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FINANCIAL REPORTING POLICY ISSUES

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1. Inflation's impact on financial reporting.
2. Future prospects for insolvency within the financial security industry.
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6. The reflection of the current economic environment in life insurance valuation.

MR. JOHN L. MC DONOUGH, JR.: It is a pleasure to be here today and I thank Virgil Wagner for the opportunity to present my views as an independent accountant on financial reporting policy issues--and more specifically the financial reporting of inflation and the pressures for changes in financial reporting.

Financial Reporting of Inflation

The past is reputed to be a source of direction for the future. Of the past, I feel reasonably comfortable with my knowledge of insurance events. Let us take a look at the past history of life insurance for a minute as a basis for my subsequent remarks. I will then look at the specific impacts of inflation reflected in insurers' financial statements. I will also identify inflation impacts which are not clearly shown in the financial statements and try to explain why this happens. Lastly, I will appraise the appropriateness of insurers' disclosures regarding the impact of inflation.

With due cognizance of the facts, the early history of life insurance, 100 odd years ago, was one of assessment societies and of insurer failures. This issue was resolved by development of the level premium policy--a product which provides a life contingency coverage while serving as an investment vehicle through its cash surrender value. During this early period only the wealthy owned life insurance.

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About forty years ago we saw the development of Social Security and more germane to our discussion, other retirement benefit plans. The expansion of such benefit packages, caused principally by union efforts, resulted in the development of group life--a product providing coverage only for life contingency and group health--a product providing benefits relating to morbidity risks. Late in this period, we saw significant expansion of individual term insurance sales--a product providing only life contingency coverage. By the mid-seventies, a majority of Americans had some form of life and health insurance.

Inflation became a problem for the U.S. economy in the mid-seventies. For the insurance industry the problem generally was not identified until several years later. The key concern about inflation and the product of insurance is the uncertainty as to real value of future cash flows. Unfortunately, while the concern is easy to identify, it is difficult to quantify. So those formerly happy with general account investment yields may not now be satisfied. Now they direct investment dollars to inflation sensitive instruments. And everyone has insurance while no one is sure of its real value. This is not a satisfactory conclusion for an industry whose cornerstone is to provide security!

From a financial reporting perspective, I characterize the impact of inflation on insurance products as a situation where insurers, more and more, are passing on investment results to policyholders. For example, you only have to look to guaranteed investment contracts, real estate and other separate accounts. In the health and workers' compensation segments we see more administrative services only and minimum premium plans and the emergence of captive insurers.

Even the approaches developed for the 80's--non-guaranteed premium products as well as the prospect for variable interest rates on policy loans--are reflections of the response to economic conditions.

Turning to the impact of inflation on financial reporting, what do we see? In recognition of inflation's effects, the Financial Accounting Standards Board (FASB) adopted Statement No. 33 which became effective in 1979. For the large stock life insurers required to present the supplementary information, key disclosures include:

Income from continuing operations adjusted for the effects of general inflation,

The purchasing power loss (or gain) on net monetary items, and

A five-year summary of selected data including revenues, net assets, dividends per common share and market price per share.

FAS No. 33 was adopted with criticism by various insurance industry representatives. Concern was expressed about the disclosure requirements and methodologies prescribed. Even the fundamental applicability of the statement to the insurance industry was questioned. While concentrating on what the required disclosures tell us about the industry, it will be of benefit to also consider the Statement's shortcomings, real or perceived.

First, operating income expressed on a constant dollar basis reflects a significant reduction in real earnings growth. The reliability of these adjusted values is dependent foremost upon the correlation of the index used to adjust the historic cost amounts and the real inflation rate experienced by the companies. However, the conclusion that real earnings growth is significantly reduced remains valid.

Second, insurers' hypothetical net monetary losses in purchasing power, as a percentage of net income, are significant. As you know, this results because life and property/liability companies are basically in a net monetary position. This particular measure was the most criticized by property/liability insurers since unearned premiums and deferred acquisition costs are treated as non-monetary. Such treatment has the effect of significantly increasing the reported purchasing power loss.

The five-year summaries reflect similar results. Generally, real revenue and net asset (i.e., stockholders' equity) growth is significantly less than that reported on a historical cost basis. Stated in 1980 dollars the real growth in life insurance sales (base adjusted using the CPI) for the period 1977 through 1979 was 17%; less than 6% per year. These percentages also are representative for ordinary; however, group sales declined through 1978 with the entire net increase occurring in 1979. It might be interesting to note how many of you can recall reading financial statements citing only 6% sales growth for any of these years.

As important as the disclosures presented by insurers complying with FAS No. 33 are disclosures not reported. Segment information, as required by FAS No. 14, provides some insight into each insurer's change in business segments or markets. However, the effect of trends or the introduction of new products is rarely measurable in the segment information presented. Other parts of the annual report to stockholders, particularly management's discussion and analysis of financial condition and results of operations (MDA), can provide significant insights.

