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ACCOUNTING ISSUES FOR INSURANCE COMPANIES

Moderator: RICHARD S. ROBERTSON. Panelists: PAUL KOLKMAN, WILLIAM J. SCHREINER, ROBERT W. STEIN. Recorder: STEPHEN P. HODGES

1. Current GAAP topics.
   Deferred taxes
   Single premium deferred annuities
   Universal Life insurance
   Other current topics

2. The value of interim earnings reports.

3. Statutory issues.

MR. RICHARD S. ROBERTSON: Good morning. This is a Concurrent Session on Accounting Issues for Insurance Companies. I am a Senior Vice President at Lincoln National Corporation. My reason for being here is that I have the responsibility for our company's financial reporting. All of us on this panel have been involved one way or another in the development of these accounting issues. On my left is Paul Kolkman, who is Vice President and Corporate Actuary, IDS Life. In his capacity, Paul has some of the same responsibilities I do including the responsibility for IDS Life's financial reporting. On my immediate right is Bill Schreiner, who is on the staff of the American Council of Life Insurance and, in particular, is staff to the ACLI Statutory and GAAP Financial Reporting Committees. On his right is Bob Stein of Ernst & Whinney. Bob is both a Fellow of the Society of Actuaries and a Certified Public Accountant.

MR. ROBERT W. STEIN: Life insurance GAAP accounting issues are routinely examined by both the actuarial and accounting professions. The primary actuarial body studying these issues is the Academy's Life Insurance Financial Reporting Principles Committee. The AICPA efforts are generally conducted by their Insurance Companies Committee. As a member of the Academy's committee and as a technical advisor to the AICPA Insurance Companies Committee Task Force on Non-Guaranteed Premium Products and Purchase Accounting, I have been requested to briefly discuss the major issues currently being considered by these groups.

The major area currently being reviewed concerns the determination of accounting guidance for new types of insurance products--principally indeterminate premium policies, single premium deferred annuities (SPDA's), and Universal Life (U.L.). In addition, discussions of purchase accounting practices continue by the AICPA Task Force.

The Academy Committee and the AICPA Task Force have worked closely in the new product area. Recommendations with respect to indeterminate premium products were initiated by the Academy. After appropriate consultation with the AICPA, the Academy exposed and subsequently adopted Interpretation 1-I. Essentially, this Interpretation calls for the adoption of new assumptions when gross premiums are changed. Existing reserves and deferred acquisition cost (DAC) are to remain unchanged and the new assump-

tions are to be used to determine a revised level valuation premium for the remainder of the contract's life. The Interpretation should be reviewed in detail, but this summarizes the major conceptual issue.

The AICPA Task Force has conceptually agreed with this position and has developed an issues paper discussing this matter which has been forwarded to the parent committee for further action. Certain minor editorial changes are being made, at which time it will be determined if exposure is necessary or if the paper should be forwarded to the AICPA for approval or other action. This is not a controversial issue and, while the timing of formal adoption is uncertain, the accounting guidance being provided is not in question.

The Academy Committee began a review of SPDA accounting as a prelude to studying U.L. It was believed that an examination of the relatively simple SPDA product would raise issues and concepts applicable to U.L. which could be more easily isolated and studied in an SPDA contract. An initial discussion memo prepared by the Academy was embraced by the AICPA Task Force, though not without significant changes. At that time, the AICPA Task Force and representatives of the Academy Committee began joint meetings to resolve the major SPDA accounting questions and to eventually address U.L.

The results of these joint efforts is a draft paper which provides tentative guidance with respect to SPDA accounting. The major issues and the AICPA Task Force's current position are listed below. It is important to note that the Academy Committee has expressed certain concerns regarding the tentative conclusions and our final position has not yet been determined. Also, all conclusions are tentative and subject to change as a result of further discussion and analysis, particularly with respect to the outcome of the U.L. analyses. Nonetheless, the major issues being addressed are:

1. The appropriate pattern of income. Specifically, should any income be reported at issue, or should <u>all</u> income emerge after issue in relation to the investment performance under the contract? The tentative conclusion is that no income should be reported at issue and that investment margins should emerge only as interest earned exceeds that credited to contractholders.

