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CURRENT DEVELOPMENTS IN FINANCIAL REPORTING

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MR. JOE B. PHARR: A useful tool for discussions of the purchase method of accounting has been to establish the basic or fundamental relationships which are involved. A rather simplified method for expressing such relationships is as follows:

$$C - (TA + IA - L) = G$$

In the above equation, C denotes the cost of the acquired company, TA denotes tangible assets at fair value, IA denotes identifiable intangible

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assets (values of business in force and value of agency force, for example), L denotes liabilities for future benefits at "fair value" and G denotes goodwill (a balancing item to the equation), if any.

The methods and responses to purchase accounting situations observed in practice show considerable variations and quite often seem to involve as much emotion as logic. Materiality seems to be a principal consideration, also. The industry seems to be badly in need of more precise guidelines at least for the use of actuaries in understanding the concepts of the purchase method of accounting.

There seems to be some conflict between the recent promulgation of actuarial guidelines such as the Academy's Interpretation 1-D and practices allowed under accounting guidelines and practices. There seems to be considerably more flexibility in establishing procedures and assumptions as far as the accounting profession is concerned as opposed to typical approaches and guidelines followed by actuaries.

It is believed that it is very important for actuaries to better understand this situation. Examples of the types of flexibility which come to mind would include the approaches for obtaining estimates as to values of business in force. Apparently future profits can either be discounted at a reasonable current interest rate or a risk discount rate or they can be estimated as margins relative to future projected premium revenue. Once a reasonable value of business in force has been identified as part of an intangible asset, methods for amortizing such assets are rather numerous: straight line (probably not exceeding 40 years); double declining balance; percentage of projected premium revenue; follow future projected earnings patterns; and rate of return on the amounts paid for the in force business.

Paragraph 4 of Recommendation 4 by the American Academy of Actuaries indicates that rather simplified approaches are appropriate for measuring the impact of reinsurance ceded on GAAP financials. Quite often this statement seems to have been used to adjust for reinsurance ceded without reference to materiality (one might wish to refer to American Academy of Actuaries <u>Survey of GAAP Practices</u>). Interpretation 4-A, from the Academy, seeks to remind the actuaries that special care should be exercised in taking into consideration materiality where a simplified approach is used and references are made to previous publications on handling reinsurance for GAAP reporting purposes in the <u>Transactions</u> of the Society of Actuaries (Dick Robertson's paper).

Quite often, at least in actuarial circles, one often hears disparaging remarks made about GAAP financials for life insurance companies. It would seem based on such remarks that GAAP financials are not widely used for management reporting and decision making purposes. However, it is doubted that accountants would hold that GAAP financials are necessarily the ultimate approach for providing the most meaningful financial statements for life companies.

Hence, what are the most readily available or appropriate alternatives for providing management with meaningful life insurance financial statements? The statutory Annual Statement? Financial statements used to support IRS filings? Internal company calculations relative to increases in present values of future profits on business written?

It is submitted that the production of GAAP financials currently does provide life insurance company management with the most meaningful financial statements for management purposes and analyses that are readily available. Furthermore, several experiences indicate that such financials have significantly altered managements' views of the profitability, or lack of profitability, of some major lines of business.

Several life insurance companies routinely produce GAAP financials for internal operating purposes and make reconciliations to statutory financial statements either in footnotes to published financial statements or totally disregard the statutory figures for day to day management purposes. Admittedly these experiences are based on observations and discussions with several large life insurance companies in the southeastern part of the United States, but it would not be surprising that this view is compatible with the views of management of many other stock life insurance companies.

"Loss Recognition" is covered rather clearly in the Audit Guide on pages 86 and 87. "Recoverability" is mentioned in about three places in the Audit Guide (more specific references will be found in the "Ernst & Ernst GAAP" publication in Chapter 24 on "Recoverability and Loss Recognition").

In any discussion of "loss recognition", one should keep in mind that the prior GAAP financials are "locked-in" unless a life insurance company fails the prescribed "loss recognition" tests.

Although some actuaries consider "loss recognition" and "recoverability" tests as being the same, there would seem to be a number of rather clear distinctions between such tests.

