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FINANCIAL REPORTING IN CANADA AND IN THE U.S.

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1. 1978 Canadian Accounting Changes

   a. What they are
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2. U.S. GAAP Developments

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MR. KENNETH T. CLARK: The Canadian life insurance business is basically the same as the American one, but there are some differences. There are not as many companies in Canada, even in proportion to population, and the cleavage between stock and mutual is not so sharp in Canada. Stock companies write substantial par business and mutual companies write substantial non-par business. And, finally, many Canadian companies have very large foreign operations which is a complication on account of exchange of currency rates and different reserving requirements in different countries.

As to how we got where we are, I will not say much. Suffice it to say that in Canada as in the United States, things started because of pressure for better income reporting. The actuarial and accounting professions had their go at the thing--so did the industry--but, nothing really happened until our Federal Department of Insurance took the initiative. They are the people who made the whole thing possible. On their recommendation, we got some new legislation which took effect for the 1978 financial reporting year. The new legislation, I believe, is a very fine piece of work. One of the things that makes it a fine piece of work is not what it does but what it does not do. It does deal with the traditional and proper solvency concern of the regulator. It does create a means by which the two GAAP's, Generally Accepted Actuarial and Generally Accepted Accounting Principles, can develop and be used. But, it does not define what these principles should be. There are a few hints. The first thing tackled was the question of assets. The attempt was to get a way of reporting asset valuation and the income from those assets in a way which no longer inhibited investment decisions and permitted the actuary to better formulate his assumptions for projections. The main change is in the area of capital gains. In the case of bonds, if you have a bond which you bought at 100 with an 8% coupon that is now trading at 80, the right investment decision might be to sell the bond and reinvest in something at a better yield. To do that involves

swallowing an up-front loss. It also obscures the problem of what the actuary's investment assumption should be. Under the new legislation, the capital gain or loss, when realized, is brought into income over the remaining term of the bond so that the decision to sell or to hold will not affect the income that is reported with respect to that bond. In the case of stock, the problem is with unrealized capital gains, and there what we are doing is bringing that into income on a gradual basis. The formula results in about 7% of the difference between book and market being brought into each year's income. There is obviously nothing magic about 7%, but a lot of careful tests show that it gave reasonable results. We now have, I think, a rational system for income reporting of assets,and we have something that the actuaries can look at when setting assumptions.

This gets us to the liabilities. For the liabilities, the board of directors of each company has to appoint a valuation actuary. He has to be an FCIA, but, otherwise, can be anything at all. The CIA itself has responded to this by developing a set of recommendations embodied in CIA Opinion #6 which is analogous to the Society and Academy Opinion #6. In 1978, the recommendations were not binding on the membership, but the Council urged everyone to be mindful of them. They are now binding because they were adopted by the Council and by the membership at our June meeting. The recommendations consist of 25 typewritten pages. They deal with the appointment of the valuation actuary and one's comportment in that position. They deal with how the actuary should be sure he is dealing with proper valuation files, how he should make his assumptions, what kind of valuation methods he should use, and how he should make his reports for the purpose of the government's statement and any other published financial statements.

We have $1.3 billion of reserves released as a result of the revaluation but a lot of that is not distributable income and much of it has been admitted to surplus only to be appropriated. One problem that remains is that we need more standardization in the work of valuation actuaries.

That gets me to where we are going. We do not have GAAP and there is still a strong desire to get to that. The CIA and the CICA (Canadian Institute of Chartered Accountants) have formed a joint task force to recommend to the two professions principles which can become generally accepted actuarial and generally accepted accounting principles. It is stipulated that those principles must be capable of application in a single set of financial statements which will be applicable to both solvency and income reporting. They must apply to life and accident and sickness insurance and to participating and non-participating insurance and to stock and mutual companies. They must be in a form which permits them to be put into the CIA recommendations and into the CICA *Handbook*. And, finally, we have to do all of this by May of 1980 or at least write a report which demonstrates that we are making good progress. We have had only two meetings and are developing a working relationship with the accountants who have shown themselves very willing to accept some things which are strange to them. These include for example, the bringing into income of unrealized capital gains, and the idea of a mortality fluctuation reserve being something which is not an income manipulating device but which can improve the reporting of income. In short, I think they have shown a willingnesss to not get hung up on some traditional details of accounting principles. I am optimistic that we can work out something in cooperation with them that both professions can accept. Another development is that the CICA itself has a committee working