2. The definition of revenue. This issue concerns the concept that previously premiums have been defined as revenue for reporting purposes and for determining the primary pattern of GAAP income (excluding release of the provisions for adverse deviation). However, the desired income pattern is consistent with the definition of revenue as the "interest spread". It has been tenatively concluded that no definitional changes will be made. Rationalization of the potential inconsistency between SPDA revenue (premium) and income patterns (in relation to interest spreads) has not been finalized.

3. Amortization of deferred acquisition costs. Tentative conclusions require the deferral of acquisition costs (as defined by FASB #60) in excess of front-end loads, if any. Amortization would be based on the expected interest margins and surrender charges.

4. Benefit reserves. Reserves could be maintained in amounts equal to gross accumulated contract values prior to surrender charges. Alternatively, reserves could be based on the present value of benefits and expenses, using assumptions as to mortality, withdrawal, and credited interest. The earned interest rate would be determined such that a break-even result was achieved at issue. The practical ramifications of these alternatives have not been fully resolved.

Other, less important, issues also have been reviewed.

The next steps are expected to be as follows. A final draft will be prepared, probably at the June AICPA Task Force meeting. It is not expected that the current tentative conclusions will be changed. However, it will be recommended that no guidelines be finalized or formally adopted until other products, most notably U.L., can be studied. This paper will then be sent to the AICPA Insurance Committee for their review. Industry exposure is possible at this stage. The Academy Committee will prepare a comment letter when the draft is finalized and sent to the AICPA Committee. At present, the Academy's major comment is likely to be that, actuarially, there is no reason why income should not be allowed to be earned and reported at issue.

On completion of this SPDA work, the joint AICPA Task Force and Academy group will address U.L. Progress is likely to be slow, especially as some individuals appear to want the SPDA conclusion to be adopted for U.L. without significant change. That is, income would not be reported in proportion to premium revenue, but would emerge only as earned interest exceeds credited interest and as mortality charges exceed mortality experience. Neither the AICPA Task Force nor the Academy Committee has debated this or any other U.L. issue at this time. Therefore, the potential outcome cannot be predicted.

MR. ROBERTSON: In your experience with your clients on universal life, what general approaches are you finding?

MR. STEIN: The one extreme would be something akin to the no earnings at issue of the annuity products. That is, all the sources of earnings identifiable in a universal life contract would contribute to earnings in those years when that experience becomes more favorable than the policy charges. Some companies are using that approach. More commonly, perhaps, people are attempting to adopt procedures and mechanics that would get you to an "audit guide" approach which releases earnings as a percentage of gross premium revenue. A good many companies in the industry are using something along these lines, and the mechanics are quite complex. Essentially, the process is to project and quantify aggregate future earnings and then levelize them as a percentage of some anticipated income stream.

MR. ALBERT K. CHRISTIANS: When you look at different products and try to figure out what the revenue base should be for recognition of profit you see that there are quite a few differences between products and between companies. Did your committee take it as a given that you had to choose the revenue base? Did you give any thought to the idea of having companies decide whether they are sales companies and should recognize profit in proportion to sales, or service companies and should recognize profit in

proportion to service or investment companies and should recognize profit in proportion to investment income?

MR. STEIN: Originally, when the Academy committee first put together their draft of the annuity situation, we left room for the selection from that range of alternatives for each company. We felt that the Audit Guide, as written with its provisions for adverse deviation, gives a company the latitude to reflect the peculiarities of its product in its market in the way it does its accounting. If you were writing a highly investment-oriented universal life product, earnings as the interest was realized would be appropriate. If it were sold and marketed like an ordinary life product, then maybe it ought to be accounted more like traditional ordinary life. Originally, the guidance that started out in the annuity paper allowed those kinds of variations. When the Institute Task Force reviewed those preliminary guidelines, they thought they were too flexible and not sufficiently restrictive. They thought that type of guidance would essentially be no guidance at all with respect to annuities. That latitude was deleted from the accounting guidance that is now being considered with respect to annuities. It is unclear where we will be when we get back to universal life. My firm's position on that is that you should be able to select the accounting method that matches best how you design, price, and market your product.