With respect to "loss recognition" tests, timing of such exercises is when the losses first become apparent. Although the Audit Guide suggests that gross premium reserves be compared periodically with actual reserves (benefit reserves less deferred acquisition expenses), such exercises would seem to be quite costly and a rather harsh requirement for life insurance companies. Hence, it would seem that these tests clearly are required only when there is probable cause or reason. The mechanics of the "loss recognition" tests seem rather clear in that gross premium valuation reserves are compared with GAAP benefit reserves less deferred acquisition expenses. If the gross premium valuation reserve exceeds the net of the GAAP benefit reserves less deferred acquisition expenses then no "loss recognition" situation exists and the company remains locked-in to its prior assumptions. Revised assumptions based on actual and anticipated experience are appropriate for loss recognition tests. Such assumptions are interpreted to mean assumptions with no inherent or expected margins for adverse deviation. Expense assumptions should be singled out for particular emphasis from an actuarial viewpoint. Apparently, it is not necessary (from an accounting point of view) in the selection of such assumptions to fully cover overhead and service expenses, for example.

"Recoverability" might better be described as "issue year recoverability". "Recoverability" tests are associated with the deferral of acquisition expenses and should be available each time acquisition expenses are deferred. It would seem that typical actuarial profit analyses, or asset share or book profit type of tests would be appropriate to show that gross premiums are sufficient to cover future benefits and expenses and the amortization of the acquisition expenses being deferred. With the respect to assumptions they would seem to be the same type as those used for "loss recognition". Apparently "recoverability" profit analyses can be such that the maintenance expense assumptions do not need to fully cover overhead and service allowances and furthermore the tests would not need to show a margin for profit (all from an accounting perspective). Furthermore, the excess acquisition costs and developmental costs could be excluded from the "recoverability" tests.

On page 64 of the AICPA Audit Guide, it is indicated that in the actuary's choice of assumption he has responsibility to use assumptions which are "adequate and appropriate" and that such choice and responsibility is consistent, under generally accepted accounting principles, that actuarial assumptions be characterized by conservatism which is "reasonable and realistic".

There seems to be some natural tendency to have been somewhat conservative in selecting actuarial assumptions in initial GAAP conversions. However, in recent years there seems to be less conservatism in the selection of new business assumptions. In other words, there recently seems to be more emphasis on the "reasonable and realistic" aspect of actuarial assumptions and less emphasis on "conservatism".

For example, the selection of interest rates for recent blocks of new business seem to put more emphasis on "reasonable and realistic" than would have seemed to be the case in the initial conversions. Furthermore, definitions of deferrable GAAP acquisition expenses may be more liberal in that there is more emphasis on whether the expenses are primarily related to the production of new business as opposed to varying directly with the production of new business.

The recent American Academy of Actuaries "Survey of GAAP Practices", which was sent to 125 stock life insurance companies in the United States who employed two or more actuaries, indicates the following general trends:

(1) Most companies have indicated no apparent "recoverability" deficiencies on current issues and "loss recognition" tests have not been performed by a majority of the life companies since original conversion to GAAP.

(2) A majority of the companies seem to utilize their own experience or professional judgement in setting assumptions for GAAP relative to interest, lapse and expenses. There has been some tendency to use intercompany experiences in the mortality and morbidity areas. The underlying actuarial assumptions seem to be based more on implicit rather than explicit provisions for margins for adverse deviation.

(3) Appropriate GAAP interest rates, used for non-participating whole life type policies issued in 1977, average approximately 6½% initially grading down to around 4½% by the thirtieth policy year. More than two-thirds of the companies consider interest assumptions as being before federal income taxes.

(4) Expenses which are clearly deferrable for GAAP purposes include: agents commissions, general agents override, medical examinations, inspection reports, underwriting department and policy issue.

(5) In response to the methods used to defer GAAP acquisition expenses, approximately two-thirds of the companies use the factor approach as opposed to a worksheet approach. Most companies indicated the use of interest in their amortization procedures.

(6) About one-third of the actuaries responding did not indicate that they provided actuarial reports in accordance with Recommendation 3 of the American Academy of Actuaries with reference to the documentation of GAAP assumptions and methods.

(7) A significant majority of the companies indicated that the following sublines of business were not adjusted from statutory levels: reduced paid-up life insurance; extended term insurance; premium waiver disability; active and disabled lives and accidental death benefits.

These American Academy of Actuaries GAAP survey results do not seem inconsistent with the December, 1975 LOMA "second survey" of GAAP practices and assumptions.