on what an auditor should do with the work of a specialist. That includes, of course, the work of a valuation actuary. They would like to adopt the system used in the United States where the auditor gives an unqualified report making no reference to the actuary. But, there are a lot of people in the accounting profession who think that, because of the importance of the actuary's work in life company financial reporting, it really is misleading the public to not acknowledge its existence. The new legislation in Canada requires that any published financial statement contain the actuary's opinion of the reserves and the CIA has formally recommended to the CICA that the auditor accept the work of the valuation actuary and state in his report that he has done so. I do not know what the CICA is going to do with that recommendation.

MR. RICHARD S. ROBERTSON: I wonder if I could ask a question about the experience of Canadian companies which have to also provide U.S. GAAP statements. Have the Canadian developments gone far enough that they have been able to simplify the second statement they have to prepare?

MR. CLARK: No. The companies in that position have had to do GAAP accounting for several years. There are not many of them because while a number of Canadian companies are subsidiaries of U.S. companies, in many cases they are so small that their reporting is not material. There are, however, a few companies which have been preparing U.S. GAAP reports for several years and they just have more work to do now. I think in time we may get to a point where a Canadian statement could be consolidated into a U.S. one and the U.S. auditor could accept it as being GAAP.

MR. VIRGIL D. WAGNER: With respect to the valuation actuary, you said he must be an FCIA. Is there any lesser way to become a valuation actuary?

MR. CLARK: As regards Canadian companies, the valuation actuary has to be an FCIA. There is provision in the legislation in the case of non-Canadian companies which have Canadian branches for a non-FCIA to be appointed. This requires the permission of the superintendent. It is intended that will happen only where the amount of the business involved is not large or the company is not active and it makes sense for the chief actuary of that company, whether he be sitting in London or New York or wherever, to do the work. But, the basic principle is obvious. It is felt that the valuation actuary should be an FCIA.

MR. PETER F. CHAPMAN: One of the things about the role of the valuation actuary in Canada that has intrigued me is the degree of insulation he has from any pressures that might be exerted from management to make the valuation more favorable in areas when circumstances might dictate. I think it might be interesting to the audience if you would point out what a company has to do to remove or change a valuation actuary.

MR. CLARK: The appointment must be made by the board of directors of the company. The officers themselves do not have that power. The superintendent of insurance has to be notified of any new appointment. For its part, the CIA has in its recommendations imposed the following requirements. If I become the valuation actuary for a company, I must communicate with my predecessor if at all possible and ask him if he was replaced because of any dispute concerning his recommendations, and he is under an obligation to disclose those facts to me so that in taking up the appointment I am at

least on notice that there was some past trouble. What we have tried to do is give a company the flexibility to fire its valuation actuary if it seems proper, but to put the successor on notice as to any difficulties concerning the termination.

MR. ROBERTSON: Let us move along to the subject of U.S. GAAP. We have two developments to talk about that I am aware of. The first is GAAP for mutuals.

MR. CHAPMAN: The issue of GAAP for mutuals has been with us for the better part of ten years, in defiance of whatever societal rules dictate the current rates of change in our profession and in our industry. Its relative stability and persistency are comforting. There are not too many old problems to hang on to and gnaw on these days. The AICPA, however, has now acted. The situation is stabilized, at least until the next change. But, first, some background.

When the Audit Guide was being prepared, the AICPA sidestepped the issue of GAAP for mutuals to avoid delaying its introduction for stock life insurance companies. The accounting and actuarial professions were both divided on this subject. Some members felt that the Audit Guide provisions for participating insurance issued by stock companies could apply equally well to participating insurance issued by mutual companies.

Others dissented on the basis of their perception of the nature of the entity. A stock life insurance company has investors who are entitled to an orderly, realistic portrait of the rate at which the value of their ownership interest is increasing, or decreasing. Matching revenues and expenses and calculating the present value of future flows of income and benefits on a realistic current basis comes closer than statutory accounting to portraying that portion of the net worth increase contributed by current earnings. By introducing recoverability tests for the amortization of capitalized acquisition expenses, and earnings tests for the current dividend scale assumptions, the stockholder comes closer to being informed of the contribution made by the company's participating insurance line to the soundness and growth potential of his investment.