MR. CHRISTIANS: Would that imply some disclosure not only of what we are doing but the reasons why?

MR. STEIN: Disclosure in the sense of footnote disclosure?

MR. CHRISTIANS: Some way of telling the people who are reading the financial statements how we are recognizing profit, because that revenue base represents a key aspect of our operations.

MR. STEIN: It could easily lead to some requirement for more elaborate footnote disclosure. Current disclosure is usually somewhat general and broad and, if a significantly different accounting approach or earnings pattern is accomplished, then that should be highlighted. Today there is probably a need for more disclosure with respect to annuity accounting in the first place and it will probably be more demanding and more necessary when we get to universal life if these variations and options become available and are used.

MR. CHRISTIANS: It sounds like you have given a lot of freedom with the simple prohibition on front ending the earnings and, within that constraint, you can still pretty much do what you want--make provision for whatever elements you think are likely to deviate adversely or whichever elements will give rise to your profits.

MR. STEIN: There is that flexibility. I do not know how significantly that impacts the pattern of earnings during the course of the policy years, but the two extremes or two positions which are being examined are (1) a projection of all future transactions--the normal sort of prospective estimation of incidence and amount of future transactions--discounted at a rate of interest such that you will break even at issue. That will force all the profits in the surrender charges and settlement options back through the interest rate. That is one option. (2) carry the account value.

MR. ROBERTSON: In general, the accounting profession puts a high premium on standards that are objective in nature and consistent. They do not like standards that allow a great deal of flexibility on the part of the company. Partly, because that puts a lot of pressure on the practicing accountant. He has to determine whether the company has, in fact, applied the judgment that they are allowed appropriately. That is a very difficult thing to do. We, as actuaries, generally tend to approach from the other side. Generally, we see no reason to preclude a sound practice unless it is absolutely necessary. And, that would tend to be the same position that most company managements would take--they like having the flexibility. There is this conflict that colors all these discussions.

MR. STEIN: I would like to ask one question of the audience. Many companies are writing universal life. I would be interested in a show of hands for those companies who would be tending to follow a procedure that would be more comparable to the traditional GAAP--that is, trying to project earnings and levelize them as a percentage of premium. How many companies are going to be following that type of approach? The companies that would be following a simplified version of carry-the-account value and let the earnings fall as they emerge? Kind of 50-50--maybe a few more for the traditional GAAP approach.

MR. PAUL KOLKMAN: Our company intends to take the simplified approach and let earnings fall where they may for the first year to 18 months until we get a better feel for it and then do it right. Any new product presents a problem. The first tendency is to account for it on a relatively simple basis going in until a decision is made about how you really want to do it.

MR. ROBERTSON: Would it be an appropriate observation to say that we are not going to get guidance on this from the accounting profession until well after practices are established in the industry? That is, the profession will probably follow the industry rather than the reverse.

MR. STEIN: There is a good chance of that. The companies are obviously establishing their practices and procedures now and it will become increasingly difficult for the AICPA to come up with very strict and concrete guidance that goes against the broad practice. That is not to say that they will not give that a try.

MR. ROBERTSON: That is not bad. I would rather have the accounting rules made out there in the real world than by a group of individuals who do not have a great deal of experience other than in an audit environment trying to establish standards in a theoretical vacuum. The concept of letting standards evolve from practice is a very good one.

MR. STEIN: It is and the Institude does do that. There have been other instances where they have tried to do some things that were just totally against current practice and have backed away.