MR. **CLAIRE J. GALLOWAY:** The GAAP disclosures in financial statements are generally governed by the official pronouncements of the boards and committees of the American Institute of Certified Public Accountants, the successor board for official pronouncements, the Financial Accounting Standards Board, and from regulators of "public companies", the most prominent being the Securities and Exchange Commission. Some of the specific GAAP disclosure requirements for life insurance companies are found in the Industry Audit Guide prepared by the Committee on Insurance Accounting and Auditing of the American Institute of Certified Public Accountants entitled "Audits of Stock Life Insurance Companies." The disclosure requirements in these official pronouncements and regulations are most often the same, differing only in the amount of detail that is prescribed for each item. In considering the disclosures that are necessary for life insurance financial statements it is necessary to look to all these sources with specific attention given to the disclosure requirements peculiar to the life insurance industry.

General Requirements

The Industry Audit Guide suggests some specific disclosures required for stock life insurance companies. That guide also prescribes that the GAAP contained therein is applicable to all stock life insurance companies. It specifically exempts mutual life insurance companies from the application of GAAP as set forth therein. Regulation S-X which governs the form and content of financial statements filed under the Federal Securities Acts contains similar rules of application except it also excludes wholly-owned stock life insurance company subsidiaries of mutual life insurance companies.

All stock life insurance companies are required to include a reconciliation that discloses material differences between the statutory capital and surplus and net gains from operations and the GAAP stockholders' equity and net income. This disclosure is required to be in a tabular form and usually will be included in the notes to financial statements accompanied by explanations of items not apparent from their title.

Investments

There is an underlying GAAP principle that investments are to be carried at cost. Cost can be the original purchase price, the original purchase price adjusted for amortization of premium or discounts, original purchase price minus permanent write-downs, and underlying net asset values. Each of these definitions can be described "cost" and an investment caption may contain a mixture of all of them. The adjustment to the cost basis for an investment is carried to the income statement. Adjustments that arise from time to time from the change in market value are carried to a valuation account in the shareholders' equity. For insurance companies marketable securities are usually carried on the basis of market value with the alternative cost amount being disclosed either on the face of the balance sheet or in the notes to financial statements. Other investments are stated on the basis of cost and in the case of real estate investment the amount of accumulated depreciation or amortization is disclosed. As a general rule, if any class of investment exceeds 5% of the total assets, it should be set forth separately under a separate caption. Where the investments in a single person or affiliate exceed 2% of total investments, a disclosure is required to provide the name of the investee.

Accounts Receivable

Under GAAP accounting a life insurance company may have a series of receivables that would be considered "not-admitted" in the annual statement blank. These amounts may consist of amounts due from agents, amounts of uncollected premiums, and other receivables arising in the normal course of operation of the company. Any class of receivables in excess of 5% of the total assets should be shown separately. Allowances provided against any of the receivables for doubtful accounts should be disclosed if the amounts are material. One item in the nature of accounts receivable, that is deferred premiums, is not included in the accounts receivable but is deducted from the liability for future policy benefits.

Deferred Policy Acquisition Costs

The expense reserve portion of the policy reserve must be shown as an asset in the balance sheet. Only that portion of deferred and uncollected premiums which are adjustments of future policy benefits may be deducted from the liability for policy reserves. It is necessary that disclosure be made of the nature of the costs deferred such as commissions and other expenses directly related to the production of premiums. The method of amortizing this expense reserve to the income statement must also be disclosed in footnotes to the financial statements. The amount of the acquisition costs deferred may be shown as a deduction of the expenses incurred or it may be netted against the appropriate expense categories. However, it is necessary to disclose separately any amount in the acquisition costs deferred which is in excess of 15% of the total amount of deferred policy acquisition costs. The amount of policy acquisition costs that is amortized and charged to the income statement must be set forth separately.

Property and Equipment Used in the Business

Property and all equipment used in the conduct of the business operation must be stated on the basis of cost. The amount of accumulated depreciation on the property and equipment must be stated separately. The net amount is the carrying value in the balance sheet. If there are encumbrances against the property and equipment, they must be set forth separately as a liability.

Future Policy Benefits

The benefit portion of the policy reserve must be stated separately on the balance sheet for life insurance and accident and health insurance. The disclosure of the valuation basis, the interest assumptions used, the withdrawal assumptions, and other assumptions and computational methods are usually disclosed in the notes to the financial statements in a tabular form.