But, what is the comparable concern of a mutual insurance company policyowner? He has no ownership interest in the sense of any of the conventional criteria of ownership. His interest in the company is limited to his reasonable expectations: the adequacy of the financial resources that underly the contractual guarantees, and the equitable apportionment of the cost of insurance. It is difficult for those who hold this position to understand how communicating a mutual company's financial results in terms of GAAP, as the Audit Guide defines it for stock companies, will convey useful information about either of these objectives.

Recognizing the absence of consensus over the unresolved issues, the AICPA limited itself to saying that the Audit Guide would not apply to mutual companies and to establishing a task force to look into the question of GAAP for mutuals. The activities of the task force over the almost ten years following the issue of the Audit Guide, accelerated and relaxed as the SEC either prodded them or ignored them. In 1976, the SEC proposed a rule which, if applied, would have resulted in mutual companies getting a "dirty" audit. The proposed language would have stated, in effect, that

the financial statements were not prepared in accordance with generally accepted accounting principles because these principles have not been defined for mutual life insurance companies.

Responding to protests, the SEC withdrew the proposed rule on the understanding the AICPA would accelerate its adaptation of the Audit Guide to mutual life insurance companies.

Within the last twelve months, however, the accounting rule-making authority shifted from the AICPA to the Financial Accounting Standards Board.

On the unassailable premise that FASB's rules will override the Audit Guide for any segment of any industry, the AICPA task force attempted, in August of this year, to discharge itself by releasing an exposure draft of its "Auditing Statement of Position".

The core of this Statement is its conclusion that "until an authoritative accounting pronouncement on the measurement principles and the financial statement presentation principles that should apply to the general purpose financial statements of mutual life insurance companies is issued by the Financial Accounting Standards Board, the accounting practices...prescribed or permitted by state insurance departments should be presumed to be generally accepted accounting principles for those companies' general purpose financial statements".

The Statement goes on to suggest appropriate language for the auditor to use in commenting on a mutual life insurance company's general purpose financial statement, language which explicitly equates GAAP for mutuals to statutory accounting.

Critics of the Statement and its position, drawn principally from actuaries and accountants employed or retained by stock companies, have been quick to pounce on the apparent inconsistency of the AICPA's position. If statutory accounting does not equal GAAP for stock companies, how can it for mutuals? They would prefer some limitation, restriction, or caveat on the use of the words "generally accepted accounting principles" in presenting a statement of statutory results.

Others, strangely enough in the employ of mutual companies, take the position that generally accepted accounting principles are those that depict fairly and accurately the financial position of the reporting entity. The differences, already cited, between stock and mutual companies, determine the conformity of statutory accounting to generally accepted accounting principles for the latter alone among life insurance companies.

There is some sanction for this point of view in Statement of Auditing Standards #5 which, in discussing the meaning of the term "present fairly in conformity with generally accepted accounting principles" says, in part, that "in the absence of pronouncements comprehended by Rule 203, the auditor should consider other possible sources of established accounting principles...including...industry accounting practices".

Although, personally, I am persuaded that SAAP equals GAAP for mutual life insurance companies, I sympathize with the discomfort of those of my good friends who would prefer terminology which would modify the absolute equation

between the two. They perceive an exception, a deviation from uniformity favoring one type of reporting entity. It is true that accounting is a delicate balance between uniformity and recognition of the idiosyncratic reporting problems of unique entities. The utility of financial statements can be severely impaired if the tension between the two is lost in favor of either mindless uniformity or a free form customized document that can neither be understood by anyone besides the preparer,or compared with any contemporary or prior document.

Finally, there should be no intemperate rejoicing by those of us who approve of the Statement. FASB Statement #12 "Accounting for Certain Marketable Securities" flatly acknowledges that "there is disagreement as to whether generally accepted accounting principles exist for mutual life insurance companies". And, they have the final rule-making power. I am not aware of any plans to use that power in the near future. But, I do know that FASB is hypersensitive to any distress displayed by the SEC which has not, within the last three years, questioned the meaning of GAAP for mutual life insurance companies. If the SEC is displeased with the AICPA's position, I think we will all find out rather quickly how FASB feels about how mutuals should report their financial results.