On balance, the reader of stockholder reports should find the supplementary disclosures with respect to changing prices are adequate and appropriate to disclose major trends impacting insurers. The effect of insurers' reactions in the form of new products and changes in emphasis are generally not as readily determinable. This is not an ideal situation since I believe the proliferation of new products will continue and that these products will pass, more immediately, the investment results to the policyholder.

What about inflation disclosures? We now have supplementary information for large insurers. There is speculation by some that all companies, large and small, will be required to present supplementary inflation adjusted financial data within 3 to 5 years. Because the problem of capital erosion resulting from inflation is so significant, my firm believes that appropriately determined "inflation losses" should be reported as an element of the primary financial statements. If this is done, perhaps the IRS will eventually permit recognition of the inflation loss as a deduction in corporate tax returns.

The Pressures for Change in Financial Reporting

The pressures for change in financial reporting come from the SEC, FASB, AICPA, financial analysts, investors, companies and creditors. The companies and industry associations are concerned with how to report for new products; for example, non-guaranteed premium or guaranteed investment contracts. They also have concern about accounting for some of the newer investments such as shared appreciation mortgages.

Other groups like the SEC are principally concerned with disclosure. The SEC's new integrated disclosure requirements which became effective in 1980 are the best and most recent example of this. Of particular note in this regard is the recently issued proposed revision of Articles 7 and 7A of the SEC's Regulation S-X which govern the form and content of insurers' financial statements. The proposed Article 7 combines and significantly amends current Articles 7 and 7A.

I should mention the FASB at this point, since it **serves** in a dual role. The FASB acts principally as an initiator of change but in many instances also acts in response to pressures for change. One only needs to consider the FASB's vast project on conceptual framework for financial accounting and reporting and other major projects to see how the FASB is an initiator of change. Completion of the conceptual framework project is expected to lead to consistent standards and a coherent system of interrelated objectives and fundamentals that prescribe the nature, function and limits of financial accounting and reporting. Related projects, such as the FASB's Discussion Memorandum on reporting fund flows, liquidity, financial flexibility and the task force it recently established to extract insurance accounting principles as part of the FAS No. 32 project, are also of particular interest to insurers.

Before I pursue the discussion on pressures for change, it should be useful to you if we spend a moment on the process through which accounting pronouncements are developed and the role of the FASB and the AICPA in this regard.

- A. FASB has had sole authority since 1973 to set accounting standards (actually the SEC has authority, but has delegated it to the FASB).
- B. **AICPA** has in recent years issued Statements of Position (SOP's) on accounting matters which are proposals to the FASB.
- C. Preface to those SOP's indicate that such recommendations are subject to ultimate disposition by FASB.
- D. Issues Papers will now be prepared on accounting matters by the AICPA and sent to the FASB for its consideration and its decision to add the matter to its agenda or not.
- E. Issues Papers will, in most cases, include advisory conclusions on the issues.

- F. Under current procedures, the AICPA can still issue SOP's on auditing matters (and on accounting matters when the FASB does not choose to add the matter to its agenda).

Returning to the pressures for change, through what channels do they come? As regards the AICPA Insurance Companies Committee, issues come from the sources mentioned earlier including companies, industry representatives such as your Society, the SEC or the FASB. An inquiry my Committee recently received is a good example.

The recent introduction of non-guaranteed premium products has given rise to a question about the appropriateness and applicability of the "lock-in" principle to this product. The question was formally raised by an actuary with a major life insurer. Subsequently, the company has provided the AICPA Insurance Companies Committee and the American Academy of Actuaries' Committee on Financial Reporting Principles with studies on the emergence of profits resulting from this particular product when there are changes in premiums. Since the issue is still under study, I am not in a position at this time to speculate on the question's resolution.

How does the process work for obtaining the views of interested parties? Let us consider a recent example. An accounting paper currently in process is the proposed AICPA Statement of Position on Mortgage Guaranty Insurance. In October 1979 the AICPA submitted a draft Issues Paper to the FASB who sent the paper back to the AICPA for exposure as a Statement of Position (SOP). In October 1980 it was exposed for ninety days for public comment. The SOP will soon be considered by the AICPA's Auditing Standards Executive Committee for approval. If approved, it will then be sent to the FASB for final approval and then published. Throughout the process there has been close contact with interested parties, particularly members of the Mortgage Insurance Company Association. The AICPA received letters of comments on this SOP from groups other than those associated with the mortgage guaranty insurance company industry. Perhaps some of you were involved in the comment process.

