules and requirements. Essentially, these rules are contained in Regulation S-X. The SEC also supplements that document with sporadic releases which are very much a part of the official rules of the SEC. There are two supplemental formats, one being referred to as an Accounting Series Release -- an ASR -- and the other being a Staff Accounting Bulletin -- a SAB. Since its formation in 1933, the SEC has issued about 250 ASRs and a couple of dozen SABs.

I think it is fair to state that the insurance industry has been somewhat exempted from all sorts of rules and regulations that affect other corporations in general. That general exemption which has existed for many many years is slipping away at an accelerated rate. Unfortunately, because many insurance companies have not historically felt it necessary to follow pending and proposed regulations from the accounting organizations, many insurance companies do not now have a mechanism, except for their trade associations, to monitor the activity in the world of accounting.

Some evidence of that situation became apparent late in 1977 when many insurance companies had to grudgingly face up to the implications of FASB #8, which was issued in October 1975. This unpalatable situation occurred principally because the Canadian dollar went from par to 91 cents in 1977. At that time, many insurers were holding Canadian bonds. As you well know, statutory and GAAP accounting for foreign currency translation transactions are much different, being an income statement charge for GAAP purposes and a surplus statement item for statutory purposes. This is a big difference by any standards -- and one that caught many insurers completely by surprise.

Inasmuch as you are already governed and regulated within your own profession and by the various insurance departments, accounting pronouncements do not affect you too directly. However, because your independent auditors

are bound by these edicts, they superimpose their entire body of rules on your company and you, as part of management, become subject to them and must comply with the ramifications resulting therefrom.

Just so that you do not feel that the life insurance industry has been selected for particular harrassment by the accounting profession, you might be interested in knowing that there are projects underway within the AICPA which affect property/casualty insurers, mortgage guarantee insurers, and title insurers. An NAIC hearing was recently held in Chicago with respect to the proposal to require the certification of casualty loss reserves. There was a real difference of opinion between the two professions as to who was qualified to do what with these reserves. However, this particular issue remains unresolved at this time.

Another recent situation where the insurance industry was caught napping involves the segment reporting requirements dealt with in Statement #14, which was published by the FASB in December 1976. Throughout 1977 the AICPA Insurance Industry Committee had discussions with various trade associations and nearly everyone concluded that there were basically only three segments within the insurance industry: life/health, property/casualty, and title. Throughout most of 1977 there prevailed a rather passive and nonchalant attitude regarding segments for insurance companies. This attitude resulted somewhat because the SEC had not raised any questions with filings made by various insurance companies during 1977. Unfortunately, this casual complacency was short-lived. Late in 1977 the SEC suggested that most insurance companies were simply too big to be only one segment. As a consequence, in December of 1977 and January of 1978, a few insurance companies huddled with the SEC to discuss the matter. However, the SEC continued to state that a life insurer was comprised of more than one segment. As a result, the AICPA Insurance Industry Committee decided to contact the SEC, and a letter was sent in an attempt to establish a record that there were only the three foregoing segments. For a period of time, the SEC was silent with respect to the letter. Then, during the first week of March, the SEC issued Accounting Series Release #244 addressing property/casualty companies and concluding that many casualty insurers were in more than one segment. The FASB was disturbed by the issuance of ASR #244 since the SEC was interpreting FASB #14. Apparently, the FASB did not believe that it was the role of the SEC to interpret FASB pronouncements. While a confrontation between the FASB and the SEC did not occur, the AICPA Insurance Industry Committee wrote the FASB requesting an interpretation of FASB #14 as it relates to insurance companies. In essence, the AICPA repeated the various arguments and again concluded that there were only the three basic segments. As of this date, the FASB has decided not to issue a formal interpretation, but it has put this interpretation request on its agenda for possible future consideration.