Income Taxes

The balance sheet will usually disclose the amount of currently payable income taxes and the amount of deferred income taxes. The notes to the financial statements should disclose the general nature of income taxes applicable to a life insurance company and should state the amount and the nature of untaxed income. The amount of the policyholders' surplus account and the future contingency arising from that special surplus should be described in the footnotes. It is necessary to disclose the amount of net operating loss available, if any, and the reason for the variation from the usual and expected tax rates. If an assessment has been made by the Internal Revenue Service, disclosure of the potential of that assessment must also be made in the notes to financial statements.

Undistributed Earnings on Participating Business

For those companies which have limitations upon surplus relating to the restriction of earnings on participating policies it is necessary to calculate the total liability to the participating policyholders and disclose the total undistributed earnings of the participating policyholders in the balance sheet. Dividends that have accrued on current policies are excluded from this amount and are recorded separately as a liability. The method of determining participating policyholders' share of earnings should be described and disclosed in the footnotes to the financial statements.

Capital and Surplus

Each class of capital shares must be disclosed by their title. The shares authorized, issued and outstanding must be disclosed. The amount of additional paid-in capital is set forth in a separate caption. The amount of accumulated unrealized appreciation or depreciation on investment securities is set out as a separate item in the capital and surplus section of the balance sheet. Earnings retained for use in the business are disclosed separately. It is also necessary to describe the changes in each of these accounts from year to year as well as describing any restriction on any of the surplus accounts.

Premiums and Expenses

Premiums arising from life insurance and annuities and accident and health insurance should be disclosed separately, if significant. Other premium and consideration except supplementary contracts may be combined. The consideration for supplementary contracts are excluded from the income account and must also be excluded from policy benefits. A footnote disclosure should describe the method of recognizing premium revenues. Investment expenses should be deducted from investment income and disclosed parenthetically. Any material classes of expenses not deferred should be shown separately.

Other Disclosures

There are a number of other GAAP disclosures that should be made and usually will be found in the notes to financial statements. These include items such as reinsurance contracts, summary of accounting principles and practices, the essential provision of pension plans including cost of the plan for the period, the excess of vested benefits over total fund assets, and unfunded past service costs. Other disclosures to be considered include material commitments and contingencies, details of stock option plans and warrants or rights outstanding, significant lease commitments, and selected quarterly financial data.

In this discussion we will focus on two of the recent pronouncements of the Financial Accounting Standards Board that impact the reporting of stock life insurance companies.

FASB Statement No. 14 entitled Financial Reporting for Segments of a Business Enterprise has presented some troublesome aspects for life insurance company reporting. The Statement is not difficult to understand but there is a wide variance of interpretation as to its application to life insurance companies. Appendix D set forth some factors that should be considered in determining whether products and services are related for purposes of industry segment reporting. The first criterion is the nature of the product. The opinion states that if the products or services have similar purposes then they may be expected to have similar rates for profitability, degrees of risk, and opportunities for growth. The second criterion refers to the nature of the production process. This criterion has little effect upon life insurance company reporting considerations. The last criterion is markets and marketing methods. The FASB felt that if there were similar geographical marketing areas, similar types of customers and similar marketing methods that this might lead an industry to conclude that there is a single product or service. Following these criteria it was easy to conclude that in most instances the sales of life insurance, annuities, and accident and health contracts are a single business segment. The Securities and Exchange Commission indicated in their Accounting Series Release No. 244 that such an easy conclusion was not in accordance with FASB Statement No. 14. While they did not include in that Statement a reference to life insurance companies, they did include references to property/casualty companies. Here they indicated that the identification of industry segments would require an analysis to (1) list the various products and services sold and (2) group the related products on a basis of relevant factors including the nature of the product and their markets and marketing methods. The SEC staff in their example stated that consideration should be given to the profitability, risk, and growth of the products. They held that all insurance products are not sufficiently related to be grouped together as one industry segment. The SEC staff position seems to be that no large company can have a single business segment. It would appear that at a minimum companies will have to show business segments at least as detailed as shown on page 5 in the Annual Statement Blank.