MR. HENRY B. RAMSEY: I just wanted to say that not all mutual life insurance company actuaries agree that SAAP equals GAAP. I am convinced that a better income statement for mutual life insurance companies will at some point be worth the effort on our part to develop and will be more useful to our management than the statutory statement.

MR. CHAPMAN: I did not mean to imply that all actuaries of mutual companies felt one way and all actuaries of stock companies felt another way. I think what I said was that those who said that SAAP equals GAAP work for mutual companies which is not quite the same thing. The second point is that in stating the position that SAAP equals GAAP, I am only talking about published accounting statements. I am not talking about any internal analysis that may be done for management purposes. In fact, we did an analysis at Mutual Benefit on the effect of acquisition expenses on our financial results. And, by employing relatively conservative assumptions, we did not get a great deal of difference in the results between SAAP and GAAP. I offer this as an illustration of the fact that many mutual companies are undoubtedly using some form of GAAP or modified GAAP analysis as a management tool. But, I think that information developed for management purposes is one thing. Information that is disseminated to the public and investors and creditors is quite another story.

MR. ROBERTSON: I would also assure you that not every actuary working for a stock company gets that concerned about calling GAAP and SAAP the same as mutual companies. Let us move to another subject still in the GAAP area. Peter, would you tell us what has been going on in the area of inflation accounting for insurance companies?

MR. CHAPMAN: Inflation accounting is another subject of more than casual interest to actuaries. The SEC, the accounting profession, financial analysts, and economists have become increasingly concerned about the quality of earnings reports in an era of endemic inflation. How much earnings are attributable to the effect of inflated inventories? Has adequate allowance been made for the replacement of capital assets?

The FASB, in December of last year and in March of this year, responded to these concerns by issuing two Exposure Drafts called respectively, "Financial Reporting and Changing Prices" and "Constant Dollar Accounting". The exposure draft identified six industries, including life insurance, which were sufficiently unique to place them beyond the reporting requirements exposed in the Draft. Special Task Groups were organized for each of the six industries. Three actuaries, including the chairman of this panel, served on the Insurance Task Group. The Financial Reporting Principles Committees of both the ACLI and the Academy of Actuaries were in close contact with the Task Group. Both bodies contributed statements of opinion.

In its Exposure Drafts, FASB defines current generally accepted accounting as historical cost/nominal dollar, meaning that capital assets are carried on the balance sheet at their historical cost less assumed depreciation, and current transactions, revenues and expenses, are reported in nominal dollars unadjusted for inflation. The draft goes on to introduce four new concepts:

1. Constant Dollar Accounting, which reports income and expenses in an operating statement in dollars that are linked to a measure of purchasing power. If, for example, January, 1977, were the base period, $1 of premium received in January, 1979, would be recorded as $ .86.

2. Current Cost Accounting, which reports assets in terms of current cost on the balance sheet date. This current cost may either be fair market price or depreciated value adjusted to replacement cost.

3. Current Cost/Constant Dollar, a combination of the first two that incorporates Current Cost Accounting and reports the entire results in dollars with fixed purchasing power.

4. Historical Cost/Constant Dollar, a compromise which reports assets at historical cost less depreciation and reports results in dollars adjusted to a purchasing power index.

The Drafts also suggest the classification of assets and liabilities into monetary and nonmonetary items. Monetary items are affected by depreciation of the dollar and should be adjusted accordingly. Bonds held at amortized values, time deposits, long-term receivables, life insurance cash surrender values, and notes payable are examples of monetary items. Nonmonetary items need not be adjusted for inflation because they are shown on a current value basis (common stock, inventories), or because they represent an intangible asset (patents and trademarks, goodwill), or because they are shown under the proposed Current Cost Accounting rules (property, plant, and equipment).

With this as background the Task Group went to work. Their principal recommendations were:

1. The basic financial statements should not be changed.

2. Any supplementary material presented should be capable of easy calculation and should be informative and comprehensible to users and preparers.

3. The effects of currency depreciation should be reported as a supplement, should show results over the most recent five-year period, and should include the impact on total revenues, operating income, net income, and shareholders' equity.