MR. D. BRUCE DIXON: A question relating to these accumulation products. Are there any parallels with the banking industry? Do we look to see how accounting is done in the banking industry and compare that to how we should do our accounting for accumulation type products?

MR. STEIN: The analogy that is always used at these committee meetings is the CD. The bank does not project what its spreads are going to be. It

earns interest and it credits interest just as an insurance company does. It gets the funds on a universal life contract or a single premium deferred annuity contract. It pays interest and it earns interest. The banking industry and other industries which work with other people's money simply report the difference between that which they earn and that which they pay in the periods in which that takes place. There is no projection of the ability to earn those spreads and, via some actuarial technique, move the reporting of those spreads to different periods.

MR. KOLKMAN: I work for a company that sells both annuities and the other types of products. We have a subsidiary which sells face amount certificates which are accounted for in a manner similar to CD's, and also a large family of mutual funds. The accounting rules are different between, for example, the mutual funds and SPDA's. We have spent a lot of time trying to figure out how to account for the mutual funds the way we account for our annuities and not the reverse. We think that the insurance industry is ahead of the banking industry and calls for us to be like them are going backwards rather than forwards.

MR. STEIN: These committees are going to be studying the issues and trying to develop some guidance fairly heavily, as heavily as those committees ever do work on anything. During the next 6 to 9 months you should, by all means, communicate with Virgil Wagner, the Chairman of the Academy Life Insurance Company Reporting Principles Committee and state your position on these issues. This should be worthwhile to his committee's task force. We would appreciate any input you may have.

MR. ROBERTSON: I would also suggest that you lobby your outside auditor.

MR. STEIN: Finally, there are many purchase accounting questions which the AICPA Task Force is studying. Dormant for many months, the Task Force has recently been reactivated. Tentative conclusions have been reached in many areas, though two major issues remain unresolved. The first concerns the appropriateness of using a risk rate or return (as opposed to a net investment earnings rate) in calculating and/or amortizing the value of acquired insurance inforce. The second broad area to be studied, and the area where practice appears to vary the greatest, is the manner in which federal income tax is considered in the initial and subsequent accounting. At this time, it is not possible to determine when these questions will be answered or when public exposure of the recommended procedures will occur.

MR. ROBERTSON: It is a very creative way of handling the tax accounting problem. If you cannot figure out how to account for taxes, wait until the law changes into something you can account for.

MR. STEIN: That may have helped or it may have hindered the task force. I am not sure the way the law has changed in that regard. I have been involved in acquisitions, both big and small, in the last 5 to 10 years. I think the pre-tax practices of 5 to 8 years ago were wider than they are now. Practices have conformed some. There is some feeling that the urgency of getting this task force reactivated is not what it was a few years ago and that has been used partially as an excuse for inaction. The major fluctuations and differences in technique and approach and significant changes in income in the post purchase period are due to different tax treatments. The major area of discussion in the coming meetings of that task force will be with respect to federal income taxation not in the

literal tax return filing for the purchased entity, but the book accounting in the financial statements for tax effects as of the balance sheet date primarily with deferred tax accounting subsequent thereto.

MR. ROBERTSON: There is one other area where we are seeing a fair amount of activity—reinsurance accounting. There is a task force, other than the ones you have been referring to, working under the auspices of the AICPA Insurance Companies Committee that is examining reinsurance accounting in all its contexts. They have issued audit standards on both life and property-casualty reinsurance and now intend to examine accounting policy, which will be controversial. Probably, the most serious area of controversy is how one administers the requirement that a reinsurance agreement have risk in it to be accounted for as insurance as opposed to a deposit of some kind. What standards can be developed, if any, to determine when that condition exists? They are going to have to wrestle with that.

MR. KOLKMAN: I have the feeling that this process seems to be heading down a road of defining zero profit at time of sale for SPDA's and extending that to immediates and other forms of payouts. Then, specify that for installment annuities the sum of the GAAP premiums should equal the sum of the gross premiums so that your profits will be investment margin. Then, probably extending that to universal life, most likely with industry opposition, since the industry is going the other way. Historically, actuaries have given most of their thought to determining what assumptions they are going to use and then they will determine how much the company earns based on those assumptions. This seems to be a reversal. There will be a determination by product of how much you should report at issue and then the actuary's job is to back into assumptions to produce that result. Does that tend to trouble you?

