

# RECORD OF SOCIETY OF ACTUARIES 1983 VOL. 9 NO. 3

## ACCOUNTING ISSUES FOR INSURANCE COMPANIES

*Moderator: GLEN M. GAMMILL. Panelists: GRACE V. DILLINGHAM, DOUGLAS A. ECKLEY, NORMAN E. HILL, NEAL N. STANLEY. Recorder: CLARK A. RAMSEY*

1. Current GAAP topics:
  - (a) Deferred taxes
  - (b) Single premium deferred annuities
  - (c) Universal life insurance
  - (d) Other current topics
2. The value of interim earnings reports
3. Statutory issues

This session will include a discussion of the paper "Purchase Accounting: A Fresh Look" by Douglas A. Eckley.

MR. GLEN M. GAMMILL: In this session, Doug Eckley will present his paper on "Purchase Accounting: A Fresh Look", Norm Hill will discuss current Generally Accepted Accounting Principles (GAAP) accounting issues, Grace Dillingham will discuss statutory accounting issues, and Neal Stanley will discuss the subject of interim financial reports.

MR. DOUGLAS A. ECKLEY: Let me start by pointing out that if you disagree with what I am about to say, you are not alone. I received five discussions of this paper, and not one was in agreement with me. Nevertheless, I am sure the arguments presented in the paper have merit.

The point of the paper is that more uniformity could be achieved in purchase accounting because there is a single most appropriate approach.

The basic reason for purchase accounting is that accounting theory considers a purchase to be grounds for revaluing that which is purchased on the books of the acquirer. A simple analogy can be made with buying a computer for \$10,000. The buyer records the asset at \$10,000 on his books regardless of what the carrying value was on the books of the former owner. When a life insurance company is purchased the accounts are similarly revalued. The accounts whose revaluation requires actuarial expertise, and which are therefore the subject of my paper, are the reserves and the present value of profits.

The question arises: Why should we restrict the available purchase accounting methods to one? Choosing a method could be left to the actuary. One answer is that the actuary already has major responsibility in that he selects the experience assumptions to be used. You may have seen a recent article in Best's Review lamenting the lack of

uniformity in GAAP accounting. Uniformity is not an end in itself, but where a certain approach can be demonstrated to be the most logical, it should be adopted.

Reserves must be set before the present value of profits can be calculated, so reserves are the first concern.

The American Academy of Actuaries provides some guidance in its Interpretation I-D. That interpretation identifies two purchase accounting methods: the Defined Initial Reserve Method and the Defined Valuation Premium Method. Under the former the actuary fixes the reserve at the outset and uses it to solve for the percentage of gross premiums he will need to provide for future benefits and expenses. Under the latter the actuary determines a reasonable profit margin, such as 10% of the gross premium, and uses the complement of this, or 90% of the gross premium in this case, as the valuation premium. Given the valuation premium, he can calculate the initial reserve. Experience assumptions would include GAAP-type margins for adverse deviation. The Academy did not contemplate the capitalization of the present value of future profits. Under either method, if actual experience equals assumed, then earnings will emerge as a level percentage of premium revenue prior to amortization of goodwill. Either method leaves the actuary plenty of leeway in revaluing the reserves.

Practice has evolved so that the present value of the profit portion of the gross premium is calculated and booked as an asset. The effect is that 100% of the gross premium is capitalized: 90% (using the previously mentioned figures) in the reserve calculation and 10% in the profits asset. Goodwill is then reduced since it is the balancing item. In practice the discount rate used in valuing the profits is greater than the interest earnings rate assumed in the reserve or net valuation premium determination. In other words, the net premium is capitalized at the interest earnings rate in the reserve, and the complement of the gross premium is capitalized at the discount rate in the profits asset.

My paper defines the "gross premium method" as that which capitalizes 100% of the gross premium in the reserve calculation. There is no profits asset. Appropriate margins for adverse deviation in the experience assumptions would be required. Use of the method would add a significant degree of uniformity in practice, since there would be no decision as to a reasonable initial reserve or valuation premium, and no selection of a discount rate for valuing profits.

The paper goes on to argue that the gross premium method is the most appropriate approach to purchase accounting. Here two paths may be taken: the direct arguments discussed below, and indirect arguments. The latter say that future profits should be discounted at the assumed interest earnings rate, leaving a net liability equal to the gross premium reserve. Thus, the same amount of goodwill results as under the gross premium method directly.

Accounting Principles Board (APB) Opinion No. 16 deals with purchase accounting in general. That opinion says that contractual liabilities should be valued at their present values at current interest rates. Insurance liabilities are certainly contractual, and one might view them as the net of future outgo less income. Outgo and income consist of benefits and gross premiums, suggesting the gross premium method. Further, current interest rates must be represented by assumed interest earnings rates.