4. Further research and study on inflation accounting and the insurance industry is necessary.

The Task Group next turned its attention to the monetary/nonmonetary classification and concluded that it would be a satisfactory approximation to consider all insurance company assets and liabilities as monetary items. This would satisfy the stated criteria of simplicity of calculation and ease of understanding. A single-index ratio, the CPI-Urban could be applied to all items.

To justify its position, the Task Group had to assume the following:

1. Nonmonetary items, land, buildings, and equipment (mostly computer mainframes) are not a material part of an insurance company's balance sheet.

2. Deferred acquisition costs are monetary. They are not a claim to future services (nonmonetary by FASB definition) and not, for life insurance at least, an asset but, rather, a negative liability. They represent past services already performed and amortized by a flow of "constant", i.e., inflation adjusted, dollars.

3. Unearned premium reserves are monetary because they are "surrogates" for loss reserves for claims which will not be submitted until after the date on the balance sheet.

The Task Group's report was submitted on May 31. On August 24, after public hearings and eight deliberative sessions, FASB issued Status Report #91 which contained the requirement that those reporting entities with assets of at least $1 billion or capital assets (inventories and property, plant and equipment, gross of depreciation) of at least $125 million must disclose both current cost and constant dollar adjustments for fiscal years ending after December 25, 1979, although 1979 results need not be reported until the 1980 annual report. In 1980, and thereafter, all current cost and constant dollar adjustments must be reported on an annual basis, with certain selected financial data shown in a five-year historical summary.

No exception was made for the insurance industry. There was some question about that but FASB Statement #33 came out last week and it pretty much says what the preliminary draft says. FASB Statement #21 clearly states that "An enterprise is no longer considered a non-public enterprise when its financial statements are issued in preparation for the sale of any

class of securities in the public market." Supposedly, there is something in FASB Statement #14 on financial reporting for segment of business enterprises that appeared to exempt mutual life insurance companies from that requirement, so that exemption would be extended by analogy. I could not find any such exemption in FASB Statement #14.

Responding to the Task Group's recommendations, FASB "tentatively" decided the following:

1. Deferred acquisition expenses are monetary items.

2. Loss reserves may or may not be monetary items, depending on how each individual reserve conforms to the general definition.

3. The Board will continue its study of deferred acquisition expense and unearned premium reserve and, presumably at some future date, definitively classify them as monetary or nonmonetary.

At this date it is reasonable to infer that the required adjustment can be made by applying a single CPI index to the bottom line unless a company has enough nonmonetary assets to meet its accountant's test of materiality, or has a material part of its total liabilities in loss reserves. In the former case, it will have to do a separate current cost calculation. In the latter, it will have to be prepared to prove that all its loss reserves meet what FASB calls "the general definition of monetary items". Little security is provided; the so-called "general definition" is nothing but a lengthy list of examples. Appendix A of the March 2 Exposure Draft (Constant Dollar Accounting), in introducing this list, denies its definitiveness and concludes by saying "preparers may find it convenient to resolve doubtful and immaterial cases in favor of monetary treatment".

MR. WAGNER: I think I should comment on the mutual company exemption or non-exemption. From what I understand, an exemption was given at least in the exposure draft to non-publicly-held companies and then to get the definition of non-publicly-held companies there was a reference to the segment reporting FASB statement #14. It was stated to me that it has been interpreted that mutual companies are not required to file segment reporting as non-publicly-held companies and, therefore, the analogy does hold that they would be excluded from this particular requirement. It is true that the exposure draft encouraged non-publicly-held companies to report on the effects of changing prices. It may be a moot point, anyway, since companies of this size may very well volunteer to do it regardless of the requirement.

MR. ROBERTSON: I will make the observation,having participated in this task force and in the process of developing this standard,that while we did not get nearly all we wanted, I am encouraged that FASB is at least listening to actuaries. I think they have come a long way in that direction. I find some encouragement in some of the conclusions they have reached here, particularly with the treatment of deferred acquisition expenses as a monetary item. I think we are making some progress and I hope they consider this an experiment that is at least partially successful and will do it again in the future.

Let us now turn to statutory items, and start by asking Virgil to tell us what changes are in the blank for 1979.

MR. WAGNER: The changes to the life, accident and health blank, the blue blank, are quite modest this year. This is largely because the NAIC, under its recently adopted rules, limits its consideration of changes affecting only the blue blank to even numbered years. Changes affecting only the fire and casualty blank, or yellow blank, are considered during odd numbered years, and changes affecting both blanks are considered in any year. Since this is an odd numbered year, the changes in the life blank, except for some editorial changes, are those which relate to all blanks.

