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NEW ACTUARIAL STANDARDS FOR INSURANCE COMPANY REPORTING IN CANADA

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MR. H. EDWARD HARLAND: Life insurance companies operating in Canada must report their financial results on a basis approved by the Department of Insurance in Ottawa. The dominant considerations in these government reporting requirements have been solvency and the protection of policyholder interests. The result has been particular emphasis on the balance sheet, with quite conservative valuation of both assets and liabilities being the norm. Earnings, on the other hand, can be either understated or overstated on the current basis of reporting. However, the usual result for a growing company would be for the conservative government basis of reporting to understate earnings as well as surplus.

Not surprisingly, the principles influencing the government basis of reporting in most cases have been carried over into the published financial statements of Canadian life insurance companies.

This long-standing situation is now at the point of change. Partly in response to pressures from the investment analysts, and following the move to Generally Accepted Accounting Principles (GAAP) for U.S. stock life insurance companies, the Canadian Institute of Chartered Accountants (CICA) published a Research Study in 1973, recommending a basis of GAAP reporting for life insurance companies.

A primary purpose would be to report earnings on a going concern basis, rather than on a basis dominated by solvency considerations as at present, and to promote improved comparability of reported financial results among companies.

Since then, much work has been done in the Department of Insurance, the Canadian Life Insurance Association (CLIA), and the Canadian Institute of Actuaries (CIA), as well as in the CICA, to seek understanding and agreement on acceptable definitions and standards for GAAP reporting for life insurance companies operating in Canada. From the start, it has been agreed that the objective is one set of financial statements that will conform both to Department of Insurance requirements and to the principles of GAAP reporting.

In 1977, the law relating to life insurance companies was changed to provide for revised reporting in accordance with these objectives. The amendments to the law have not yet been promulgated in their entirety, nor have supporting regulations. However, the Superintendent of Insurance has recently expressed his tentative decision that the new government requirements will be effective for the reporting of 1978 annual results.

Unfortunately, important uncertainties remain. The Department of Insurance is still ready to hear any serious reservations that may be expressed concerning the specifics of the proposed regulations or the timing of promulgation. The CLIA or its member companies may yet express reservations. The CIA will meet soon in an attempt to finalize guidelines for the ranges of assumptions within which Valuation Actuaries can exercise their judgement.

The CICA has not commented on the acceptability of the revised government basis of reporting in terms of satisfying GAAP standards.

However, with all these uncertainties, it remains clear that GAAP reporting will come, probably for 1978, and with major consequences on at least some of the figures reported by life insurance companies operating in Canada.

MR. WAYNE E. BERGQUIST: In order to understand the role of the Valuation Actuary, I think it would be useful if I very briefly reviewed the responsibilities given to the Valuation Actuary and the auditor by the new Insurance Act. The company must appoint a Valuation Actuary who, except under certain circumstances for a foreign company, must be a Fellow of the Canadian Institute of Actuaries (FCIA). The Valuation Actuary may be an employee of the company. The statutory duties of the Valuation Actuary include the following:

1. To file a valuation report with the Annual Statement -
   (a) describing the valuation assumptions and methods employed
   (b) giving an opinion that the reserves are "good and sufficient" and that the valuation assumptions are appropriate.
2. To give an opinion as to the appropriateness of reserves that must be a part of any general purpose financial statements published by the company. As well, the same reserve amount must be used for both the Annual Statement and any general purpose financial statements.

   The legislation is silent as to the Valuation Actuary's responsibility on the determination of the proper charge against earnings for the increase in reserves. As well, the legislation does not require the Valuation Actuary to give an opinion that the valuation <u>method</u> is appropriate.