MR. STEIN: I would describe it in a different fashion. You could describe it as a backing into a predetermined answer of zero, but when Al asked about how do you allocate—are there different means of allocating earnings between sales functions, service functions, etc., we say yes, and the vehicle for doing that at present is the provision for adverse deviation. While there is still perhaps a balancing act, I think the Institute would say you select provisions for adverse deviation such that you have totally used up the loadings in the gross premium. Based on how you view your product, you will select mortality loadings, possibly expense, certainly interest, and put them all together so that, in total, all the loadings will be apportioned in some reasonable way to the various elements of the contract. When presented in that way, I have some sympathy. That is not to say that there ought not be some portion of the total loadings left out to come out as premium is earned but, as a fundamental basis of saying the process should work in that way with selection of provisions for adverse deviation, that does not bother me. I would like to see a method devised on how to quantify how much of the total loadings should be allowed to come out with the premium. The committee has not been able to provide any kind of a reasonable technique to do that. If that cannot be done to everybody's satisfaction, then the other approach, the use of total loadings equal to the total profit allocated to the elements, might be the only acceptable solution.

MR. ROBERTSON: I have a contrary opinion as to where we are headed. The direction this task force is going has all the appearances of a train steadily rolling down the track. But, I do not think they realize they are

on a siding and not the main line. They are going to come to a dead end and are going to have to back up. If you presume that the accounting for SPDA's should result in no profit recognition at issue, then we have a couple of problems. We have the anomalous situation that you can recognize profit at issue when you write a whole life contract where you have only one of a series of premiums, but, if you get all the premium up front, you cannot. That does not make any sense. In addition, it presumes you can draw a very careful line around an SPDA or perhaps a broader class of products that will distinguish it from another class of products which would include ordinary life insurance. The problem is that there is really a continuum of products. You have SPDA's and you have flexible premium annuities. You have single premium whole life and single premium annuities. You can create products which are very similar, but one is on the annuity side and one is on the life insurance side. You can have fixed premium whole life or variable premium whole life and they can look very similar. Someone observed at the last task force meeting that, if you define a series of rules that the industry does not like for single premium annuities and do not extend it to flexible premuim annuities, there will be no single premium annuities written. Every annuity written will, at least technically, be a flexible premium annuity. You can carry that step by step until you wind up with a whole life contract. There is a growing recognition that you have to look at this as a whole and, unless you are willing to overturn existing accounting standards for life insurance, which some would like to do but as a practical matter will not be done, you cannot come out with something for any class of these products that is inconsistent with the rest. I have not sold that point of view yet, but I believe it eventually will come out that way.

MR. STEIN: We are not too far from that now. At the last meeting it was pretty much decided that we would not try to actually and literally adopt the FASB statement or an AICPA statment of position or anything binding on the accounting profession with respect to SPDA's until we could expand the investigation to look at other products. Whether that is a practical recognition of the fact or people are getting pressure from their clients who are doing what is going to be prohibited, I do not know. It is more likely now that these groups will be looking at all these products to make sure that some kind of uniform guidance is actually presented and will stand for all the products and will work for all products.

MR. ROBERTSON: They are not backing the train up yet, but at least they are putting the brakes on.

MR. STEIN: We are slowing down.