Another example is the AICPA Reinsurance Accounting and Auditing Task Force which has at least eight industry liaison groups actively contributing comments. These liaison groups were established to respond to the need for participation in the Task Force's efforts by people who are not CPA's and thus could not serve on the Task Force itself. The Task Force intends to address auditing and accounting concerns for both life and property/liability companies. The first paper recently completed by the Task Force deals with auditing property/liability reinsurance transactions. I expect that it will be available for public review and comment this summer. Incidentally, this particular AICPA Task Force was set up primarily as a result of the urging of the SEC.

Perhaps you are interested in monitoring and responding to proposed changes. If so, one step you can take is to be placed on the mailing lists for newsletters such as the "AAA's Newsletter", "The CPA Letter", "The FASB Status Report", or the "SEC News Digest". All of these publications provide short, key-item summaries of proposals, issues and scheduled public meetings. They also provide information on the current status of such proposals and how to obtain copies of the various research studies, exposure drafts, etc. Also, as actuaries you have access to the American Academy's Committee on Relations with Accountants. This is a standing committee which

meets periodically with the AICPA's Relations With Actuaries Committee to discuss issues of concern to both disciplines.

In summary, an adequate process exists and the channels are available through which you can actively participate and communicate. We look forward to your participation.

MR. RICHARD S. ROBERTSON: I am not one of those who enthusiastically supports what the Financial Accounting Standards Board has come out with on Statement 33. I am one of those who Jack referred to when he talked about "some people in industry".

I believe that inflation represents a serious and potentially fatal threat to the current accounting framework. The current accounting framework, and this applies both to statutory and GAAP accounting, is primarily based on historical cost accounting. That is, the elements that are accounted for in current financial statements are primarily measured by historical transactions. Inflation destroys the usefulness of the dollar in measuring those financial transactions. The fact that something had a certain dollar value several years ago has little relevance to what its value might be today or to its meaningfulness today. Also, the high interest rates that accompany inflation tend to reduce the meaningfulness over time of a given transaction.

Statement 33 is an effort to patch up the historical cost framework by adjusting for the differences in value over time of a dollar, but there are so many factors that are affecting the value of the dollar over time that I believe it is not likely to be successful. In particular, I do not think the kind of disclosures that are coming forth today are meaningful, and I do not think they will be put to much use.

I am afraid that the only solution put forward will be some form of current value accounting, which will supplement and may ultimately replace historical cost accounting if inflation continues at its current level. If I am correct and this happens, it has significant implications for the actuary. I think we are more comfortable with a current value accounting framework than we are with historical cost. We are accustomed to putting values on future cash flows, and we certainly are accustomed to taking into consideration the effect of interest. In fact, if it is true that accounting will move into this framework, I believe that the actuary has a significant role to contribute, not just to insurance and pension accounting, but to accounting in general. I think that we are going to be called upon to provide that contribution. In fact, to some extent we are today. We were asked by the AICPA to make a contribution to their task force on discounting. We responded by proposing that an actuary be placed on that task force and he was.

Let me talk for a minute about liquidity. Until very recently those of us in the insurance business have taken positive cash flow for granted. Last year for the first time, many of us have learned that we have to become better acquainted with our bankers. Many companies which never **considered** the use of debt are now doing so on a regular basis.

Mike Frinquelli will be talking about how financial statements report company cash flows and liquidity needs. He and his associates are quite accustomed to looking at financial statements and trying to evaluate the ability of companies to meet their financial commitments. They never have had to do this in the past for insurance companies, but now they are beginning to. They will discover that the kinds of financial information that are available to analysts are not adequate to do the job. This is actually a general problem, but it is probably worse for insurance companies than it is for other types of organizations. What is even more shocking is that those of us who are in management of an insurance company do not have the tools to do the job either. But, we are learning.

There are many people in industry who are very active in trying to pursue how better to measure current and future liquidity needs of insurance companies. The Academy of Actuaries is also working on it, as is the American Council of Life Insurance. This will be a major project in the year or two ahead.

The program asks which social issues influence financial reporting. Probably a legitimate question would be: Why should social issues affect financial reporting? Whether they should or not, we have to look at who is setting the rules. As Jack indicates the Financial Accounting Standards Board has the authority to determine accounting policies, and that authority has been delegated to them by the Securities and Exchange Commission. The FASB, therefore, needs to look over their shoulder continually to determine what the interests and needs of the Securities and Exchange Commission may be. If the SEC is not satisfied with what the FASB is doing, they can and, in the past, have issued their own rules. The SEC, in turn, must continually look over its shoulder at the primary standard-setting body, the U.S. Congress. Therefore, the SEC is very sensitive to political and social issues.

Let me give you a couple of examples. In the recent past, the use of bribery to establish positions in certain foreign markets was commonplace. I think the consensus in this country is that this is not a proper practice for U.S. corporations, but what is interesting is that the SEC used financial reporting as a tool to control and try to eliminate the process. They would look at companies that had paid bribes, if you will, of perhaps a few hundred thousand, a million, two million dollars and said that failing to disclose that information represented inadequate financial reporting. Now we are talking about billion dollar corporations. Most of us would not consider a million dollar item material to the financial statement of a very large organization, but the SEC made it material.