The auditor reports on the overall fairness of the company's financial statements. In doing so, he may accept the Valuation Actuary's opinion, although he is not bound to do so. The auditor can "audit" the Valuation Actuary with regard to the appropriate charge against earnings in respect of the increase in actuarial liabilities. The Valuation Actuary would, of course, like the auditor to accept automatically as being appropriate the Valuation Actuary's opinion as to what constitutes an appropriate charge against earnings. In order to encourage this, the auditor must have a high opinion of the Valuation Actuary's work, specifically that:

1. the Valuation Actuary is acting according to defined and generally accepted actuarial principles.
2. the Valuation Actuary is subject to professional disciplinary action, should he not act competently.
3. the Valuation Actuary can explain his work in an understandable fashion.

Some actuaries (perhaps the majority of actuaries) believe they are immune from the judgments of the auditor. The general public, however, looks exclusively to independent accountants to give opinions as to the fairness of the financial statements of all economic entities. It seems unrealistic to give actuaries immunity from the auditor when no other professionals, including accountants, are entitled to such immunity as to what constitutes fairness in a published financial statement.

The Superintendent of Insurance, the accounting profession, the actuarial profession, and the life insurance companies all agreed that it would be desirable to have one statement rather than the two statement format which had evolved in the United States for stock life insurance companies. Since most companies operating in Canada are subject to federal government regulation, the development of a one-statement approach was possible because only one rather than fifty regulatory authorities were involved. A one statement format ensured that the reporting basis for stock and mutual companies would be the same. This was particularly important as most Canadian companies write both participating and non-participating business, and since most companies in Canada are mutuals.

Under the new financial reporting requirements for life insurance companies, the book value of an asset will be:

1. for bonds and mortgages -- amortized values.
2. for common and preferred stocks -- cost but with a special adjustment applied to the whole stock portfolio to recognize on an annual basis a portion of realized and unrealized capital gains and losses. The aggregate book value of stocks will be written up or down each year by 7% of the market excess or deficiency relative to the adjusted book value.
3. for real estate -- cost less depreciation.

Realized capital gains and losses on bonds, mortgages and stocks will be treated as normal income items. However, such gains and losses on the disposition of bonds and mortgages will be amortized over the balance of the remaining term to security. The unamortized deferred loss or gain will be shown as an asset or liability in the Annual Statement.

As a transition rule, companies have the option of determining 1978 book values as if the new system had always been in force, or alternatively, by assuming that all securities were acquired in 1976 for their book values at that time under the old system. If the 1976 book values are unrealistically low, the resulting investment income amounts for 1978 and subsequent years will be overstated.

In discussing the asset valuation rules, some of you may think I am unduly straying from the subject under discussion. However, actuaries have paid insufficient attention to the implications of the asset valuation rules of the new financial reporting requirements. Therefore, this brief description of the asset valuation rules should serve as a reminder for all of us to become more familiar with the asset valuation rules.

The actuarial liability valuation rules employ a number of new concepts in the definition of the new Minimum Valuation Method, which is often called the Superintendent's Valuation Method (SVM). It incorporates to a large extent the actuarial view that a gross premium valuation approach is preferable to that of a net level premium valuation accompanied by deferred acquisition costs showing up as an asset. The new SVM maintains the appearance, in most circumstances, of a modified net premium valuation method. A lid is placed on the size of the valuation premium in terms of the maximum amount of acquisition expenses subject to "deferral." Such maximum amount is equal to the least of:

1. the actual amount of such acquisition costs (subject to determination by the Valuation Actuary).
2. 150% of the net level valuation premium, including therein a provision for policyholder dividend expectations. The 150% may be changed by regulation. The 150% modification will result in negative reserves at low durations. Such negative reserves are acceptable for income statement purposes. However, a surplus appropriation is required to cover such negative reserves and, as well, any amounts by which the cash value on a policy exceeds the reserve otherwise held.
3. the amount of such acquisition costs which are recoverable after first providing for policyholder benefits, administrative expenses, and policyholder dividend expectations. When this limitation is applicable, the SVM takes on the form of a gross premium valuation.

   (Many actuaries consider that a gross premium valuation requires the use of "best estimate" valuation assumptions, since a gross premium valuation is usually done with "best estimate" assumptions. However, a gross premium valuation can be done with any level of valuation assumptions, including those appropriate under the new financial reporting requirements. Thus, the term gross premium valuation does not necessarily mean a "best estimate" valuation).