An alternative view is that future benefits are liabilities, but that future premiums are separate receivables. APB No. 16 goes on to say that receivables should be valued at current interest rates. Since the gross premium is the amount received, the gross premium method is again suggested. Again, a current interest rate would not be higher than the experience assumption.

The AICPA Audit Guide is another insurance accounting reference. In discussing revenue, the Audit Guide says that assumption of risk by an insurer is recognized by earnings resulting from the release of margins for adverse deviation. The selling effort is recognized by earnings equal to the excess of the gross premium over the net valuation premium. The gross premium method is in closest conformity with this reasoning. The purchasing company does assume risk, and should include margins for adverse deviation in the experience assumptions; these margins will release into earnings over the policy lifetimes. Ergo, the gross premium method.

Pedantically, one should not discount part of the premium at the assumed interest earnings rate in the reserve calculation and the rest at a higher risk rate in the profits asset calculation. The effect is to have two different margins for adverse deviation from assumed interest. This is not done for lapse or mortality; why should it be done for interest? The one part of the gross premium has just as much likelihood of being collected as the other. If actual experience equals assumed, earnings should be zero - not the case if the discount rate exceeds the assumed earnings rate.

It is my opinion that in a purchase situation the present value of the gross premium less a net valuation premium does not constitute a separately identifiable asset. There is no parallel to deferred acquisition costs here since the purchasing company did not sell the business. The existence of any reserve means that the value of future outflows will exceed the value of future inflows. In such a situation the burden of proof for the existence of an asset falls on those who would set it up. Further, the profitability of a block of life insurance is inseparable from the invested assets and interest income resulting therefrom. The absence of a separate asset means that the full gross premium should be utilized in the reserve calculation.

MR. GAMMILL: Doug's interpretation of APB No. 16 is right on target in the view that the present value of gross premiums could be reflected as a receivable, with some allowance for doubtful accounts introduced by the provision for adverse deviation, and in the view

that the present value of future contingent benefits and expenses is the fair value of the liability of the organization. Also, I agree with Doug's paper that the idea of the insurance inforce being treated as an "inventory" requiring some profit to be imputed is not a valid concept.

I too believe that one valid approach to purchase accounting, notice I didn't say the best approach, is to begin with the gross premium reserve concept. The "rub" is how to provide for sufficient conservatism in establishing the fair value of the benefits and expenses, and the fair value of receivables or gross premiums. The provision for adverse deviation concept ordinarily implies that we have a knowledge of what the most probable or realistic assumptions are, which may or may not be true. In practice, the unloading of the gross premium for a profit margin or the discounting of some GAAP profit premium, possibly at a risk rate, are just ways in which the actuary, in addition to using reasonably conservative assumptions, is able to provide for the risks inherent in assuming the business through a business combination.

Finally, sometimes I feel like I understand purchase GAAP, but every acquisition I come across and every different fact situation I run into tends to convince me that any uniform and/or best way to approach purchase GAAP will continue to remain a very elusive concept.

Doug mentioned comparability, as did the recent article in Best's Review written by Mel Gold. GAAP was never intended to produce comparability on an intercompany basis. The qualities of a GAAP financial statement have to stand on their own merits independently for each and every company and be evaluated as to whether it is conservative, liberal, or all wet. The main purpose of GAAP was to have inter-period comparability. When a company does well, GAAP earnings should go up; when it does poorly, GAAP earnings should go down. This is sometimes contrary to earnings under statutory accounting.

MR. NORMAN E. HILL: I want to start out by taking a calculated risk and dating myself a little bit by taking you back to 1970, because it was in 1970 that the concept of a uniform Audit Guide for stock life companies first began to take shape. It took the three years from 1970 to 1973 to reach a completed product. Those of us that were intimately involved in the formation of the Audit Guide from ground zero were very impatient in wondering how something like that could possibly take such a long period of time - an unconscionable period of three years.

Since then, of course, 10 years have elapsed and we are in 1983. There have been very significant events affecting the entire life insurance industry such as runaway inflation, replacement of policies, proliferation of term insurance and a whole wave of mergers and acquisitions. In that 10 year period, despite the significant events, there have not been any really significant accounting guidelines issued to supplement the Audit Guide. There has been one pronounce-

ment issued by the Financial Accounting Standards Board (FASB), the main accounting rule-making body in the U.S. That pronouncement, FASB 60, essentially just restated some of the key provisions of the Audit Guide.

As a result, in a great many issues that have arisen today because of the significant events of the last decade, there is a complete lack of uniformity. Each company has an approach significantly different from the others. "Lack of uniformity" here doesn't mean merely different lapse or interest assumptions from one company to another, but a deep, significant difference in the underlying methodology. The differences are so deep that only the practitioners, namely the actuaries, can understand just what those differences are. This state of affairs causes great frustrations to some of us, but on the other hand is probably applauded by others.