The most significant change of this type is in Schedule H, the Schedule of Accident and Health Insurance. The intent of the changes, initiated by the NAIC Blanks Subcommittee, is to uniformly present accident and health insurance for all blanks. A major thrust behind this was to eliminate the division of claim reserves and liabilities into the components, present value of amounts not yet due, and liability for accrued claims. The present value of amounts not yet due is a concept somewhat foreign to the fire and casualty blank.

In developing the new Schedule H, the guidelines were to minimize changes to the basic statement, to make the schedule the primary source of all accident and health information and to eliminate unimportant or infrequently used data.

The new Schedule H is in a four-section format with the same column headings as the old schedule. The sections are (1) Analysis of Underwriting Operations; (2) Reserves and Liabilities; (3) Test of Previous Year's Claim Reserves and Liabilities; and (4) Reinsurance. Following are some of the changes in reporting which might be of interest.

First, the item "premiums in force" has been eliminated. The usefulness of this item has been subject to question for some time now.

Three types of reserves are exhibited. These are premium reserves, policy reserves, and claim reserves. Premium reserves include unearned and advance premiums and reserve for rate credits. Policy reserves are the additional reserves for guaranteed renewable or non-can policies and reserves for future contingent benefits. In developing the underwriting gain, "Increase in Policy Reserves" is a separate item so that it is not automatically incorporated into either premiums earned or claims incurred. When developing loss ratios, you are left to your own imagination as to which of these is most appropriate.

The comparison of current payments and outstanding reserves on prior year claims to the corresponding reserves held in the previous year is developed in a separate section. In this development, the increase in reinsurance recoverable is used for the reinsurance ceded offset rather than the amount recovered. This change is made to provide consistency with handling of the corresponding items in the fire and casualty blank.

The separate reinsurance section summarizes the reinsurance adjustments which are netted out in the underwriting analysis and reserves sections.

Other changes in the 1979 blank are a revision of the Schedule S format to provide an accident and health subtotal in Part III such as exists in Part I, and the elimination of all references to premiums in force. An additional column in the Policy Experience Exhibit will give the first year of issue of the policy form for use by regulators in interpreting loss ratios.

Looking beyond 1979 and its modest changes, we see possibilities of some very significant revisions to the blanks. The NAIC Blanks Subcommittee, at its 1978 spring meeting, assigned a task force to review the current blanks and make recommendations in five areas.

While any or all of the areas could result in changes to the blank, the most direct effect would be from the first charge, which was to specifically review the presentation of data in the blanks.

Some of the changes being considered by an advisory committee for probable presentation to the NAIC Blanks Subcommittee task force are as follows:

(1) In a further effort to reduce the size of the blank to 9" x 14", amounts would be shown, except on certain exhibits and schedules, only in thousands of dollars.

(2) There is an attempt to eliminate the worksheet approach utilized by the blank. For instance, many instructional notes now interspersed with the financial data would be centralized or eliminated. More importantly, the worksheets which merely calculate accrual basis items from a beginning cash figure would be eliminated. Only the accrual amounts would be shown.

(3) Pages currently being considered for elimination include the Reconciliation of Ledger Assets, the Asset Exhibit (13) and Page 6, the Analysis of Increase in Reserves. The annuity exhibit will probably get the ax also. These pages are viewed as worksheets in nature. Such information would still be developed by the company and would be available to the regulator within 30 days of his request.

(4) The investment schedules would be streamlined to show information on assets held at the end of the year, eliminating the voluminous detail on transactions during the year. An expanded schedule of verification between years for all types of assets would be included.

(5) Those schedules which contain primarily administrative detail would be reduced or eliminated. For example, Schedule G would be reduced to the top five highest paid officers. Schedules such as E, I, J, K, and X will probably go.

(6) A new reinsurance schedule, replacing Schedule S, would summarize all reinsurance information in one

place. Regulators have consistently asked for more understandable reinsurance information in the statement. This would be in response to that request.

(7) The instructions will be rewritten in their entirety, both for changed and unchanged portions of the statement. They will probably propose a format for accounting notes which is similar to that required by generally accepted accounting principles.