The existence of the 150% lid retains the accountants' concept of deferred acquisition costs but transforms a deferred expense "asset" into a liability offset item. As well, the amount of such deferred acquisition costs is disclosed since the amount of the actuarial liabilities assuming no deferred acquisitions costs (i.e., net level premium reserves) must be disclosed by all companies in addition to the actuarial liabilities determined on the basis of SVM or the Alternative Minimum Valuation Method as described in Section 82(8)(b) of the Insurance Act.

Under the SVM, there is technically no deferral of acquisition costs as the actuarial reserve is determined prospectively. Any expenses incurred in the year are charged against income in the year of incurral.

The valuation assumptions employed to determine actuarial liabilities must be appropriate. By appropriate, one means realistic but including therein a reasonable provision for the possibility of adverse deviations in experience.

In order to assist the Valuation Actuary in his work, the CIA Committee on Financial Reporting has attempted to write guidelines, formally called Recommendations, for the use of the Valuation Actuary. The Recommendations are also intended to serve other roles:

1. to encourage the auditor to accept the Valuation Actuary's opinion as being fairly presented.
2. to assist the Valuation Actuary in defending himself against any allegations of malpractice.

The areas covered by the Recommendations include valuation and benefit assumptions, methods, approximations, materiality, the actuary's opinion, and verification of policy particulars used in the valuation.

Complementing the Recommendations, which are essentially statements of principle, are associated interpretations and background papers which amplify and expand the meaning of the Recommendations and comment on their practical application.

The Recommendations generally confine themselves to areas followed by the legislation. They are balance sheet orientated. As the majority of actuaries wish to retain the freedom to hold any level of reserves as long as solvency requirements are met, the Recommendations do not have an upper limit to the amount of reserves held. The Recommendations define the appropriate charge against earnings as the increase in these reserve amounts. Consequently, the charge against earnings for the increase in reserves will vary most substantially from company to company. Unless the auditor establishes an upper limit on the reserves used to determine the appropriate charge against earnings, there will be little in the way of improvement in the quality of the income statement.

The Committee on Financial Reporting failed to define an upper limit to the reserves because the actuarial profession in Canada did not wish to dictate the level of reserves to its members. The continued existence of the Valuation Actuary's freedom to pick the level of reserves through the choice of the valuation method seems to be contrary to GAAP.

The Committee faced many difficulties in drafting a set of Recommendations that were acceptable to a majority of actuaries and which were more than a mere recital of the lowest common denominator motherhood statements. As we have operated without any written guidelines in the past, a number of actuaries disagree with anything that might possibly infringe on any of their traditional freedoms. The historical preoccupation of actuaries with the balance sheet accompanied by a benign neglect of the income statement carried over to the formulation of the Recommendations. Actually, this is quite understandable as most large Canadian life insurers are mutuals and do not have to contend with shareholders and stock exchanges desiring a meaningful income statement.

A second general area of difficulty arose in those areas where United States GAAP has less than fully satisfactory answers. These areas include reserve weakening and the incorporation of policyholder dividend expectations into the reserves. With respect to reserve weakening, the United States GAAP approach of "locking in" assumptions at the policy issue date leads to the holding of unduly conservative reserves. On the other hand, reserve weakening leads to an undesired anticipation of future earnings. The Committee has not been able to arrive at a satisfactory solution with the result that the Recommendations allow the Valuation Actuary complete freedom with regard to reserve weakening. This, of course, leads to a further dilution in the quality of the income statement.

A third general question is the application of the Recommendations to the Valuation Actuary of a non-resident insurer. Since the Canadian Annual Statement of a non-resident insurer is not directed to the general public and does not include an income statement per se, the Recommendations should only serve to assist the Valuation Actuary in conforming to the Annual Statement requirements and should not impose upon him any additional requirements.