Another example involves accounting for federal income tax. To most of us income tax is just another item of expense, although a large one. But look how it is reported. It is not up in the summary of operations with the rest of expenses, it is on a special line of its own after you calculate a pre-tax income. And then you turn to the notes to financial statement and there is, probably, a whole page discussing the relationship between current and deferred taxes, why our tax rate differs from the overall corporate tax rate, and so forth. Why is so much attention being paid to the calculation of the tax. The primary reason, I submit, is that it is a political and social issue. People want to be sure that we are paying our fair share.

The consumer of financial information is the investor or potential investor. A great deal of attention has been paid in recent years to being sure that we provide that consumer with the information that it is deemed he is interested in, and I am a strong supporter of that movement. I believe that, by-and-large, it has been beneficial. If you were to take the 1980 shareholder report for any corporation and compare it with the 1970 shareholder report, you would find dramatic differences, mostly improvements, in the kinds of information the shareholder is receiving. Examples include much more detailed information on quarterly financial information; much more information on segment reporting, with the earnings and other information of the various lines of business in the organization shown. Look at the management's discussion that Jack was referring to: it talks about liquidity and inflation. Thus, you find that the content of the report, the text, is generally much better written, much more complete, and has much more information included than in the past. I can give you many other examples, but there is no question that the quality of financial information and the completeness of it that we are providing to our shareholders and to professional investors is far, far better than it was only a few years ago.

There is, also, an interest in protecting the small shareholder. The Securities and Exchange Commission and others that have an influence want to be sure that we are not favoring just Mike Frinquelli and his associates by giving them access to information that the average shareholder is not getting. Thus, we work hard at trying to make sure that we are being fair to all of our investors, giving all of them information of the same kind and in a timely manner.

The other area that I want to talk about is the changes in valuation that are required or that are needed as a result of these developments. We can talk about valuation in at least three contexts: statutory accounting, GAAP accounting, and the more general question of putting a value on a company, either in assessing the price of its stock or in an acquisition context. It turns out that the issues in these three contexts are the same. They might be addressed a little differently, but they are the same issues.

Look, for example, at valuation of assets. Most insurance companies, especially life insurance companies, find that the current market value of their assets is significantly less than the carrying value. Is this a problem? Some of us might say, "Not especially, because the same thing holds true on the liability side. Both sides represent discounted cash flow, and we are using historical interest rates to value both." There is a lot of merit to that, but nevertheless, the fact remains that, if you compare two companies, the one that has a substantial volume of assets invested at relatively low yields has a relatively lower market value than a second company whose assets are invested at higher interest rates and where, therefore, the market value is much closer to the stated value. The second company is clearly in a much stronger financial position than the first.

One might say, "Well maybe the problem is on the liability side." To some extent it is. We have the same problem there. If a company has substantial permanent cash value life insurance that is not borrowed and that is valued at 3%, 3½%, or a similar interest rate, that company is clearly in a stronger financial position than a similar company that might have all of its cash value borrowed, or if it is writing predominantly term insurance, or if in some way it does not have that substantial interest margin. But there is no way of assuring us that the overstatement of the assets and the overstatement of the liabilities are comparable.

The answer, undoubtedly, will be to pay much less attention to the differences between assets and liabilities. They are not two separate problems. Jack mentioned the trend toward companies linking their investments and their products closer together, but unless we recognize that linkage and reflect it in the way we prepare our financial statements, we are going to come up with financial statements that do not make sense.

Look what is happening to some companies in the pension area. They are required to establish substantial deficiency reserves or other reserves to provide for contracts with little investment risks at all. The same thing might hold true of permanent cash value life insurance. The idea of holding a policy loan asset and then setting the reserve up on the same policy for what in the final analysis may be only a form of term insurance really does not make much sense. In the long run, we will probably move much closer to the concept of allocating our assets, either formally or on paper to the various products. Perhaps, 10 or 20 years from now the balance sheet of a life insurance company will bear no relationship at all to a current balance sheet, but will make a lot more sense to a user of it.

MR. A. MICHAEL FRINQUELLI: I have been asked to address two topics--first, the prospects for insolvency in the financial security industry--second, who is the public for whom financial statements are prepared. These, in a sense, are related subjects, and I will treat them as such.

First, the matter of insolvency. The possibility of a financial company insolvency--a financial accident if you will--may rarely have been greater than it is today. The financial security industry is based on one key assumption--economic stability, a condition that allows people like yourselves to make projections with some reasonable degree of confidence. Such stability has eroded insidiously over the past decade--in such areas as interest rates, cash flow, lapse, taxation, even distribution outlets. Remember, it was as recently as the 1960's that many financial experts were proposing that the prime rate was dead. It rarely changed noticeably anyway, so who cared about it? Who of us here today would care to bet our homes on where the prime will be a month from now, much less a year or five years from now?