In fairness to the accountants, I should point out that despite my complaints about the lack of uniformity and the slow progress in issuing accounting guidelines, it's not that they are not trying. There are bodies in place to discuss these matters on a fairly regular basis. There is the Insurance Companies Committee which in turn has several different task forces under it. There is a Purchase Accounting Task Force, an Indeterminate Premium Task Force, a Keymen Insurance Task Force, and probably several others which I'm overlooking.

Notwithstanding what I have just said about the complete lack of uniformity in many significant issues today, I want to comment about a few trends that I have seen develop over the last 10 years. Perhaps here to some extent there is a little bit of uniformity in a special way. There is a tendency towards new definitions of revenues today. These definitions differ from or at least expand on the original definitions that were presented in the Audit Guide. There is also a tendency to refine the definition of the lock-in concept regarding assumptions. Lock-in was a key part of the original Audit Guide back in 1973. The idea was that a set of actuarial assumptions as to interest and lapses, once defined for a closed block of business, did not change thereafter except for any problems with losses or very adverse conditions. Because of special conditions there has been a tendency to expand that definition. When we consider amortizing deferred acquisition costs, I point to a tendency to have new definitions of what I call "expected bases". If you are using some type of actual-to-expected ratio to write off deferred acquisition costs, there are new definitions of what the expected item is. Finally, one other trend which I see is a tendency to experiment by developing new approaches and new proposals. Sometimes I think I have seen them all, but it turns out that I haven't; there are still things that surprise me quite a bit from time to time.

To be specific in one area, I want to talk briefly about purchase GAAP to expand on what was said before. Some uniformity that does exist is that most acquisitions today are defined as purchases, giving rise to the term "purchase GAAP". Purchase GAAP has a particular accounting definition. When that definition is followed, reserves are almost

always recomputed. Recomputation results in a situation that is a significant undertaking of magnitude similar to the original GAAP conversion. Some type of actuarial asset is almost always established on the books of the company. We may call that asset deferred acquisition cost, present value of profits, profits expense, asset expense, or various terms like that. Even if a unitary reserve is actually calculated, it is a reserve net of some type of expense asset. To meet accounting objectives or requirements there is almost always a grossing up, whether approximate or otherwise, so that this net unitary reserve is split on the balance sheet into some type of asset and some type of reserve.

Another trend I see under purchase GAAP is that whatever the opinions expressed about the lack of uniformity between companies, management, at least of the acquiring companies, tends to rely on purchase GAAP as a measurement of management performance. This may not take place right away; a couple of years may elapse after purchase during which companies may stick with historic GAAP or some other measurement. What I see happening is that normally, probably as a matter of convenience to avoid the problems of keeping various sets of books, the tendency is to convert everybody's thinking to purchase GAAP.

Let's move on to specific topics relevant to today, starting with single premium deferred annuities. Originally, it was thought that this was a very simple product with no complex issues. There was one premium received at issue; that premium had to stand whatever expenses were incurred, and no other issues were involved. But that has not been the case. Partly due to competition, the loadings in annuity gross premiums have tended to decrease, sometimes to zero. Acquisition costs therefore tend to exceed loadings, so the companies must look elsewhere for profit potential in these policies.

One source of profit is excess interest, the spread between what the company earns and what gets credited to reserves or to policyholders. In some cases we have seen the practice of looking at deferrable acquisition expenses not covered by loadings and using the excess investment income as the new definition of revenues. The incidence of that stream of revenues forms the base for writing off the excess acquisition cost.

It is interesting to note that the stream of the excess investment income spread tends to be somewhat back-ended; it goes up for a period of years on a closed block before it starts to come down, whereas normally the stream of premiums for life insurance follows the ski slope pattern. This method seems to have merit, though, and it seems to have fairly wide acceptance.

There has been still another trend with single premium deferred annuities. The excess investment income could be or should be recognized at the point of issue. In some cases the anticipated spread, the present value of excess investment income, is recognized at issue and, therefore, the present value of profits is set up at issue. This method is about as prevalent as the first case which involved the

deferring of acquisition expense. One could argue that if a company is fully immunized regarding the assets backing the single premium deferred annuity, that it therefore makes sense to recognize the present value of the spread at the point of issue before that spread is actually collected.