The present draft of the CIA Recommendations has been forwarded by the CIA Committee on Financial Reporting to the Council of the CIA. The Council has accepted the Recommendations in principle and has authorized their use for the time being as a working guide. This decision is subject to ratification by vote of the general membership at the Institute's 1978 annual meeting. Formal adoption of the CIA Recommendations and associated Opinion CIA-6 of

the CIA Guides to Professional Conduct will follow sometime in 1979 and will also be subject to ratification by vote of the general membership at the Institute's 1979 annual meeting. The draft Recommendations are of a sufficiently low common denominator that they will be passed by an over-whelming majority of the CIA membership.

During the next year, the Recommendations will be subject to revisions as there are a number of issues not yet fully resolved. A partial list of these issues is:

1. What transition rules are appropriate? If the switchover is for 1978, as seems likely at this date, transition rules must be very quickly drafted.
2. What valuation methods are appropriate? A number of actuaries wish to continue measuring earnings and holding reserves on the basis of net level premium reserves without any recognition of deferred acquisition costs. However, it is interesting to note that for 1978 and subsequent years, even reserves for Canadian income tax purposes will involve some recognition of deferred acquisition costs.
3. What should be done with deferred income taxes?
4. Should one of the objectives of the Institute be to promote the comparability of financial statements among insurance companies? A majority of the CIA Committee on Financial Reporting do not wish to endorse comparability as an objective as this implies the restriction of the Valuation Actuary to an industry-wide single set of actuarial principles.

It is expected that the CICA will make some pronouncement sometime in 1978, concerning the new financial reporting requirements and whether or not they fit within the confines of GAAP. The accountants probably will require some recognition of deferred acquisition costs in the income statement and the use of deferred tax accounting.

From the reference point of the actuarial liability requirements, the "new" law will deliver some very desirable improvements in some areas; in other areas, expected improvements may not materialize. On the "definite" side, the major improvements are as follows:

1. Valuation strain, which artificially lowers earnings, has been substantially reduced.
2. Other valuation strain, such as reserves required to cover cash values, will not impact the earnings statement.
3. The reserves must cover policyholder dividend and experience refund expectations.

On the "maybe" side is the following improvement:

The charges against earnings to build up contingency reserves of an assigned surplus nature will be eliminated.

The "new" law will <u>not</u> deliver:

1. additional employment opportunities for Canadian accountants and actuaries, unlike the case with United States GAAP when it came into being.
2. comparability of financial statements between insurers.
3. GAAP earnings.

Canadian GAAP, as seen from an actuarial perspective, doesn't exist. Rather than GAAP what we have is simply a modernization of Canadian statutory accounting practices for insurance companies.

MR. CECIL G. WHITE: The amended Foreign Insurance Companies Act requires the Board of Directors of each company, including non-resident companies, to appoint by resolution a Valuation Actuary for the purpose of the Act. A certified copy of that resolution and of every subsequent resolution relating to the appointment of a Valuation Actuary must be filed with the Canadian Superintendent of Insurance. Except in rare instances, the Valuation Actuary must be a FCIA. The Valuation Actuary must comply not only with the amended Foreign Insurance Companies Act, but also with the Recommendations for financial reporting as promulgated by the CIA. The home office actuaries and other executives of non-resident companies doing business in Canada would be well advised to become familiar with both the amended Foreign Insurance Companies Act and the Recommendations for financial reporting.

The amended Foreign Insurance Companies Act was proclaimed to apply to accident and sickness insurance for year-end 1977. We expect it to be proclaimed next month to apply to life insurance for year-end 1978. Valuation Actuaries of non-resident companies are not going to be left with very much time in the balance of 1978 during which all necessary work must be performed to comply with the new Canadian requirements at year-end 1978. It is to be expected that compliance this coming year-end may not be as complete or as sophisticated as one would wish. However, the Valuation Actuaries will improve, no doubt, with each passing year-end. In this connection the Canadian Department of Insurance has said "We appreciate that it will take time for companies to adapt to the new system and to solve all the problems that will be involved. For this reason, we will exercise the discretion given to us under the law in as broad a manner as possible in order to ease the problems faced by companies in getting the new system into operation."