Today, interest rates represent news. People regularly brag about shifting money from a bank CD, to a money market fund, to options, to a fancy new life insurance product. Such continual shifting breeds instability--instability that may sow the seeds of that financial accident.

Let's concentrate now on the effects of all this on the life insurance industry. Most fundamentally, can the industry tell with any real

confidence anymore just what the maturity structure of its liabilities is? And consider cash flow. So many new flexible life products have hit the market in the past few years, I certainly cannot keep up with them--and I question how many life company managements can. And then consider the industry's most rapidly growing segment of business--annuities. Many individual annuities today virtually solicit instability of cash flow and profit margins rather than seeking to inhibit it. As for corporate pension business, this was a presumably stable source of cash flow--until March of 1980. How many life companies, I wonder, fully match assets and liabilities in the guaranteed investment contract business? How many life companies are so expert in the real estate business as to confidently solicit funds for new real estate separate accounts?

The life insurance investment process is changing dramatically, spearheaded by these new growth products, and by policy loans, and certainly by tax considerations. This is an exciting but dangerous time for investment departments accustomed to standard long bond and mortgage investment, and which must now become familiar with a dizzying new array of circumstances and devices such as:

A negative yield curve. A negative yield curve is an unnatural state of affairs. A lender can earn more by getting shorter than by going out long. With all the pressures from boards and others to get shorter, it seems like a very easy thing to do without impacting earnings. However, consider the implications of all this for asset and liability matching, a fundamental concept, I think, in your business.

Second, real estate. Real estate is once again a "can't lose" proposition. Those of us here who own homes, I am sure, feel like financial wizards because our values have gone up phenomenally in the past five or ten years. People have lost money occasionally in real estate, I am told. You only have to look back as far as 1974 and 75 to recognize that. And, of course, consider liquidity aspects or illiquidity aspects of the real estate business. Another very popular, increasingly popular, area these days is oil and gas. It is hard to find a life insurance company that is not looking into some kind of oil and gas joint venture. Sounds like a very sound idea, based on what has happened in the recent past. Yet, what will happen in the future?

Also, option writing and something akin to option writing, interest rate futures. A relatively recent development, interest rate futures, I am told, if used properly as a hedging device can be a very strong and new weapon in the fight against instability. But consider the speculative possibilities of this new device which allows us to bet, in effect, on the future course of interest rates.

And, finally, one other concept that is brand new--and sounds like something straight out of James Bond--Zero Coupon Bonds. I wouldn't get into what zero coupon bonds are except to use it as an example of the very innovative new devices being created by investment bankers.

Consider capital allocation. How much capital is needed today to back up a dollar of ordinary life insurance liability? ... to back up a dollar of pension liability? As a financial analyst, I can tell you that it is awfully difficult to get direct, on the record responses to such questions.

Specifically, how might a financial accident happen? I am sure all of you could think of a few ways yourself. But let me point out one particularly stern taskmaster: the commercial paper market. A few years ago there were only three large life companies actively issuing commercial paper. Over the past year or so, that number has swollen to well over a dozen. I am certainly not questioning the efficiency of that market, quite the contrary. It is a very closely watched market--by investors, investment bankers and rating agencies. It is an impersonal, unforgiving market. Incur a serious liquidity problem and the commercial paper market will notice, and as a result, so will the rest of the financial markets and ultimately the customers who look to the financial security industry for protection and security.

Another area of discussion that represents both a risk and a possible solution to the insolvency question is that of mergers and acquisitions. A company finding its balance sheet and income statement becoming more and more unstable might be well advised to seek consolidation with a more stable enterprise, or one with offsetting sources of instability. On the other hand, the acquisition process itself could increase the risk of instability. After all, we may be trying to put together different management styles, different books of business, different agency plants or distribution outlets, and so on. If we are lucky, all goes smoothly and the sum winds up being something better than the two separate parts. But if we are not lucky, we wind up trying to mix oil and water, and instability is increased rather than reduced.

The dangers may be even greater when one of the partners is essentially unfamiliar with the U.S. insurance business and its changing nature (for example, when one of the partners is a foreign entity or a U.S. industrial entity). There have been more than 40 life insurance acquisitions effected over the past five years, and the jury is still out, I think, on the success of that takeover wave.

One final point on this matter of insolvency: the Federal Government. Do financial security professionals really have to worry that much about out-and-out insolvency? Hasn't Washington shown a distinct distaste for financial instability, be it Lockheed, the city of New York or Chrysler. Well, let's just keep in mind that Washington these days sounds a lot different than it did as recently as last November 3. Some have suggested that this administration might almost welcome a financial accident to show its steadfastness and policy of hands-off government. In the insurance business we have the thorny issue of insolvency funds--visions of a domino effect inevitably come to mind.