FASB Statement No. 16 - Prior Period Adjustments requires that all profits and losses be recognized during the current period. This Statement **requires** that accruals of estimated losses from loss contingencies be included in the determination of income for the current period. The previous standard was a little more permissive and generally allowed restatement of prior periods where the adjustments depended primarily on determination by persons other than management and were not susceptible to reasonable estimation prior to that determination. The current Statement effectively removes those adjustments and makes only two exceptions to the requirement that all profit and loss be recognized in the current period. One exception is that it is permissible to restate the financial statements for the correction of an error in the financial statements of a prior period. Such an error would be primarily the result of a mathematical calculation. Errors in estimates would not be considered errors for purpose of restating the financial statements. The second exception results when there is a realization of income tax benefits of pre-acquisition operating loss carry-forwards of purchased subsidiaries. These adjustments would be quite rare for most companies.

The concept of materiality is a fundamental consideration in the financial accounting and reporting process. While there is no conceptual disagreement for the disposition of material items, the absolute measurement of an item described as material is subject to numerous interpretations. The American Institute of Certified Public Accountants in its first Accounting Research Bulletin issued in 1939 rather succinctly stated the materiality concept as follows:

> The Committee contemplates that its pronouncements will have application only to items large enough to be material and significant in the relative circumstances. It considers that items of little or no consequence may be dealt with as expediency may suggest.

This general idea suggests that a thorough consideration of the relative circumstances should provide the criterion for whether or not an item is material and would require adjustment. This concept does provide broad latitude for management to assess the materiality and significance of an item of income, expense, asset, liability, or net worth. Materiality must be measured in terms of the total financial statements and not relegated to a simplistic approach of considering only one of the previously-mentioned items. However, in recent years the Accounting Principles Board, the Securities and Exchange Commission, and other regulatory agencies have resorted to rule making to determine whether or not an item is material. For example in Accounting Principles Board Opinion No. 15, relating to earnings per share, the Board concluded:

> Any reduction of less than 3% in the aggregate need not be considered as dilution in the computation and presentation of earnings per share data as discussed throughout this opinion.

The APB made numerous other references to materiality but did not undertake to address the specific question of measurement for materiality rather leaving to management the responsibility of making that determination. The APB in general ruled that the materiality of an item should be considered to the extent that it was material to the total year's operation.

The Securities and Exchange Commission in Regulation S-X defines material as follows:

> The term material when used to qualify a requirement for furnishing of information as to any subject limits the information required to those matters about which an average prudent investor ought reasonably to be informed.

In other sections of Regulation S-X the SEC has set **quantitative materiality** guidelines. For example, a significant subsidiary for purposes of filing separate financial statements are defined as being those that exceed 10% of total assets, 10% of total sales and revenue, or 10% of income before income taxes.

In other guides published by the SEC references are made to disclosure requirements for changes in assets or liabilities of 10% and changes in net income or loss of 2%.

Other government bodies such as the Cost Accounting Standards Board and the Interstate Commerce Commission published rules and regulations that set some **quantitative measures for a material item. For example, the Interstate** Commerce Commission gives a general standard as follows:

> In determining materiality, items of a similar nature should be considered in the aggregate; dissimilar items should be considered individually. As a general standard, an item to qualify for inclusion as an extraordinary or prior period item shall exceed 1% of the total operating revenues and 10% of ordinary income for the year.

The Financial Accounting Standards Board is studying the concept of materiality at the present time. When the FASB may complete this study and issue **quantitative measures of materiality is not known.**

As a general guideline for measuring materiality of an item going into the income statement, it probably would be safe to assume that any adjustment in excess of 10% of the net income would likely qualify as being significant.

Summary

Some of the disclosures required in GAAP financial statements can be found in the Audit Guide for Stock Life Insurance Companies and includes such items as deferred policy acquisition costs, future policy benefits, deferred income taxes, and reinsurance contracts. Other GAAP disclosures are set forth in opinions issued by the boards and committees of the American Institute of Certified Public Accountants, the Financial Accounting Standards Board, and the Securities and Exchange Commission. Only those companies that are required to file financial statements with the Securities and Exchange Commission must abide by the rules published by that body. To provide the disclosure of GAAP data in GAAP financial statements on a current basis it is necessary to be aware of changes promulgated by the rule-making bodies. GAAP disclosures need not be made for immaterial items. The measure of materiality is based on factors such as the absolute dollar amounts, the relationship of the item to either the balance sheet or the income statement, and the needs of an average prudent investor.