More will be known about the future of this project after the December joint meeting of the advisory committee and task force. I would expect that, at least, some of these proposals will make their way through the NAIC committee structure and will appear as changes to the blank, if not as a package, then in piecemeal fashion over the ensuing years.

MR. CHAPMAN: I notice that in the crystal ball phase of your presentation you did not mention two items that I have not heard much of in the last year or two but that have been talked about in the past: a reconciliation between financial statements and rate-making bases, and presentation of financial data on a liquidation basis. These items have dropped into abeyance after they had a change in administration in Massachusetts. Do you see any prospect of their being revived in the foreseeable future?

MR. WAGNER: The task force which is looking at the blank simplification here actually was given five charges. The two that you mentioned were included in that list. One of them--reconciliation of statement data to rate-making data, I believe, has been dropped. I think the task force has agreed that this is not a feasible reconciliation to make because of the problems between calendar year and policy year data. The one on reconciliation of the balance sheet on a liquidating basis is still being discussed and the advisory committee is trying to determine just exactly what a liquidating basis means. The task force, of course, cannot make much progress until that is settled.

MR. ALLISON G. HASSELMEIER, JR.: I wanted to ask if you would comment on the recent request for lapse study information that went out to, I believe, all insurance companies.

MISS GRACE V. DILLINGHAM: My understanding was that this was being sent to companies with the request that certain information be supplied. The results would be tabulated, distributed to commissioners, and they would be asked if this information is useful. There has been a great deal of controversy on whether it is valuable or not and whether it would serve any useful purpose.

MR. WAGNER: I have seen a statement that was filed by a company that objected rather strongly to the proposal on the grounds that different companies writing different types of business would be expected to have different lapse rates and companies that operate in a market that is less conducive to good persistency would appear to do poorly simply because of the way they write their business. I think there is some merit to that proposition.

MR. ROBERTSON: Last Saturday morning, Virgil, you and I sat in a meeting with others to talk about profitability ratios at an NAIC Advisory Committee. Could you tell us what is going on there?

MR. WAGNER: Another matter of interest to those concerned with financial reporting is the current activity of the NAIC in developing measurements of the profitability of life insurance companies. The NAIC has published reports to regulators on the profitability of fire and casualty companies for over five years now. These reports include ratios of income to premium, assets, and net worth. Also, an extensive report is made of profitability by line and by state as well as summaries by line and by company group giving financial statistics along with market share information. The statutory results for the fire and casualty companies are adjusted to GAAP results by an approximate method.

During 1978 the NAIC Subcommittee on Financial and Profitability Information was asked to develop information for 1979 by line and by state for A&H insurance. Since this was already being done for fire and casualty companies, it was assumed that life companies could easily provide data for a similar report. In addition to A&H by line and by state, overall profitability results for life companies were to be developed on a statutory basis and development of profitability results on an approximate GAAP basis was to be investigated. An advisory committee is now working with the task force to help achieve these objectives, or otherwise satisfy the requests.

The advisory committee has deliberated on the definition of life insurance company profitability and has found the answer to be elusive. The basic data must come from the statutory statement and a measurement must be found which is meaningful for the large variety of companies which exist. For example, the measurement must be meaningful for both stocks and mutuals, life and A&H, group and individual, permanent forms, term, industrial, etc.

Meanwhile, ratios which are based on the calculations for fire and casualty companies have been proposed and are currently being tested by NAIC staff. These include ratios of underwriting income and insurance operating income to premium, overall operating income to assets and to net worth, and total return to assets and to net worth. The task force has agreed that an underwriting test which excludes investment income is not appropriate for a life company. Likewise, it has been generally agreed that investment income should be included with premiums so that those tests which are ratios to premium would become ratios to total revenue. Of continuing concern to the advisory committee is the validity of tests based on net worth. For instance, does a higher ratio of income to net worth for a given company show higher profitability or lower capitalization? Does it show anything about profits?

We expect continued deliberation with testing of proposed ratios to continue well into the future. There will, however, be some profitability tests for life companies in the near future, very probably by year end 1980. There may be limited loss ratio results compiled for A&H by state based on the 1979 statements, as requested in the original charge.