Universal Life products have gotten a lot of publicity in recent years and are growing as a key source of new sales for life insurance companies. The Universal Life product is normally a fund of some sort plus one-year term insurance. There have been some arguments that Universal Life is really an unbundling of a permanent product and that it would make sense to value it as a permanent product on a package basis. In other words, for GAAP purposes, ignore the difference between the fund and the one-year term and treat it as a permanent product with reserves and deferred acquisition costs. The complication with that approach is of course the complete flexibility in paying premiums from year to year; Universal Life has the same premium flexibility as the flexible premium annuity. Premiums can go up, they can go down, or you can have stop-and-go situations where premiums are completely stopped for a number of years. The trend is to modify that approach and, for reserve purposes, treat the fund as a bank account and hold it as one part of liabilities. As for the term insurance portion, treat that as a long-term, step-premium term product for some period and reserve for it separately.

We must also address the question of what to do with the deferred acquisition cost. Often the methodology used in practice is a type of worksheet approach. Sometimes it is called a model office today, but really it is an actuarial study made to determine a pre-set schedule of how to write off deferred acquisition costs. To take that one step further and convert it into a dynamic approach instead of a static approach, the pre-set schedule of the remaining unamortized balance would be multiplied by some version of an actual-to-expected ratio. Were this just fixed premium life insurance, the approach would probably be to use an actual-to-expected income ratio, but because of the flexibility in premium payments the actual cash needs to be taken into account in some manner. One approach I have seen is called an "actual-to-expected asset ratio". This approach entails comparing the actual funds to those expected based on the actuarial study.

Replacement business is often seen in companies today. For business replaced within the same company, often an older permanent product is replaced on an attained-age basis by some new product which may be term insurance or some other type of insurance. The question comes up of what to do about the deferred acquisition cost of the original product. If a company uses the factor method or has some type of actual-to-expected ratio, the original balance of deferred acquisition costs would get written off at replacement. But the argument has been made that the policy in an economic sense does continue because there still is coverage, albeit under a different form. Frequently the original deferred acquisition cost is therefore retained by adding it to whatever new acquisition cost is incurred at the time of issue on

the replacement policy. Of course, this new balance of deferred acquisition costs has to be recovered from a new stream of revenues, which may reflect tougher competitive considerations than the original stream of revenues. The assumptions for the new deferral and amortization of acquisition costs would therefore be different than the original assumptions. This is one indication of change in the lock-in principle. It may not be fair to call it an unlocking of the lock-in approach, but it is at least an expanded definition to meet current conditions.

Indeterminate premium policies have become popular today. Instead of the traditional guaranteed premium or guaranteed cost, companies now write both permanent and term insurance under which they reserve the option to change premium rates if they wish provided they do so for everybody. So far, the extreme competition today has resulted in rates usually being lowered when changed. That might reverse itself at some future time.

The main accounting issue that arises is encountered at the point premiums are changed. The balance sheet includes a certain reserve and a certain deferred acquisition cost balance for the policies affected. What do you do prospectively with these reserves and deferred acquisition costs? The original approach that people would presumably have argued for back in the early 1970's would be to keep the original assumptions under the lock-in provision. Today the thinking that often comes up is to look at it on a prospective basis by starting with the reserves and deferred acquisition costs held at the point of change, which are based on the old assumptions. Using those reserve and deferred acquisition cost balances, a new set of future net premiums is determined based on new assumptions, including a new set of assumed future benefits. There is no discontinuity for the current financial statements because the current reserves have not been changed.

Following this approach literally would require a new set of factors for the replaced block of business for each year of issue as well as each issue age and duration, creating many data processing complications. Maybe that would have been unthinkable 10 years ago, but today it probably is feasible given the hardware that exists. I do know of one company which took that approach and followed it through.

As an alternative, companies have used a modification of this approach which usually involves comparing the reserve and deferred acquisition costs at the point of change to what the balances would be if the new assumptions had been used from issue. The difference is then written off over some period such as ten or fifteen years. This approach could be viewed as a practical expedient.

Revertible term insurance is a popular product today among many companies. Sometimes it's sold on a non-smoker basis, sometimes on a combined basis. The idea behind revertible term is that the policyholder at some future point will have the option to resubmit evidence of insurability so that instead of the normal renewal term insurance



rates, his rates will still increase, but will do so on a more favorable basis. The question is how to reserve for such a policy. The approaches that I've seen used often take some kind of weighted average of future events. Some assumptions are usually made as to what percentage will revert, and what part will stay with the company on the less favorable basis of attained age or ultimate rates. Weighted-average streams of future premiums and mortality are all put together in a hopper and out comes a stream of reserves and deferred acquisition costs.

Last week, I talked to one representative from the Insurance Companies Committee and asked him what he sees for the future regarding when, if ever, there will be any additional definitions. Unfortunately, he could not give a timetable about anything. But he did say that at least there are certain rules right now among the Committee members which I'll pass along to you.

The front-ending of profits on annuities as I described before is not popular with members of the Committee, so if any ground rules are ever issued, there probably would be some restrictions on it.