MR. JOHN K. BOOTH: Broad statutory authority is given to the commissioner of each state to require annual statements from insurers. An example of the breadth of the commissioners' powers with regard to statutory accounting is contained in Section 26 of the New York Insurance Law which states:

> "Every insurer and every fraternal benefit society which is authorized to do insurance business in this state, and every pension fund, retirement system or state fund which is required by any law of this state to report to the superintendent or is subject to his examination, shall file in the office of the superintendent, annually on or before the first day of March, a statement, to be known as its annual statement, executed in duplicate, verified by the oath of at least two of its principal officers, showing its condition on the thirty-first day of December then next preceding or, in the case of a pension fund or retirement system, on such date in the year next preceding as the superintendent may approve. Such statement shall be in such form and shall contain such matters as the superintendent shall prescribe."

Over the years insurance commissioners, to the extent permitted by the laws of their respective states, have cooperated through the National Association of Insurance Commissioners in developing uniform annual statement forms, uniform procedures for valuing securities and uniform procedures to be followed in examining the records of insurers. Out of this cooperative effort has emerged a set of practices and procedures for reporting to state regulatory authorities which is known as statutory accounting. For nearly a century statutory accounting was the only recognized form of accounting for insurance companies. It has provided and continues to provide the basis for regulators to measure an insurer's ability to fulfill its outstanding obligations to policyholders as they mature.

Within the last decade, as a result of criticisms from investors that insurance company financial statements are not comparable to those of other industries, the American Institute of Certified Public Accountants has developed audit guides for property and liability insurers and for stock life insurers which define generally accepted accounting principles for insurers for the purpose of providing a realistic and current appraisal to investors and the public of an insurer's earnings and net worth. As more and more insurers have published statements prepared in accordance with generally accepted accounting principles or have hired CPA firms to audit their statutory statements, there have been increasing questions as to the role of or support for the existing system of statutory accounting.

Recent Developments

In 1974, McKinsey and Company completed a study to determine how best to improve the state regulatory system for surveillance of insurance companies. One of the suggestions contained in their final report was that the NAIC assess the effectiveness of making greater use of CPA audits in financial surveillance of insurers. At about the same time, the states of Illinois and Massachusetts established CPA audit requirements as part of their financial surveillance systems. Illinois also undertook to compile all existing statutory accounting practices into a handbook and persuaded the NAIC to establish a Subcommittee on Accounting Practices and Procedures. The new Subcommittee, in trying to compile statutory accounting practices which are accepted nationwide, made little progress during its first year due to confusion regarding its relationship to NAIC Subcommittee on Blanks and the fact that there were some differences in reporting requirements among the various states.

During 1977, the Accounting Practices and Procedures Subcommittee modified its approach to statutory accounting topics when it took up the question of accounting for deferred taxes and several other issues. The deferred tax question was first raised before the NAIC Blanks Subcommittee in 1976 by a New York domiciled company which wished to establish a reserve for future taxes payable on deep discount bonds. Under statutory accounting the discount on such bonds must be accrued as interest each year, but for Federal tax purposes the discount is treated as a capital gain when the bond is sold or matures. The company argued that a proper matching of income and expense dictated that it increase its reserve in the statutory statement for future Federal taxes payable on the interest as it accrued each year. The New York Insurance Department had taken the position that in establishing such a reserve the company was trying to reduce surplus to avoid exceeding the upper limit on the accumulation of surplus prescribed by the New York Insurance Law. It argued that in all probability there would be no tax to pay since capital gains on the deep discount bonds would be offset against capital losses on other investments. In June, 1976, the NAIC Blanks Subcommittee concluded that accounting for deferred taxes was a broad issue which affects both life and property and liability insurers and that it should be referred to the Accounting Practices and Procedures Subcommittee. Under the chairmanship of Massachusetts, that Subcommittee called for white papers to be submitted on the subject of accounting for deferred taxes and the other accounting issues that were before it.

At a public hearing held by the Subcommittee in October, 1977, the American Council of Life Insurance urged that any position on accounting for reserves for future taxes payable should be consistent with the purposes of statutory accounting and therefore should recognize the likelihood of payment of future taxes, the tax rates which will be applicable and the time value of money. The Council specifically noted that the treatment of deferred taxes in Accounting Principles Board Opinion Number 11 is inconsistent with the reporting objectives of statutory accounting since it is concerned with the accrual of deferred taxes as a consequence of past allocations of revenues and expenses to particular accounting periods. The property and liability company trade associations were generally opposed to establishing a liability for deferred taxes in the statutory statement. Another issue that emerged from the discussion was the lack of a formal conceptual framework for statutory accounting.