As Mr. Bergquist has said, the amended Foreign Insurance Companies Act and the work of the Committee on Financial Reporting of the CIA has led to "a modernization of statutory accounting practices for insurance companies." However, non-resident life insurance companies, for the most part, will continue to file a pair of unbalanced annual statements with the Canadian Superintendent of Insurance - one for life and one for health and other lines. These statements do not include a balance sheet, a proper income account, or a surplus account, and they are not directed to the general public. They can be of little interest to shareholders or investment analysts. In view of these considerations, there would seem to be little to be gained by imposing on the Valuation Actuary of a non-resident company any requirements beyond the most fundamental ones relating to the new approaches and concepts for determining actuarial reserves.

Thus, the amended Foreign Insurance Companies Act imposes fewer requirements with regard to the methods of determining actuarial reserves for a non-resident company, than are imposed on a Canadian company. For example, in contrast to the requirements for a Canadian company, a non-resident company need not show minimum reserves in its statutory statements if it is holding reserves higher than the minimum. The Department of Insurance is prepared to accept that net level premium reserves are higher than the statutory minimum reserves. The Recommendations for financial reporting of the CIA also carry out the intention of the amended Foreign Insurance Companies Act by allowing Valuation Actuaries to choose methods producing reserves higher than the statutory minimum reserves.

The Foreign Insurance Companies Act requires the Valuation Actuary to use assumptions that, in his opinion, "are appropriate to the circumstances of the company and the policies in Canada in force" and a method that, in his opinion, produces reserves not less than the prescribed minimum. The Valuation Actuary must state in his report that "the reserve makes good and sufficient provision for all the unmatured obligations guaranteed under the terms of the policies in Canada in force." Net level premium reserves on traditional valuation assumptions would seem to satisfy all these conditions, providing the Valuation Actuary is of the opinion that his assumptions are appropriate to the circumstances of the company and the policies in Canada in force. The Valuation Actuary may well be of this opinion because the assumptions reflect total company philosophy, a philosophy that has kept the company solvent for many decades through inflation, wars, depressions, epidemics, and other calamities. Therefore, why should the Valuation Actuary not go on using net level reserves? Such reserves would seem to fit well the chief purpose of the Canadian statutory statements, because net level reserves will require larger deposits of assets in Canada than would be required by minimum reserves.

The Valuation Actuary in Canada of a large non-resident company with a sizeable business in force in Canada and a long-established Canadian Head Office is in a much better position to comply with the new Canadian requirements than the Valuation Actuary still located outside Canada in a non-resident company with a relatively small Canadian in force. If the company is too small to be using branch accounting, how are its Canadian assets to be determined? How is its investment income to be determined?

What is its Canadian net earned rate? What is its Canadian experience for mortality, morbidity, etc.? How is the Valuation Actuary with his limited staff going to cope with the new problems and circumstances? What about additional expenses? If the valuation work is actually done outside Canada, will it be possible for the Valuation Actuary in Canada to have sufficient firsthand knowledge to be able to sign the report of the Valuation Actuary? If not, will companies face the cost and time required to move the actuarial valuation of Canadian business to Canada?

The Recommendations for the Valuation Actuary require that he examine all facets of the company's operations that might impact on the valuation basis. There would appear to be a question as to how far, if at all, the Valuation Actuary may temper his assumptions with the knowledge that the Canadian operation is part of a larger block of business. As an example, the Recommendations dealing with valuation assumptions indicate that the company's retention limit may affect the provision for adverse deviations. A branch of a foreign company may have a retention limit which is appropriate if the branch is viewed in isolation. In this situation, should the Recommendation be read with reference to the Canadian branch business only, or should the Valuation Actuary attempt to take account of the condition of the total company?