MR. CHRISTIANS: There may be an area where perhaps some new guidelines could be promulgated as well--on the testing of recoverability. It seems like these new products are generally priced very competitively so recoverability is likely to be more of a problem than on products that have been issued over the past several decades. They are more subject to fluctuations in the external environment and, thus, it is far more likely that they will, in fact, turn out to be losers rather than winners. It is also probably far more difficult to do any kind of recoverability testing once you have a block of flexible annuities or U.L. policies. Are there any guidelines for how one determines whether or not one's provision for the future is adequate? An example is a company with a lot of annuities in force and, because they have been in the papers, they are starting to have

a cash flow problem. If they made provision for that cash flow problem in their finanancial statements, it would probably only make their cash flow problem worse. It might be impossible for them to actually report on a consistent basis with what they really expect because, the worse the picture they paint in their reporting, the experience would stay ahead of it. Has any thought been given to just keeping up with this once you have embarked on such a program?

MR. STEIN: It has been discussed. So far the task force has backed away from it. They have not wanted to enunciate very strict guidance on loss recognition recoverability for particular products when those guidelines for the rest of the industry are as broad as they are. But, there are certain people on the task force who strongly believe there should be some very firm guidance given on such things as asset allocation and liquidity projections. I suspect, in the long run, additional guidance will be included, perhaps somewhat general, addressing those kinds of points on anticipating maintenance of spreads or liquidity needs, and possibly edging towards recommendations concerning allocation of assets to particular product types. There is nothing right now in the guidance being considered, but that has been talked about and we may come back to it before we are through.

MR. ROBERTSON: It is a tough problem because, traditionally, recoverability standards presume that you know what your future revenues are or what your future pricing is going to be and that is a variable for most of these new products. You can get even beyond recoverability. The company you are referring to gets into the question of a going concern and that presents all kinds of additional accounting problems.

MR. STEIN: The drawback on that right now is the task force is reluctant to prescribe what it views as primarily management techniques or to tell management "how to run your company". If you say that is how you are going to have to judge recoverability, etc., it almost forces management to run their operations that way. There is a great reluctance to tell individual companies via accounting rules how to run the company.

MR. ROBERTSON: Let's talk about statutory accounting issues. We are primarily talking about what the NAIC has been up to lately. Bill Schreiner is going to cover that subject for us.

MR. WILLIAM J. SCHREINER: I would like to start with a report on the results of last month's NAIC Blanks Task Force Meeting. But, before I go into those specifics of the statutory annual statement issues that they considered, I should note that the changes that the Blanks Task Force approved have not yet been officially adopted by the NAIC. The NAIC will take up these issues at their next meeting in June and, at that point, we will know whether these items will actually be adopted. Past history would suggest that all, or nearly all, will be.

First, let me note that the proposed revised simplified blank is dead and was interred by the NAIC last fall. However, there are two concepts that came out of that endeavor that are proceeding. You will recall that the proposed Notes to Financial Statement was added to the Statutory Blank for 1982 reporting. In addition, detailed instructions based on those proposed originally for the simplified blank are now under consideration. Presumably, if not too many problems are turned up in the review of these in-

structions, they could well be adopted for use with the preparation of the 1983 Statement.

Some other items that the Blanks Task Force considered were housekeeping amendments for Schedule DA for short-term investments. You will recall that Schedule DA was put into the Blank last year on an optional basis. As a result of its being put in at the last minute, there were a number of areas that did not receive attention which have now been taken care of. I should note that this Schedule of Short-term Investments is not optional for 1983, but that it will continue in the format of 1982 with only the December 31 status required to be reported. The similar schedule in the Separate Account Blank, of course, requires transactions to be reported. It is quite likely that consideration, serious consideration, will be given next year to the adoption of a requirement to show the transactions in the Blue Blank.

Another item that was adopted was a revision to Schedule M which requires mutual company dividend disclosure. In addition, it requires an actuarial opinion that specifies that dividends have been determined in accordance with the actuarial principles and practices of the American Academy of Actuaries applicable to the determination of dividends paid by mutual companies. There is no similar requirement for stock companies, primarily because the Academy has not yet established standards of practice for dividend payments with respect to the participating business of stock companies.