Unitary reserves are still presented to the Committee as a reserving basis for some types of new products, such as Universal Life. The Committee still does not like unitary reserves, so that proposal will never get off the ground.

In the area of purchase GAAP all of the calculations made today are variations of the Defined Premium Method, whether or not we call reserves gross premium reserves and whatever discount rate we use. A different method, the Defined Reserve Method, has been mentioned in the actuarial literature but has never gotten off the ground and is definitely not popular with the Committee members. I doubt that it will ever be listed as an accepted method. The Defined Reserve Method is one where the goodwill is defined in advance. Reserves are pre-determined in total so it is just a matter of solving for the net premium. That type of approach has never been popular with the accounting body.

Another direction they're leaning in which affects these new products is some type of statement that it's acceptable to have first-year GAAP profits emerge. That may seem to be a strange statement to make as the original idea and approach to GAAP was to have some type of level profits emerge in proportion to premiums or revenues. In the final formulation of the Audit Guide there was a lot of discussion and phrases about provisions for adverse deviation and some restrictions on deferrable categories of expenses. At least in some circles the thinking was that it's acceptable or even desirable to have lower first-year GAAP profits or even a first-year GAAP loss. Because of policies like Universal Life or policies where profit margins may be lower than they have been historically, the Committee member I spoke with thinks that this body would like to get the point across that it is desirable to have some first-year profits emerge, rather than to just try for break-even on a GAAP basis.

If I can, I will summarize across this whole gamut of what's happening today in the industry in terms of mergers and acquisitions, interest-sensitive new products and competitively-priced term insurance. We can see that there's no timetable for any official accounting rules to use in financial statements. As for what we can do in the industry, I'd summarize by saying that there's considerable actuarial talent around and we're going to have to continue to make use of it as best we can to try and cope with our environment.

MR. STEVEN D. SOMMER: Towards the beginning of your talk you mentioned something about a change in the definition of expected bases in calculating the actual-to-expected ratio. Could you expand on that a little bit?

MR. HILL: Originally actual-to-expected ratios were just in terms of insurance inforce or premiums inforce. Now, the phrase has been expanded to include actual-to-expected assets inforce or actual-to-expected fund balances.

MR. SOMMER: On GAAP re-entry term plans, did I understand you to say that if someone re-enters or goes back and starts over again that they are not coded with a new issue and would continue on the same factors?

MR. HILL: Yes, if you're assuming a certain pattern of events which includes a percentage of re-entries. The alternative would be to somehow assume that they're treated like a lapse as far as your original reserves are concerned, and then start afresh by coding a new issue.

MR. SOMMER: If you don't start over, don't you have to put in a new commission assumption, a new stream of acquisition expenses?

MR. HILL: That's right. You could have not just a first year acquisition expense but a stream of renewals which could be uneven. The events projected in the weighted-average approach should include any additional commissions payable on conversion.

MR. M. IAN GRAY: In your discussion of Universal Life and the worksheet approach for amortizing deferred acquisition costs, you mentioned that a couple of approaches were to look at the actual-to-expected inforce or actual-to-expected asset ratio. Is any consideration being given by any company to having an actual-to-expected premium ratio, where you define an expected premium stream and then plot actual premiums collected against that?

MR. HILL: Some type of actual-to-expected cash collection ratio is a good alternative; over the years I've mentioned it to people and I've recommended it sometimes. I'm not sure that anybody has implemented that method, but it's a good way to attack the problem.

MR. NEAL N. STANLEY: Norm, on purchase GAAP, I'm assuming that we're talking about buying a company rather than buying a block of business, or do you make a distinction?

MR. HILL: All the talk that was given on purchase GAAP, and by Doug Eckley, too, if I can put words in his mouth, was when an entire company is purchased. Maybe purchase GAAP is even less defined when you're buying a block of business, but in that case at least there's no goodwill to enter into your considerations. I suppose here the practice varies all over the lot, also. But there would be some type of reserve and some type of asset representing either the reinsurance commission or some type of present value of profits.

MR. EDWARD J. BONACH: I wonder if you could comment a little more on GAAP for single premium deferred annuities regarding the issue of what is break-even at issue and how much of the excess interest should be capitalized.

MR. HILL: Some of the approaches I've heard about where excess interest has been capitalized have been limited to, say, ten years worth of expected excess interest. I don't know if anybody's taken an extremely long period like forty or fifty years. The generic approach, at least, is to look at the net funds retained at issue and to create a scenario that utilizes a differential between earned and credited rates that yields a present value of benefits and expenses approximately equal to the net funds retained.

MR. BONACH: Would the net funds reflect only deferrable expenses or would you include some non-deferrable expenses?