An interesting situation can arise when the actuarial reserves in Canadian annual statements are different from those in the total company annual statements. For example, is it appropriate to defer acquisition expenses in the Canadian statement if such acquisition expenses are not being deferred in the total company statement, or perhaps being deferred in different amounts in the total company statement? Another example may arise when the Canadian experience for a block of policies is sufficiently less favourable than total

company experience to call for higher reserves in the Canadian statements than are being held for this Canadian business in the total company statements. What is the position of the company's chief actuary under these circumstances?

With regard to participating insurance, my interpretation of the amended Foreign Insurance Companies Act is that there is nothing in the amended statutes to prevent a company from continuing to use its traditional and well-tried methods of determining the amount of surplus available for distribution to policyholders and the policyholder dividends. Providing the Valuation Actuary is convinced that his valuation assumptions are appropriate to the circumstances of the company and for the policies in Canada to be valued, it would seem quite possible for a non-resident company to continue to use net level premium reserves with implicit provision for at least a part of the policyholder dividends to emerge in the future, and to continue its method of surplus distribution, be it the fund method, three-factor method, or other method. For those companies that make use of terminal dividends, it would seem quite in order to continue this practice. The above results are to be expected because it would be unthinkable that the amended Foreign Insurance Companies Act would have such drastic impacts in the area of valuation of actuarial liabilities that these might be expected to force changes in the methods used by various companies to determine the surplus available to policyholders and to devise policyholder dividends. Of course, it is expected that companies will be able to show that administration expenses and policyholder dividend expectations can be met.

My interpretation of the Recommendations for insurance company financial reporting promulgated by the CIA is that they are designed to carry out the intention of the amended Foreign Insurance Companies Act. This is a desirable result for a number of reasons. In addition to the undesirable dislocations that might otherwise have been brought about, there is the fundamental point that the operations of non-resident mutual life insurance companies in Canada are not oriented towards the income statement. The important statement for a mutual life insurance company is the balance sheet, because this is the statement that ties into the important function of distributing surplus to policyholders. It is interesting to note that, at least in the United States, the accounting profession now seems to be swinging to this point of view.

MR. JAMES D. LAMB: Being employed by a U.S. company with substantial operations in Canada, the Amendments to the Insurance Acts were received with an interest that was more than academic. In fact, we immediately set up a group to keep an ear to the ground as to what was transpiring. This group seemed to learn little, but with passage of time we reached a position where we were on equal footing with everyone else; that is, we knew as little and had made as few decisions as anyone. We fearfully looked forward to expanding our set of valuations to six or more.

1. U.S. Statutory
2. U.S. Income Tax
3. U.S. GAAP
4. New Canadian Statutory with its two or more valuations
5. New Canadian Tax
6. In case none of the above tells how we are really doing, one that does. We haven't had to do this one yet.

The idea behind the Amendments to the Canadian Insurance Acts is a good one; that is, replacing the old statutory accounting basis with a new one which can serve as a statutory and a general purpose statement. However, since we are already producing separate statements in the U.S., we would have appreciated receiving a blessing for what we were already doing and must continue to do regardless of the Canadian amendments.

In trying to determine the similarities and differences between the new Canadian basis and the U.S. GAAP basis, it is in order to look at the reasons for the establishment of the procedures in both countries. In the U.S., a single purpose statement would have been impossible as long as we were trying to conform to two sets of laws. Companies that file financial statements with the S.E.C. must have certification from the auditor that earnings are stated according to GAAP. It is from the S.E.C. and its concern for the investor that the requirement arose. Originally, life insurance companies were exempt from the certification requirement. However, the removal of this exemption would have made it illegal to submit statutory statements without certification, nor would it have been possible to get certification for these clearly non-GAAP reports. The exemption was considered for removal, but it was left up to the accountants and the life insurance industry to devise their own set of procedures for reporting according to GAAP before removing the exemption. This actually led to a time-pressure situation since it clearly would have been impossible to alter the insurance laws of the states such that regulatory financial statements would have conformed to GAAP. The only alternative was to come up with a separate statement which conformed. GAAP principles already existed and so the problem for the accountants and the industry to solve was to come up with a set of procedures that conformed to the principles. The problem was solved, but the point is that the laws preceded the procedures.