Other items approved include the moving up of the filing date of the credit portion of the State Page to March 1. The Accident and Health Policy Experience Exhibit now will require the designation of individual medicare policies in that exhibit. You will have to indicate which policy forms are medicare policies. An investment schedule, Schedule DB, for the illustration of options and interest rate futures, was considered by the Task Force, but was rejected. The Blanks Task Force felt that the Schedule had not been completely worked out and that more work had to be done. That work is going on at the present time.

A new schedule for reinsurance assumed was also adopted. This schedule is brand new and will require disclosure of in force, reserves, premiums, commissions, and expense allowances. For professional reinsurers, the preparation of this schedule will be a considerable endeavor. One saving grace is that the due date for submitting this to the states will be April 1. Some reinsurers have taken exception to the scope of this requirement and to the speed with which it was considered and put through and are working to try to convince the NAIC that it would be more appropriate to more carefully review the matter before going ahead with what could be a quite onerous requirement.

The next item that I would like to report on is what I call the "Bad Penny" item. It is a market value disclosure for bonds and preferred stocks. The specific proposal on the agenda was that in the Notes to Financial Statement, under the basis of valuation of assets, one should "provide a statement of the valuation basis for invested assets, including bonds, stocks, mortgage loans, etc." The new material is that "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 is an issue that the chief examiners who are on this Blanks Task Force considered on a number of occasions in the past and has been the subject of considerable debate. Industry has consistently opposed this pointing out, in part, that one should not play with one side of the balance sheet and leave the other side alone. Certainly, there is concern about this type of disclosure in a time of high interest rates when bonds held have a market value that is below the amortized value, yet the expectation is that one will hold the bonds until their redemption dates. This is an issue that I assume will receive considerable attention at the next level of the NAIC.

There are two other items that are of interest, apart from the specific changes to the Annual Statement, that may be adopted at the next NAIC meeting. There is an NAIC Study Group on Market Value, Liquidity, and Cash Flow and, in fact, the study group was formed to deal, at least in part, with the issue of displaying market value in the Annual Statement. Interestingly, six months ago they concluded that it was not appropriate and they moved on from that issue and are now considering issues of cash flow. They are currently working on a cash flow schedule that would replace the current page 4A in the Blue Book. The major difference between the proposed and the current page is that the draft version better shows the sources of cash, whereas the current page starts from the end product and backs out the noncash items to identify what the cash received has been. Instructions have been developed and this schedule is currently being tested by the NAIC and the ACLI. However, the earliest it is anticipated that this schedule might be required is the 1984 Statement.

Another issue that would be of interest to you is the Mandatory Securities Valuation Reserve Study (jointly sponsored by the NAIC and the ACLI) that has been going on for over a year. That study has been published and is now available. We distributed it to our membership at the end of March.

This study was done by three consultants, former officers of insurance companies: an investment officer, an accounting officer and an actuarial officer. They have come to 15 conclusions, some of which I would consider housekeeping in nature, others could have a major impact on not only the MSVR, but on company operations.

Let me describe some of their key conclusions. The first is that the bond and preferred stock component be combined with the common stock component. Next is that the annual rate of accumulation be graded according to the degree of attainment of maximum at the end of the prior year. The accumulation schedule would range from double the present basic rates when the MSVR is below 20 percent of maximum, to one-half of the basic rate when the MSVR is above 80 percent of the maximum. Another point is that, when the result of the accumulation is negative, which means that surplus has been invaded by such an amount, the negative figure will be the beginning balance for the next year's accumulation. In other words, there would be a restoration of surplus for all items before the restoration of the MSVR. Also, the maximum permissible voluntary contributions would be increased to twice the regular annual increment plus any amount necessary to restore the ending balance. The next item responds to one of the important reasons for the initiation of the study, the question of how to deal with subsidiary organizations for MSVR purposes. The conclusion of the consultants was that controlled and subsidiary companies be excluded from the MSVR calcu-

lations, except those whose stock is carried at public market values. The consultants also recommend that Separate Account Portfolios continue to be excluded from the MSVR calculation and that the definition of Realized Capital Gains and Losses be linked to the federal income tax definitions.