MR. GAMMILL: You would include some non-deferrable expenses in terms of those expenses associated with maintaining a product. Otherwise, you'd treat non-deferrable acquisition expenses like you'd treat any others; they would impact the bottom line. They would not be considered for deferral.

MR. HILL: When I was talking about what the one Committee member expressed as the leanings of the AICPA Insurance Companies Committee, I said he made some statement that it is probably acceptable to have first-year emergence of GAAP profits. He did add that this might require some type of redefinition of what constitutes deferrable expenses. I don't think they would want to have a complete carte blanche as to what is deferrable, but maybe to liberalize somewhat the definition of deferrable expenses.

MR. GAMMILL: I would like to expand on a couple of ideas regarding replacements. You must look at the entire balance sheet. When an old policy goes off the books, a benefit reserve is released, the deferred acquisition cost is written down and a cash value may be paid. Essentially, we need to look at the loss generated by the replacement and consider whether or not that loss is recoverable from future revenue available from the re-issued product. You must not concentrate on just one element and worry about it; you have to look at the total picture.

A modification of purchase GAAP that might be a Defined Reserve Method and a method which also establishes an asset is where statutory

reserves are held as benefit reserves. The present value of statutory book profits might be the asset. It's not a generally accepted approach amongst all accountants, but it certainly could be considered.

I would also like to reaffirm Norm's comment on liberalizations of the lock-in principle. I perceive that GAAP for stock life insurance companies appears to be moving towards what I refer to as "true GAAP". With the new products we have, especially interest-sensitive products, I can see an evolution away from the lock-in principle. Deviations in emerging experience from that assumed, or situations where unilateral or competitive actions serve to reduce the profit streams available to the company, may lead companies in the future to consider unlocking the assumptions on their inforce business. In effect, they would be accounting for the changes in estimate prospectively. This methodology is really consistent with what true GAAP is all about.

MR. HILL: In commercial accounting, if a machine has a change in its useful life as estimated by accountants, they feel comfortable with the idea of changing depreciation prospectively. Starting with the remaining carrying value of the machine after current depreciation to date, the method is to determine a new future useful life. So the idea, at least on indeterminate premium policies, of starting with the reserves at their current balance and using new net premiums based on new assumptions thereafter certainly seems consistent with that practice.

MS. GRACE V. DILLINGHAM: The Blanks Task Force of the National Association of Insurance Commissioners (NAIC) met in March and approved a number of changes in the blanks which must now be considered by the Financial Condition (EX4) Subcommittee at the upcoming NAIC meeting in June.

Most of these changes are relatively innocuous, but perhaps worth mentioning. All short-term investments are now to be reported in Schedule DA - this is no longer optional as it was in 1982 - and the other investment schedules are to be used only for long-term mortgages, long-term collateral loans, etc. So far there is no provision for showing transactions affecting short-term holdings as there is in the corresponding Separate Accounts schedule, but it would not be surprising if this were given serious consideration next year.

The Credit Section of the State Page will have to be filed with the rest of the Statement, rather than on April 1, if the Task Force decision is affirmed. This is to facilitate entry of these data into the NAIC Data Base and permit the preparation of the Credit Profitability Reports on a more timely basis.

Another item affecting the State Page is the proposed addition of a line for Annuity and Other Fund Deposits, corresponding to line 1A on page 4.

Perhaps not so innocuous is a proposed supplement to Schedule M requiring detailed disclosure of mutual company dividend practices. An actuarial opinion that dividends were determined in accordance with actuarial principles and practices of the American Academy of Actuaries would have to be attached. There is no similar proposal for stock companies, primarily because the Academy has not yet established standards of practice with respect to the participating business of stock companies.

A new schedule for reinsurance assumed was also adopted by the Task Force. This schedule would require disclosure of inforce, reserves, premiums, and commissions and expense allowances, by ceding company. For professional reinsurers, the preparation of this schedule would be a substantial burden, and an ad hoc group of reinsurers has retained a distinguished member of the Society to assist them in convincing the NAIC that much more careful review is needed before this onerous requirement is imposed.

Market value of bonds and preferred stocks is the final item in the category of proposals likely to receive final approval unless there is a determined effort to stop them. I can assure you there will be a determined effort. Anyone with appropriate contacts in the Blanks Task Force, the EX4 Subcommittee or the Executive Committee is welcome to join the effort.

The proposal adopted by the Task Force would add the following language to the present requirement for a "statement of the valuation basis for invested assets" in the Notes to Financial Statement:

For bonds owned and preferred stocks owned, show the aggregate statement value (admitted value) and the aggregate actual market value and the difference in total. Describe the source for determination of the actual market value of all bonds owned. Amortized values should not be used for market values unless they are the same.