All right, you agree there is a potential problem out there. What can we do about it? Well, we are not about to set the financial world right this morning, but we do have a vital obligation to seek out and disclose sources of strain: which gets me into that second broad subject--who financial statements are for. I have been chairman of a Financial Analysts Federation Subcommittee devoted to this subject as it pertains to the insurance industry for several years now, so this is a subject I have been working with for quite some time. I think what vexes me most in this area is the apparent attitude of many companies that they really cannot disclose all that much, because the many technicalities of life insurance are really too complicated for most people. That is a cop-out, plain and simple.

What that attitude says is that the company itself does not fully understand the subject, or that it is simply too lazy to map it out--lucidly--in writing, or that it may be glossing over a painful subject.

Let me give you a few examples of poor or at least mixed disclosure today:

1. Life Insurance Company Taxation--Is the Menge slide really all that impossible to at least outline for us? Is modified co-insurance really such a big secret to the IRS? What are the ramifications of new tax legislation being discussed? What are the chances of modco being taken away by the IRS? What happens to your company if it does?

2. Market Value of Assets--Do managements really not care about this number because bonds are always held to maturity and there is an offset in marking policy reserves to current interest rates? So tell us that. It is amazing how readily available such numbers become when a life insurance company is acquired.

3. Cash Flow Volatility--If there really was a problem last March, tell us about it in something more than one sentence in an annual report. What are you doing about it? What more might you have to do? What are the implications of these moves in regard to short-term and long-term profitability?

Finally, FASB 33. The lack of really serious discussion in financial statements on the subject of inflation accounting has been simply remarkable. This is hardly unique to the life insurance business, but your business, being a financial one, might have been expected to explore this area in greater detail than a manufacturing company. The data, particularly as regards purchasing power loss, are certainly significant enough to merit some thoughtful, detailed discussion. And don't tell the financial statement reader that the numbers are meaningless, when your own investment departments are now devising more and more ways to deal with inflationary patterns.

Now, who is it that you should be telling all this to? Frankly, I think that question is irrelevant. Anything that a company or industry professional believes is important or potentially important to the current status and/or future prospects of a company or industry should be publicly disclosed somewhere, be it a revised form of convention statement, an annual report (most obviously, perhaps, an annual report), an SEC filing, or a press release.

Those who do not understand the item and/or do not care to delve into that item, need not do so. But at least those who care have been duly advised. In other words, if in doubt, disclose; that does not mean inundating the world with jargon--rather it means taking tough, meaningful subjects and discussing them, analyzing them in clear, thoughtful words and numbers. Your financial statements and disclosures should be geared to your most sophisticated audience--be they regulators, A.M. Best, institutional investors, or financial analysts. You should not assume that your audience is Aunt Jane or Uncle Charlie--the sweet 80 year old who owns a \$5,000 policy or 100 shares of stock. You may find that even Aunt Jane has gotten pretty sophisticated about financial matters.

MR. VIRGIL D. WAGNER: I now would like to open the meeting to questions and comments.

MR. ABRAHAM HAZELCORN: Jack McDonough's remark about the lock-in with respect to the development of indeterminate premium policies triggers a question. When I was actively involved in the initial conversion to GAAP of life insurance companies, there were two statements that were frequently made. One was that once a life company is on GAAP, the investor will be able to make a more intelligent decision as whether to invest in a chemical company, an automotive manufacturer, or a life insurance company. The second statement was that the assumptions used in converting to GAAP figures would be self correcting, in a sense, because of the lock-in concept. Recently, I went to a seminar at which a member of a Big 8 Firm mentioned two things which were rather shocking to me. One is that comparability is not really all that important. The second thing is, and he spoke for himself, not for his firm, that the lock-in concept was not appropriate for indeterminate premium policies. I would like some comments.

MR. MC DONOUGH: First of all the lock-in principle was developed to obtain an output which would produce a fairly level plan profit in relationship to premium revenue. And as you know, there are other aspects of the stock life guide, such as making a provision for adverse deviations and assumptions, and so forth, which should produce favorable variations as the business stays in force. So through the lock-in you have a so-called plan profit, which is fairly level in relationship to premiums, compared to excess interest and other items which create favorable variations. In looking at nonguaranteed premium products, we see that the use of a lock-in principle does not appear to maintain this level relationship. So there is a serious question in the minds of actuaries and accountants as to whether or not that lock-in principle should be continued with respect to those products. The proliferation of those products, as I suggested earlier, is a fairly big question with respect to this lock-in principle. In going back to the genesis of lock-in, lock-in was developed partly based on theory and partly on practical considerations. When the life guide was being developed, the accountants and a number of industry representatives who were very active in assisting the AICPA in developing the stock life guide did not feel that it would be appropriate to make new assumptions of the business in force every year.