In Canada, the same actions could have been taken. However, most interested parties seemed to agree that if it could be accomplished, it would be better to produce only one statement which would be acceptable to the regulators and the investors. Since the procedures which would satisfy the regulators were already stated in the Insurance Acts, changes in those procedures made in order to satisfy other users required amendments to the Acts. In the U.S., we are accustomed to having more than one set of figures, but we also have to admit that it often causes confusion and always gives us plenty of headaches when we are trying to get information from them. In any case, the laws and procedures arose simultaneously. Admittedly, the procedures as written call for clarification.

Most of us agree that the new Canadian accounting should not be called GAAP in the U.S. sense. There seems to be enough flexibility in the requirements to allow statements to be put together that U.S. accountants would not consider to be according to GAAP, and also enough flexibility that normal conditions would allow at least an income statement that would be according to GAAP. However, it may be that paragraph in the Acts having to do with the auditor's statement and the requirement for the auditor to give his opinion as to whether the statement "fairly presents the results of the company's operations" may force the preparation of statements that lack the flexibility apparently offered by the valuation requirements. This paragraph could also serve to require less opportunity for manipulation and greater comparability of companies' operations than the valuation requirements appear to do. In that case, perhaps the results of U.S. and Canadian GAAP may not be that different.

When the U.S. procedures were established, it was with the idea that experience would dictate revisions or additions. In general, the original procedures have been upheld. The only real additions have been by the American Academy for the purpose of clarifying the rules for its members. I believe the same will hold true in Canada, where much of this clarification has already taken place.

In the U.S., the primary thrust of GAAP is toward the investor. Because of this, the balance sheet should call for more realism than would be the case under the Canadian changes. Under U.S. GAAP accounting, pure contingency reserves are not allowed. It is expected that free surplus is available for contingencies. Statutory requirements take care of the solvency question, at least if we accept that a company that is legally solvent is always, in fact, solvent.

In Canada the primary thrust of the income statement should be towards the investor, and to the degree that a policyholder is knowledgeable in insurance matters, a secondary thrust will be towards him in assisting himself in making a decision to purchase insurance from a well-run company or possibly to decide whether he has been fairly treated in dividend distributions. The primary thrust of the balance sheet will be toward the regulator, just as in the U.S. statutory balance sheet.

In the U.S., GAAP and statutory accounting permit valuation of bonds at amortized cost, equity securities at market value, preferred stocks at cost and mortgage loans at unpaid balances. A big difference in U.S. GAAP accounting is that the statutory Mandatory Securities' Valuation Reserve (MSVR) is considered an appropriation of surplus and not a GAAP balance sheet liability. However, a reserve for anticipated losses is required and is to be considered a deduction from asset values related to specific assets. These reserves, then, would clearly not be contingency reserves, and changes in them go through the income statement.

In Canada, bonds in good standing may be held at amortized value, mortgages at outstanding balance or amortized value if purchases above or below par. So far, this agrees with U.S. practices. However, in Canada stocks will take on special values which start with cost as a basis. Even this approach differs only from U.S. practices in a matter of degree to which deviations of cost from market value are to be recognized. The real valuation difference between the two countries is in the form of investment valuation reserve. Even though its formula is different, the investment valuation reserve looks like an MSVR and its operation on the income statement and balance sheet is identical to that of the U.S. statutory effect of the MSVR, i.e., a liability which does not go through the income statement. The existence of this reserve then would make a Canadian balance sheet not conform to GAAP under U.S. rules.

The second major difference in asset accounting is the timing of recognition of realized capital gains and losses. In U.S. accounting, realized gains and losses may be taken into income, subject to the condition that the amounts be identified in the statement. In Canada, realized capital gains and losses are not taken immediately into income, but are taken in over a period of time that may be as much as twenty years. The U.S. practice for asset accounting and treatment of unrealized capital gains and losses is perhaps more flexible. However, it does appear that the spreading of realized gains and losses in Canada would be a violation of U.S. GAAP.