To give you an indication that the SEC was actively pondering this segments matter, I need only to refer to a company that filed its Form 10-K in mid-February 1978. Two days later, it received a one paragraph response from the SEC stating something to the effect that "the staff believes that the registrant is in more than one industry segment." FASB #14 requires a breakout of revenue, profitability, and identifiable assets by industry segment (not to be confused with product lines or lines of business). Thus, while life insurance companies have to allocate investment income by line of business on page 5 of the NAIC blank, most companies have been reluctant to allocate assets and investment income by segment. If it is determined

that the company must develop and report segments, most companies have argued that assets cannot be allocated because they are there for the benefit of all policyholders. Similar resistance occurs when it comes to investment income allocation. As a consequence, company management may request a determination whether there are better ways to allocate investment income for external segment reporting purposes than those utilized in the preparation of the convention statements. Such an exercise will raise many questions. For example, how many segments are there? Should some income be allocated to a corporate account? Should new money rates be used? Are reserves the proper criteria for allocation? In summary, the SEC is moving forward on this segment question, but at least there is a bright spot in that FASB #14 has been amended so that it is no longer applicable to interim financial statements.

There may also be a SEC trend toward requiring insurance companies to disclose the minimum statutory capital and surplus requirements in filings with the SEC. The SEC has also been requiring that registrants disclose the nature and amount of management fees charged and other services provided to subsidiaries. The SEC further requires that the basis for expenses allocated to such subsidiaries be delineated.

The foregoing items are not intended to be an exhaustive listing of the SEC's current interests; instead, they are merely indicative that the SEC makes some seemingly arbitrary requests periodically which are communicated to the insurance industry on a one-on-one basis, that being principally via deficiency letters. As you might well suspect, what starts out as an innocuous comment in a single deficiency letter may well be the harbinger of future reporting requirements for the insurance industry in general.

On another topic, let me cover what the AICPA is doing that will have some impact on life insurance companies. As background, there are several insurance-oriented committees or task forces within the AICPA. However, the committee that affects you most frequently is the AICPA Insurance Industry Committee. This committee is made up of only ten individuals, one being from each of the so-called "Big 8" accounting firms, the other two being from other accounting firms. This committee meets two days per month. There are no representatives from industry on this committee, and the meetings are closed.

The AICPA is working on a proposed statement of position affecting property/casualty companies. There are certain pronouncements in that casualty statement which, if adopted, will immediately become applicable to the life industry. These changes will primarily affect the value of investments and the reporting of realized gains. Some of the acquisition cost concepts included in the draft, if they had been adopted, could have caused a real change for life companies -- luckily, they weren't.

The AICPA has also formalized an exposure draft that outlines the situations in which an auditor should consider confirming life insurance policies in force. As you might surmise, this is an outgrowth of the Equity Funding situation in 1972.

Another matter under study by the AICPA is the subject of discounting. While we know that discounting is a sacred concept within the life insur-

ance industry, elsewhere, including the casualty industry, discounting is not as readily accepted. The committee is considering the preparation of an "issues paper" on the propriety of discounting in the insurance industry, per se. At this point, the idea is in the embryonic stage and has not yet been committed to paper.

Another item on the AICPA agenda relates to mutual life insurance companies. There is an AICPA Task Force which has been charged with the responsibility of developing required disclosures for GAAP reporting purposes for mutual life insurance companies. Now, while most mutuals, actuaries, and accountants consider statutory accounting to be GAAP for mutual life companies, there has been some question as to what footnote disclosure ought to accompany such financial statements. Accordingly, this task force is going to prepare a laundry list, e.g., lease commitments, related party transactions, reserve practices, etc., of the accounting pronouncements which are applicable to the mutual life companies and which must accompany these financial statements.

There is also the AICPA requirement that audit partners on SEC clients begin a rotation program by 1980. Under this compulsory program, an audit partner would service an account for no longer than a five-year period.

Another likely trend which is developing involves audit committees. In the past, audit committees would go through some rather superficial formalities, would meet twice a year, would invite the auditor in for an hour per year, would collect their audit committee fee, and the corporate ritual would come to an end. Recently, some audit committees have concluded that they should invite more people in for questioning. As such, they are now requesting, among others, that actuaries make an appearance and explain various matters. Such discussions with actuaries may not be limited solely to actuarial matters. Instead, topics may include internal controls, overall management capabilities, available actuarial talent in the company, related party transactions, sensitive transactions, and methods of possible defalcation in the actuarial area.