This issue has been raised every year for the past several years and the industry has consistently opposed it. It reflects, of course, a concern over today's high interest rates and their effect upon asset values and the liquidity position of insurance companies. However, inclusion of market values in the Annual Statement is an inappropriate way to address the concern, and moreover, holds the potential for significant misunderstanding of the financial health of the industry and its ability to meet its obligations. It is dangerous and inappropriate to show so-called market values - "so-called" because many of the bonds to which this requirement would apply are private placements for which there is no market - when no consideration is given to the market value of other assets held by insurers (most notably real estate), or to the offsetting impact of current interest rates on liabilities, or to the function of the Mandatory Securities Valuation Reserve and its magnitude. Better information on liquidity can be found in the new Schedule DA for short-term investments. In addition, a new cash flow schedule to provide a

better picture of the sources and uses of cash is currently under development.

This cash flow schedule is the product of an NAIC Study Group on Market Value, Liquidity, and Cash Flow. The study group was formed to deal, at least in part, with the issue of displaying market value in the Annual Statement. They concluded six months ago that it was not appropriate and moved on to the cash flow issue. The proposed schedule, which would replace the current page 4A in the Statement, is currently being tested by the American Council of Life Insurance (ACLI) and the NAIC. Early responses indicate that it is easier to prepare than the current schedule and does a better job of showing the sources of cash. However, the earliest it is anticipated that this schedule might be required is the 1984 Statement.

Another item requiring more study is the comprehensive instructions for completing the Annual Statement. The concept of comprehensive instructions - removing all instructions from the Statement itself to the instruction book - was taken over from the now defunct "Proposed Simplified Blank". The draft presented at the March meeting of the Blanks Task Force was so well done that it was hoped that it might be suitable for adoption this year. Closer study, however, has led both industry and regulators to ask for a longer exposure period followed by a careful revision.

Turning now from the Blanks Task Force to the Valuation of Securities Task Force, but staying with the Financial Condition (EX4) Subcommittee, let's look at the Joint NAIC-Industry Study of the Mandatory Securities Valuation Reserve. The consultants - one retired investment officer of a life insurance company, one retired accounting officer, and one retired actuarial officer - have made their report, the NAIC-Industry oversight group has reviewed it, the Valuation of Securities Task Force has received both reports, and industry has been asked to comment.

A major conclusion of the study is that the bond and preferred stock component should be combined with the common stock component. The annual rates of accumulation of this combined reserve would be graded according to the degree of attainment of maximum at the end of the prior year. When the result of the accumulation is negative, the negative figure would be the beginning balance for the next year's accumulation. Thus, surplus would be restored before the MSVR.

The consultants concluded that controlled and subsidiary companies should be excluded from the MSVR calculations, except for those whose stock is carried at public market values. They also recommended that Separate Account portfolios continue to be excluded, and they asked that the definition of Realized Capital Gains and Losses be linked to the Federal income tax definitions.

Some of the proposals have aroused deep concern, especially the combination of the bond and stock components, the use of an income tax definition for capital gains and losses, and (from the regulators) the exclusion of subsidiaries from the MSVR.

In view of the short exposure period - the reports were distributed late in March - and the concern that has arisen, the ACLI intends to recommend that the NAIC take no action in June. The Council has established a task force to examine company reactions and to try to develop a set of recommendations on which the industry might agree. It is hoped that a progress report could be made to the NAIC at the fall quarterly meeting, with final recommendations ready for presentation at the annual NAIC meeting in December.

One more item on the liability side: Have you considered what your liability will be - GAAP or statutory - if Congress passes the Fair Insurance Practices Act or the Nondiscrimination in Insurance Act?

In closing, let me apologize to our hosts for the complete absence of any Canadian material in this survey of statutory accounting developments, and for my own abysmal ignorance of the Canadian scene. Canadian companies operating in the United States are, of course, affected by NAIC activities and the actions of the several states and I hope the Canadian actuaries present have found at least as much of interest as the GAAP-oriented U.S. actuaries.

MR. JOSEPH L. TUPPER III: There's at least one state out there - it's on the east coast someplace - that is requiring statutory quarterly filings. Do you have any information on whether that's a trend being started or not?

MS. DILLINGHAM: That is a requirement in Connecticut. A letter was sent out not too long ago. I understand that some companies have said they couldn't comply for the first or even second quarter of this year, as it was just too late to do anything about it. It's pretty definite they're wanted for this year, whether you backtrack and give it to them for first through second quarters or wait until the third quarter. It seems that the Connecticut department has been completely reorganized. They're not taking part in any zone examinations, but if the quarterly statements turn up anything that they want to question, they send people out around the country.

MR. STANLEY: Some background information on the subject of interim reports may be helpful in assessing the value of such reports.