The AICPA Insurance Companies Committee has not considered doing away with the lock-in principle for all businesses. We haven't considered that at all. But we are looking at the implications of nonguaranteed premium products. In fact, I view it as a very important matter as many others do. The Academy certainly does, and they have a Proposed Interpretation drafted on this and that work has been summarized in a newsletter of the Academy. But we cannot ignore questions that come up, I am sure, as we go through and pursue this matter, that might relate to other business as well. So, I do not suggest that we are going to reexamine the whole principle, but we certainly are going to be touching on some aspects of it as we go through the next few months.

Getting back to your question about comparability, the view of accountants on comparability is that, in similar circumstances, Company A and Company B should have comparable results. Now I think that with respect to making assumptions for life reserves, I do not suggest that we do have comparable

results. You can see wide ranges of interest assumptions published in the footnotes to annual reports. You have to get back to the facts and circumstances of the particular companies. Investment policy does have an impact on the interest assumptions to be made, but in comparable circumstances we accountants look to see comparable results.

MR. ROBERTSON: I would like to ask Mike to talk a little more about how people are using the results of FASB 33. Are they finding them useful and, if so, how?

MR. FRINQUELLI: Well, we are trying to, but frankly, it was a question I was going to put to Jack. One of the real problems with the footnotes in financial statements now--the FASB 33 footnotes--is lack of comparability. For example, I just finished trying to compare 27 insurance companies using FASB 33, and have found some very rough degree of comparability among 10 of 27. For example, I cannot compare the three large Hartford companies--three of the biggest stock companies available--among each other, much less compare them to non-Hartford companies. So, I think some of us are making a real effort to work with FASB 33. I think one of the most obvious areas where we are trying to do some work is purchasing-power loss and just what to do with purchasing-power loss. Clearly, if one subtracts purchasing-power loss from earnings, the numbers are dramatically lower in virtually all cases I can think of. One of the key constraints we have now is lack of comparability among companies. If I could toss this to Jack for a second, I recognize that the SEC suggested this as an experiment, and it is an experimental process. It does strike me that it would be a more useful experiment if there were more clear-cut factors laid down for just how the numbers are to be derived. I found it interesting that Business Week tried to compare a number of industrial companies in regard to inflation accounting and had a very difficult time; they ignored insurance organizations altogether because of what they said were special problems over and above those of industrial companies.

MR. MC DONOUGH: Mike, I was wondering if the base period being different in some cases poses part of the problem.

MR. FRINQUELLI: One of the problems with FASB 33, in the interest, I am sure, of providing flexibility, is that a company can use a base period for the CPI of 1967 or use a current period as a base period. Now, if a current period is used, that means every year the numbers keep changing which causes, I think, some confusion. If you use 1967, at least you keep rolling the same kind of numbers forward from a prior year. That is part of it, but I think also in the application of the methodology there are certainly differences. The illustration booklet put out by the FASB on how insurance companies might report purchasing power gain or loss fosters some of that because it illustrates calculations on the basis of following FASB 33. And then, as you know, goes on to suggest that some or many insurance industry representatives do not agree with the categorization of certain items, so it gives you an option of doing it the other way as well as the required way. So, we get different numbers and different methodologies, and I agree that the results are not as comparable as I think everybody would like to see them, and, hopefully, the experimentation will move into something more tightly defined so that information can be useful.

MR. ROBERTSON: I guess I have difficulties with complaints about comparability because of the base period. The difference between the two is a division problem ... strictly a proportional difference. A more serious complaint is the differences in defining what is monetary and what is non-monetary. I will tell you the problem we see. We do not sense a consensus about what we are trying to measure. We do not really know what the so-called loss of purchasing power is. Unless we have a clear understanding of that, it is almost impossible to come up with a good concept of how to measure it. I think it is because of issues that are that fundamental that we are having problems with the concept.

MR. MC DONOUGH: I want to make one comment on Article 7 of Regulation S-X, which has just been proposed in the last few weeks by the SEC. I want to call the attention of those who may be associated with mutual life insurance companies that are sponsors in SEC filings to footnote 6 in the forepart of that release which indicates that mutual companies may file statutory statements rather than GAAP statements. However, it also says that the disclosures to be included in any financial statement filing by those companies shall be the same as for other registrants. If a mutual life company has its financial statements included in a variable annuity filing and has the customary two or three notes, this article, if applied to the letter, will require significant expansion of the footnotes to those statements. I think I would call your attention to looking very hard at this item and would suggest you make your views known to the SEC if it troubles you.