Prior to the December, 1977 meeting of the NAIC, the Chairman of the Accounting Practices and Procedures Subcommittee released a statement of position on "Accounting for Future Income Taxes" which essentially tracked APB Opinion No. 11 and a statement of position on a "Conceptual Framework for Financial Reports to State Regulatory Authorities". These positions were opposed by the industry at the December, 1977 NAIC meeting with the result that action on accounting for future income taxes was postponed and the conceptual framework was adopted as an exposure draft. During the debate on the conceptual framework, it was pointed out that it would require statutory financial statements to make reasonable but not necessarily conservative provision for the risks of adverse deviations in future experience from underlying assumptions and to reflect economic reality. These objectives appeared to pave the way for replacing statutory accounting with generally accepted accounting principles. The intent of the Chairman of the Subcommittee on Accounting Practices and Procedures became more clear shortly after the December NAIC meeting when the Massachusetts Insurance Department sent out its "Request for Proposal to Consolidate Insurance Company Annual Statements".

Current Projects

The Massachusetts Insurance Department's"Request for Proposal to Consolidate Insurance Company Annual Statements" is a request to develop a new form of annual statement to replace the existing NAIC Statement which in the Department's words "does not fairly present a company on either a going concern or a liquidating basis". In January, 1978 the Department asked for bids from contractors to develop such a new annual statement and in March awarded the primary contract to Haldi Associates, Inc. of New York supported by Gorden Associates, Inc. of Washington with the actuarial firm of Woodward and Fondiller to do the primary casualty actuarial work.

Some of the specific ideas suggested by the Massachusetts Department for inclusion in the new annual report form are:

(1) a report form similar to Securities and Exchange Commission Form 10-K with expansion to include any additional non-financial information that is now included in the NAIC Statement,

(2) prime financial statements (balance sheet, income statement, etc.) presented on a basis similar to generally accepted accounting principles,

(3) a separate financial schedule presented on a liquidating basis and fully reconciled to the prime financial statements, and

(4) an allocation of income, losses and expenses by line and by state.

Much of the impetus for the Massachusetts annual statement project arises from the fact that data filed by property and liability insurers and health insurers in support of rate increases does not reconcile to annual statement data. The Massachusetts "Request" notes that the fact that insurers have sought and received substantial rate increases and at the same time have reported a profitable year to stockholders has raised questions in the minds of legislators and the public. The proposed allocation of financial results by line and by state is intended to make it easier to reconcile data supporting rate filings with annual financial statements. Another factor behind the project is the alleged failure of statutory accounting to disclose whether or not a Massachusetts life company which had recently been in receivership was or was not insolvent. The Massachusetts Insurance Department's position is that there is a need for liquidation schedules showing assets at their net realizable values and liabilities at an amount equal to the price that an independent person would demand for assuming them.

The original timetable for the Massachusetts annual financial report project called for completion by June 1, 1978 of a conceptual framework which would define the new report. A detailed draft regulation to implement the new report was to be completed by the fall of 1978, presumably so that the new report could be required at the end of 1978. Meanwhile, members of industry groups have met to discuss the implications of the project and there has been one formal meeting with the Massachusetts Insurance Department. Although the Massachusetts Department remains totally committed to the project, recent information indicates that they will probably concentrate on developing a new annual report form for property and liability insurers and postpone for the moment the development of a new life company financial report. The American Council of Life Insurance has formed a Task Force on Massachusetts

Annual Financial Report which will be monitoring developments as the project moves forward and recommending Council action when that appears appropriate.

A more recent development which extends discussion of the Massachusetts proposal to an even broader forum, was the appointment by the Chairman of the NAIC Blanks Subcommittee in March, 1978 of a task force to review the NAIC Statement with the following five objectives:

(1) to determine what schedules can be deleted, simplified, consolidated or transferred into interrogatories,

(2) to recommend possible methods of reconciling net income on a statutory basis to net income on the basis of generally accepted accounting principles,

(3) to recommend methods for reconciling capital and surplus on a statutory basis with capital and surplus on a liquidating basis,

(4) to recommend methods for reconciling annual statement data with that filed for rate-making or rate-review purposes, and

(5) to develop alternatives for more adequately reporting each kind of insurance in the same manner by all insurers so that the effects on financial condition of interownership among insurers is more clearly displayed.

The task force was instructed to complete its review of the first two objectives by December, 1978 and the other three by December, 1979.