The NAIC has also been active and is currently in the process of developing compilations of statutory accounting practices which would be applicable to all life and all casualty insurers. To a certain extent, this is an offshoot of a similar project undertaken by the Illinois Insurance Department a few years ago, which project culminated in the issuance of two separate books of accounting practices. The initial drafting of these NAIC publications is scheduled to be completed by the end of August 1978 and the publications should be in the final printing stages near the end of the year.

In a similar vein, the Massachusetts Insurance Department has been outspoken in its approach to accounting practices for insurance companies doing business in Massachusetts. Their deputy director has advocated some type of multi-faceted reconciliation between SAP, GAAP, liquidation basis, going concern basis, rate making basis, and/or tax basis financial statements. This effort may ultimately have some impact on the Massachusetts Insurance Department reporting requirements.

MR. BRUCE E. NICKERSON: It is a little difficult to separate statutory accounting from valuation unless you are changing the asset valuation rules. All

the action is on the liability side, and most of that is an actuarial evaluation. The focus of statutory accounting is to concentrate on solvency, consistency between assets and liabilities, and consistency from year to year. In rather direct contrast, GAAP concentrates on matching expenses and revenues. Currently we are in a period of major reconsideration of basic insurance company practices by many governmental bodies, state, federal, regulatory, legislative, and judicial. The statutory blank in essentially its current form has been used for decades. It was the only form of accounting for life insurance companies until GAAP came along. In particular, the existence of GAAP as a second method of accounting for insurance companies has led to comparisons and questions of whether statutory accounting is adequate.

A few years ago the NAIC established a new committee, the Accounting Practices and Procedures Committee. The first major issue that hit the committee was deep discount bonds, which are amortized for statutory purposes. When the bonds eventually matured there would be a big capital gains tax, and a company which had many of the bonds wanted to set up a liability for this tax. When the committee considered it, they decided that they would rather take a look at the entire area of deferred taxes for which there is no explicit provision in the statutory blank. Then they realized that there was no statement of objectives and no conceptual framework for statutory accounting. So as their first substantive activity, the committee proposed a conceptual framework for statutory accounting and proposed a statement on treatment of deferred taxes and provisions for future taxes. At the NAIC meeting in December of 1977 they came very close to adopting the conceptual framework language, but decided that they would put it off for further consideration and further public exposure, and they did not take action at that time on the tax issue.

About that time, Massachusetts announced that it was engaging in a major project to investigate, then quite probably redesign the statutory statement to be filed by companies doing business in the State of Massachusetts. There were many concerns expressed by the Commissioner of Massachusetts that led to this project. He felt that disclosure of litigation and disclosure of transactions with affiliates, holding companies and subsidiaries was not adequate. There were also concerns about property and casualty reserve adequacy and Schedules O and P. He felt more information was needed on types of reinsurance arrangements. He felt that there should be CPA audits annually. They had had an unfortunate experience with a near insolvency of a Massachusetts domesticated insurer and they felt very strongly that neither the department nor management had enough information available from the statutory blank to act in a timely manner. So the department is tentatively considering two types of reporting. The first is referred to as a liquidation basis, but it may not be quite that. They are interested in the net realizable value of the assets but not on a forced sale basis. They also want a going-concern basis of reporting. They are inclined to think that GAAP is better than statutory, but they even have concerns about GAAP. Here they express concerns about the use of historical cost for fixed assets, about the use of amortized value for bonds, and the different treatments between realized and unrealized gains. They are concerned about the deferred acquisition cost asset, which doesn't go very far in paying claims, and they are concerned about the GAAP treatment of deferred taxes. They see statutory accounting as a compromise between a going-concern and a liquidation type approach, but in fact failing to give good basis for either.

Finally, they are very concerned about the relationship between the information that they get for rate making and rate control purposes in those insurance lines in which they have to make decisions. They want to know how that information relates to the statutory accounting methods.