MR. PAUL MARGUS: I am wondering if Mr. Robertson would clarify the meaning of current value accounting. If you extend this idea into the ultimate, does it mean that we would be using things like prospective gross premium reserves in discounting all future cash flows, such as deferred taxes and discounting the value of future claims, and so on?

MR. ROBERTSON: Current value accounting can cover a wide range of accounting concepts, of which probably the basic characteristics would be that you base your assumptions or your model on what currently exists or what is projected out in the future, rather than what was. It could be in a gross premium valuation context, in which case you would be, at least conceptually, trying to come up with some measure of the current value of the company, or it could be in a net premium context-- that is, where you are still programming a level of profit to emerge from existing business in some kind of pattern. There are considerable variations beyond those two. I do not really know the direction we might be heading. To use some kind of a net premium valuation rather than gross would be more consistent with the existing accounting model, but there are gross premium valuations that are currently being undertaken, both internally and externally. I think most insurance company acquisitions use some kind of a gross premium valuation, discounted cash flow concept to measure the value of the company. We certainly do it when we are making acquisitions.

MR. C. L. TROWBRIDGE: How do these issues apply to financial institutions which are organized on a cooperative or mutual principle? We lose sight of the fact that the mutual principle is very strong in the financial security area. All of the financial accounting that you are talking about today emphasizes the value of this corporation for the purpose of the investor, and it just does not say anything at all about mutual cooperatives of a general kind, where the real interest is more on the financial security. Is this thing going to stay solvent? Is there any development in financial

accounting today that really speaks to the corporation organized on the cooperative or mutual principle, or is all the development along lines of interest to the financial analyst? It seems to me that the question of what is sensible accounting for a cooperative is just not being faced.

MR. MC DONOUGH: I do not mean to speak as an expert in savings and loan and other non-insurance financial industries, but from a generally accepted accounting principles standpoint, the same principles are applied to organizations like cooperatives and mutuals. There is another body of opinion, especially with respect to mutual life insurance companies, that raises questions with regard to usefulness of some requirements for those companies when there are no investors or, in many cases, creditors. On an analogous line, there is something developing in the accounting profession that makes a distinction between small businesses and large businesses--small businesses, perhaps owned by two persons, as opposed to a large publicly owned company. The work is on the nature of disclosures rather than accounting principles, as there is a recognition that perhaps a small business entity need not have or go through all the disclosures that a big public company needs to go through. There is something developing along that line, but there is nothing specifically, as far as I know, in force or developing with respect to accounting for a cooperative or a mutual enterprise.

MR. ROBERTSON: Let me make a few comments on the more specific aspects of mutual life insurance accounting. The question is whether and to what extent mutual life insurance companies should prepare GAAP financial statements, and the question is if they do, what are they? This comes up from time to time. There is almost a cycle where somebody (the SEC, the accounting profession, or academia or whatever) says "this" is a problem we ought to solve; a task force is appointed, studies it, comes to some of the basic questions that you have raised, and generally says, well, there is really no pressure for a solution, so, let's put it back on the shelf. We have gone through that at least twice now, and I see it coming up a third time. In some sense, some of us feel it is almost a solution looking for a problem. On the other hand, I think that, if I were in the management of a mutual company, I would be interested in using some of the tools that have been developed for stock companies, especially the deferral of acquisition costs, to try to evaluate how different categories of business are doing, maybe even to develop some incentive compensation programs, but I am not sure that that is something that the public sector or the accounting profession should force on a company.

MR. FRINQUELLI: Ultimately, the most important user of the financial statement is not the financial analyst or the stockholder; it is management itself. I think that the form of the organization is not all that important. I would like to think, as an analyst, that the financial statements that a management provides me are the statements that they themselves feel are most useful to them. Frankly, I would feel that, if the management tells me that they have to prepare GAAP because we or the SEC, or the accounting profession forces them to, but they really do not pay much attention to it, there is a real problem in GAAP accounting, because it is not the real world. The important point, therefore, is not the GAAP or stock company consideration, but who are the most important users of those numbers. I would like to think the most important users are those people who are running the company and who are developing those numbers. Also,

I think regardless of form of organization, more and more entities are finding it necessary to deal, if not with stock investors, then with rating agencies, perhaps, or debt-oriented investors. Mutual companies may not have stock outstanding, of course, but I think more and more of them are finding it necessary to go to rating agencies and to the debt market and, **therefore**, must prepare some form of financial statement analysis for those entities.

MR. MC DONOUGH: I would like to expand on that with a real example. This year one of my clients, a property and casualty mutual company, has prepared GAAP financial statements for the first time; it is not for outsiders, but for their own management use to measure profitability by line of business, and the return on investment. It is something they feel is going to be valuable to them.

MR. FRINQUELLI: I really do not see how you can develop a new product, for example, without some form of financial statement, geared for that particular product. Otherwise, how do you know whether you should be offering that product?