The new Canadian approach to non-admitted assets generally follows U.S. statutory practices. In U.S. GAAP, such assets are carried on the balance sheet at values which consider probability of recovery. The U.S. concept requires separate consideration for each distinct asset. The Canadian practice of carrying such assets at a zero net would be at odds with U.S. principles.

U.S. accountants have called for "conservatism that is reasonable and realistic," and have accepted the actuaries similar requirement to be "adequate and appropriate" as being equivalent.

In Canada, certain wording in the Acts seems to imply that overly conservative assumptions might be permitted, e.g., references to companies holding NLP reserves, other than modified reserves, or assuming zero lapse rates. Yet it also appears that the wording "appropriate to the circumstances of the company," as interpreted by the CIA to mean a combination of expected experience plus provision for adverse deviation might be different. However, unless provisions for adverse deviations which are clearly excessive are permitted, there would appear to be no basic difference between U.S. GAAP and new Canadian accounting in choice of assumptions. But there is a difference in the extent to which assumptions and their bases are disclosed in the actuary's opinion and in the requirements for sensitivity tests. In the U.S., disclosure is required, but not in the detail of some Canadian examples I have seen, except to the auditor, and while the auditor could demand sensitivity testing, I am not aware of a requirement to do so if the actuary is satisfied that it is not necessary.

The U.S. GAAP basis is to make use of the concept of matching costs to the revenues intended to cover those costs. In the case of the life insurance industry, this has come to mean for typical life insurance policies, that revenue is defined as premiums as they fall due, and costs are recognized in such a way as to change non-level costs in proportion to premium income. This is accomplished through the mechanism of reserve assumptions.

In Canada, the foregoing is not mentioned in the Acts. "Presents _fairly_ the results of operations . . . and financial position" is as close as the Acts come to calling for GAAP. Rather, the Acts get to the heart of the matter and prescribe how costs are to be recognized.

In neither country is it the intention that earnings emerge as a level percentage of premium. Even in ideal situations the requirement for margins for adverse deviations should produce earnings that increase by duration relative to premium. It would be possible to construct an income statement which would be according to GAAP in the U.S. and legal in Canada. Even though we recognize that this normally couldn't be done for the balance sheet, there is sufficient disclosure in the Canadian statement that it should be possible to convert a Canadian balance sheet to a U.S. GAAP balance sheet with reasonable accuracy, provided the income statement also conforms.

Some differences in Canadian reserve methods are the 150% limitation (variable by regulation) on deferrable issue expense, the possible appropriation of surplus to cover negative reserves and the elimination of the lock-in principle. In the U.S., only conservatism dictates a ceiling on deferrable acquisition costs. In both countries the definitions of acquisition cost or issue expense is quite precise. Interpretation as to whether a particular expense meets the definition is not so precise. Since it appears that companies in Canada will generally find the 150% limitation to apply, then in both countries a fairly liberal definition of those expenses will be the rule.

The covering of negative reserves is not a major difference. It looks like a solvency check and the knowledgeable reader of a Canadian statement could mentally eliminate it as a reserve if it suited his purpose to do so.

In the U.S., to prevent manipulation of earnings, it is required that the set of reserve assumptions on a block of business remain unchanged with passage of time, unless projected experience would indicate future losses. In that case, a change of assumptions is required such that the future loss would be recognized immediately. In Canada the lock-in principle is not only not required but expressly forbidden. Assumptions are expected to change immediately upon determination that assumptions have materially changed. Incidentally, with respect to loss recognition, the same concept holds in Canada, i.e., that deficiencies be recognized in the valuation. In both cases it appears that such deficiencies need not indicate that the applicable business is unprofitable, but possibly only that valuation procedures result in earnings have been front-ended to the extent that future losses seem probable. However, there is a difference in Canada in that there is a policy by policy deficiency test. In the U.S., excesses and deficiencies in the same block of business may be netted.