MR. CHAPMAN: You raised the question and I think properly so, Virgil, as to whether a high ratio of profit to net worth indicates a highly profitable business or undercapitalization of the company and I wonder how either

conclusion can be reached in the absence of the consideration of the degree of risk that the business represents. A ratio that might be excessive for a comparatively low degree of risk might be inadequate for a higher degree of risk type of coverage.

MR. WAGNER: That, I think, goes back to the comments I made about the different types of companies and the difficulty of arriving at a ratio where the companies are involved in different risks.

MR. ROBERTSON: I will observe that practically all of us,whether representing the NAIC or the advisory committee,had a great deal of difficulty with that ratio and did not know what to do with it, or where to take it. I think it is still very much up in the air.

MR. WAGNER: Another activity in the NAIC is development of a uniform language requirement for filing of financial statements which have been audited by an independent CPA. Several states currently have this requirement. The rules of these states are generally similar but do contain some unique characteristics. The purpose of model language is to eliminate unique characteristics and to assure that an audited statement filed in one state, domiciliary or otherwise, will be deemed to meet the requirements of other states. It is generally understood that the uniform rule or "model" would not be the typical model where the intention is to get it enacted in all states. It would merely provide model language for those states wanting to adopt such a rule.

A major question is whether such model language should require audited statements of only domestic companies or if it should apply to foreign companies. I personally think that most states will want a rule with foreign application. However, a domestic-only rule may have an easier chance of adoption by the NAIC as it is not as offensive to those states which do not want a rule at all. On the other hand, there may be pressure from guarantee fund participants to utilize a foreign rule. The proposed language being developed by the advisory committee is for a foreign rule, not so much because of a preference for that over domestic, but because of the danger of a domestic rule being modified to foreign by individual states, thereby leaving out important provisions unique to a foreign rule.

I anticipate a rule will be adopted in December of this year, possibly with flexibility as to the foreign-domestic issue.

MR. ROBERTSON: Virgil, what happened to the proposal that casualty company statements be audited either by an actuary or a CPA?

MR. WAGNER: An agenda item which attracted a lot of attention at the 1979 spring meeting of the NAIC Blanks Subcommittee was the matter of certification by a "Qualified Loss Reserve Specialist" of loss and loss adjustment expense reserves in fire and casualty statements. It was of interest to life insurers, not only because of any indirect impact it may have, but because it had been included in the agenda for all blanks, including the life and A&H blank. It was of interest to actuaries because of the need to define who a "specialist" is. The Blanks Subcommittee did remove the item

from the life and accident and health blanks agenda, however, the possibility of an indirect impact remains.

Briefly, let me give you a little background leading up to this point. An NAIC task force of the Financial Condition Examination Subcommittee presented a proposal in 1978 which was adopted by the NAIC. This proposal would have required, where the Commissioner of the domiciliary state so directed, inclusion of a statement of opinion of a Qualified Loss Reserve Specialist regarding the company's loss and loss adjustment expense reserves. The Qualified Loss Reserve Specialist would have been independent of the company, in accordance with SEC rules, and included, by definition, a member of the American Academy of Actuaries, the Society of Actuaries, the Casualty Actuarial Society, and the American Institute of Certified Public Accountants. This proposal was met with much opposition at the 1979 spring meeting of the Blanks Subcommittee, and, although provisionally adopted at that meeting, was sent back to the Financial Condition Examination Subcommittee, with the suggestion that it be reconsidered.

The task force plans to complete a new proposal for presentation to the NAIC in December, applicable to fire and casualty companies' 1980 statements.

Under this proposal, the certification would be required in the domiciliary state only, for those states which want it. To accomplish this, the report would not be a part of the blank. The independence requirement has been dropped; however, there is some disagreement as to the value of a "stand up and be counted" requirement. Those who believe independence should be required are partly satisfied by the increasing utilization of statutory statements which have been audited by an independent CPA. The report of the Qualified Loss Reserve Specialist would be similar to that required of a life actuary. However, all references to "actuary" or "actuarial" will probably be removed in recognition of the fact that the specialist is not necessarily an actuary. Establishing the qualification requirements for the specialist has proven to be a most difficult task. The current proposal, again following the life statement, defines the specialist as a member of the American Academy of Actuaries, or a person who has demonstrated his or her competence in the subject of loss and loss adjustment expense reserves.