The current basic standard for these reports is APB Opinion No. 28 issued in 1973 which has been modified by FASB Statement No. 3 and by FASB Interpretation No. 18. In 1975 the SEC adopted Accounting Series Release No. 177 which expanded the amount of disclosure required in quarterly financial statements.

Over the years certain problems arose in applying Opinion 28 primarily in the area of allocating Federal income taxes to interim periods. As a result of these problems the FASB issued a discussion memorandum related to Interim Financial Accounting and Reporting on May 25, 1978. As was its normal practice the Committee on Life Insurance Company Financial Reporting Principles of the American Academy of Actuaries set up a task force to monitor developments and there was a brief flurry of interest

in this subject in the latter half of 1978. The FASB later determined not to pursue the subject of interim accounting until the Conceptual Framework Project is completed. If indeed the subject of Interim Accounting is not to be addressed until the Conceptual Framework Project is completed, it will be a long time before this subject comes up again on the FASB agenda. The Academy task force assigned to monitor this topic was disbanded.

From the Discussion Memorandum, it is clear that there are two schools of thought on how expenses should be recognized in interim statements. One is the "Integral Method" which attempts to assign expenses to interim periods in proportion to the expected annual revenue. In other words, if the revenue for the second quarter is expected to be twenty percent of the revenue for the calendar year, twenty percent of certain annual expenses such as Christmas bonuses for employees or annual sales awards would be allocated to the second quarter. This approach considers the primary purpose of interim reporting to be an aid to estimating annual results.

The other view is called the "Discrete Method". This method treats each interim period as a separate financial reporting period. Costs incurred during the period are charged against revenue for that period and are not allocated over anticipated revenue for the accounting year. It is clear that earnings from quarter to quarter will fluctuate more under the Discrete Method than they will under the Integral Method. In order to smooth out the fluctuations some advocates of the Discrete Method conceded that certain costs such as advertising and charitable contributions should be allocated over the year even if the entire annual expense is incurred in one interim period. As one might expect, this view is called the Combination Method.

There are significant differences between an interim financial statement and an annual financial report. Because the annual financial report is audited by independent auditors and because annual results form the basis for Federal, state, and local tax returns and other regulations the documentation for assets and liabilities is more vigorous. Exact calculations are made at year-end where estimates may be used at the end of interim periods.

An interim report may be made for two or more purposes. Company management needs interim reports in order to compare actual progress to date to the annual budget that was prepared at the start of the year. Investors and creditors use interim reports to help assess the amounts, timing, and uncertainty of profits in order to make investment and credit decisions. It would not be reasonable to have interim reports prepared on the Integral basis for management reporting and on a Discrete basis for public reporting purposes. Since it is arguable that a pure Integral approach is time consuming, costly, and subject to large adjustments if the sales revenue over which expenses are allocated turn out to be in error and the Discrete basis causes earnings to fluctuate unreasonably in seasonal industries or in quarters where an unusual amount of annual expense is incurred, it would appear that a Combination approach is likely to produce the best results.



The company that I am familiar with uses the Combination approach in preparing both its monthly management reports and its quarterly financial statements. On most items revenue is booked when paid; however, certain annual expenses are reserved by making a monthly charge against revenue even though the expense is paid annually. Expenses of this type are: Christmas bonuses, charge off of agents balances, cost for the sales conference which is held every two years, annual cost for agency awards, production bonuses, etc. No effort is made to smooth out life claims, but an attempt is made to smooth out group health claims because of the very pronounced seasonal pattern in these claims.

There are some aspects of interim reporting that needs more attention either in the financial statements themselves or in the disclosure that accompanies such statements. For example, if a company takes capital gains in the second quarter of the year, but management fully intends to offset those gains in the last half of the year by taking capital losses in order to avoid capital gains tax, should the gain be reported or should a reserve be established to offset the gain? If the gain is reported, should management's intent to take losses in the next two quarters be disclosed?

If the company has a loss at the end of three quarters but is in the process of obtaining a coinsurance agreement that will eliminate the loss, should the existence of the coinsurance negotiations be disclosed in the third quarter statement?

In short, if management has reason to believe that action it plans to take during the balance of a fiscal year is likely to reverse gains or losses currently being shown in the interim statements, should financial provisions be made for the anticipated action in the interim statement itself or is disclosure adequate? What if disclosure of the anticipated action may jeopardize the success of the action?

It appears that the subject of expense allocation in Interim Financial Statements does not enjoy a high priority on the list of accounting topics currently being considered by the FASB. However, if the subject is reopened again, it would be well for the industry to be prepared to present its views. A decision by the FASB to institute a full Integral approach to expense allocation could have consequences which are not fully apparent just as the consequences of the adoption of FASB No. 8 on foreign currency transactions were not realized until it was too late to undo the damage.