At the same time the NAIC Accounting Practices and Procedures Subcommittee, under the leadership of a new chairman from Illinois, initiated a project to compile current accounting practices and procedures using the Illinois Handbook of Statutory Accounting Practices as a starting point and to publish the compilation under the auspices of the NAIC. This compilation would present the prevailing view on statutory accounting issues and is scheduled for completion by the end of 1978. The NAIC Subcommittee further resolved that after the compilation has been completed, it would commence a review of current accounting practices and procedures to establish uniform and prescribed accounting practices and procedures which would serve as a standard to be adopted by all states. Two task forces, one for life and accident and health insurance and one for property and liability insurance, along with industry advisory committees are being appointed to work on this project.

Financial reporting for health insurance will also be examined inasmuch as the NAIC Blanks Subcommittee has appointed a Task Force on Uniform Reporting of Accident and Health Business for Life, Fraternal and Casualty Statements. Recommendations from this task force are to be presented in December, 1978 for implementation at the 1979 Blanks Subcommittee meeting. In December, 1977, the NAIC Subcommittee on Profitability and Investment Income in Property and Liability Insurance adopted recommendations that its scope be temporarily expanded to include life and health insurance so that it could study a proposal by the Missouri Insurance Department to include accident and health insurance in the NAIC's profitability report by line and by state.

Changes in the 1978 Annual Statement Blank

While the many projects to review or overhaul statutory accounting were being initiated, the NAIC Subcommittees on Valuation of Securities and Blanks adopted a number of changes which will have immediate impact in annual statements to be filed in 1978. In March, 1978, the Valuation of Securities Subcommittee adopted a proposal by the American Council of Life Insurance to make permanent the temporary mandatory securities valuation reserve rule which allowed companies to restore surplus incursions arising from 1973 and 1974 common stock losses. Under the new rule, if losses on common stocks in 1973 or any later year exhaust the common stock component of the MSVR and losses in excess of the component are charged against surplus, surplus incursions caused by such excess losses can be restored by common stock gains in subsequent years before such gains are required to be credited to the MSVR common stock component. Although the NAIC will reconsider this proposal in June, 1978, the action of the Subcommittee makes favorable action by the NAIC quite likely.

Probably the most significant change in this year's Blank is the new Separate Accounts Blank which was originally adopted by the NAIC in 1977 for implementation in 1978. Since the new Blank is based on a fund accounting rather than line of business approach, substantial changes in reporting this business may be required of some companies. These changes are covered in great detail in "Teaching Session 1: New Separate Account Statement Blank" on pages 1003 through 1041 of the 1977 Record of the Society of Actuaries. As with any project of this magnitude, a large number of editorial and other minor errors have been discovered and corrections were adopted by the NAIC Blanks Subcommittee in March, 1978.

Some other items which were adopted by the NAIC Blanks Subcommittee at its spring meeting are a new interrogatory relating to the control of large segments of a company's business by one agent, an increase in the threshold for reporting salaries in Schedules SIS and G from $30,000 to $40,000, a change of captions on the liabilities and summary of operations pages to provide for reporting group annuity deposit administration funds, and a statement of the purpose of the NAIC statement for Canadian life insurers operating in the United States. With regard to the last of these changes, the Blanks Subcommittee appointed a Task Force to review the manner in which Canadian companies report their United States business and to make recommendations for changes if required.

Future Outlook for Statutory Accounting

Statutory accounting is probably facing as much scrutiny from various NAIC Subcommittees today as it has at any time in the past. Although the statutory system appears to have served most regulators well over the years, the very existence of alternative accounting practices gives support to those who say the current statutory system is inadequate. The concern of the public and legislators over rising costs of property and liability insurance and of health insurance increases pressure for a system to account for insurance profits and losses that ties them directly to requests for regulatory approval of rate changes in a way that is comprehensible to the layman.

The compilation of statutory accounting practices and procedures will distinguish statutory accounting and its objectives from other kinds of accounting and their objectives. Certainly this will be helpful in determining what, if any, changes should be made in current statutory accounting practices. Any major changes in the statutory accounting system could affect the level of federal taxes. The current uniform system of statutory accounting has served regulators and the industry well over the past century and has evolved to meet the new challenges to our business. As regulators study proposed new approaches to statutory accounting, we should emphasize the need for uniformity and remind them of the implications of accounting changes for the business and for our policyholders.