Of these highlights, three items have given rise to the most contention. The first one, the combination of the bond and stock component has caused considerable concern among some companies because they feel that if capital gains on stocks are required to be added to this much larger MSVR, the capital gains from common stocks will never spill over into statutory earnings, or take a good long time to do so, thereby reducing the attractiveness of common stock as an investment. Since capital appreciation is one of the main reasons one would wish to invest in common stock, some believe that the recommendations take away a great deal of the incentive to invest in common stock. There is also concern that there is an opportunity to manipulate the aggregate results by selling off bonds which might impair the overall effectiveness of the MSVR.

There has also been some concern expressed over the use of an income tax definition for capital gains and losses. On the regulatory side, there has been concern expressed by some regulators about the conclusion that subsidiaries should be excluded from the MSVR. As I indicated, the report is now in the process of being exposed, both to industry and to regulators, and it is not anticipated that there will be any immediate definitive action. The current objective is to give it a full exposure so that all interested parties can draw their own conclusions.

MR. ROBERTSON: It is a lot easier to add and complicate this than it is to remove and simplify, isn't it?

MR. SCHREINER: The simplified Blank was a nice effort but I do not think, in our lifetime, any one of us will see a simplified Blank. My observation is that the time between December 31 and March 1 is getting shorter each year.

MR. CHRISTIANS: The one impending development with respect to the Blank that you have not covered, probably because it is not pending too closely, is the possibility that actuaries will need to certify assets or the long-range adequacy of assets or something similar. If that is looming, I would like to propose that we get this market value disclosure instead and that we put in a market value of assets and a market value of reserves. Then, just get the actuary to certify that the market value of the reserves is less than the market value of the assets and let it go at that.

MR. ROBERTSON: It appears to me that you have simplified the job of evaluating the assets but the price you have paid is that you now have established a very difficult problem of determining how that market value of reserves is to be determined.

MR. CHRISTIANS: It certainly is a difficult problem, but you are going to have to develop a much larger array of information to determine what the cash flows which go into that calculation are going to be.

MR. ROBERTSON: In either case, the actuary will be required to do some work in evaluating the possible or probable maturity of the liabilities.

MR. CHRISTIANS: That is right, but at least it will keep them off of the asset side. It will keep him in his area of expertise.

MR. SCHREINER: That has certainly been one of the complaints about the proposal to show the market value of bonds in the Statement, although I might comment that its appearing in a footnote is perhaps the least objectionable way of displaying that information. A basic problem is that you are working with one side of the balance sheet without working on the other. Some people will draw wrong conclusions from that.

MR. CHRISTIANS: I see some other people who want to do something else to the other side of the balance sheet as far as getting an actuarial opinion that the investments are proper; that the values of investment will be there as required to fund liabilities. That seems to me to be a much worse requirement than some combination of the two sides of the balance sheet in terms of market values.

MR. SCHREINER: Well, frankly, as yet, there really is little interest in the NAIC for such an actuarial opinion. In fact, at this last Blanks meeting, two of the things they did was to turn down a proposal to require an actuarial certification for HMO's and to turn down a requirement for an actuarial certification for Blue Cross/Blue Shield plans. Now, in the future, it may well get to the point where an actuarial certification is appropriate and the NAIC would rush to adopt that. But, that day has not yet arrived.

MR. CHRISTIANS: They are not discussing that seriously at all?

MR. SCHREINER: Not a bit.

MR. CHRISTIANS: We do have California on interest-sensitive products and New York on certain types of annuities?

MR. SCHREINER: Yes, but I think it will be a slow process.

MR. KOLKMAN: Just one other comment on that. I think the actuary is going to have to spend some time on the asset page too. He is going to rely on investment professionals for the quality of the investments, but he is going to have to be concerned with the maturity structure of the assets. That is in comparison with the maturity structure of the liabilities. To be statutorially solvent or solvent on a market value basis at any given point does not really tell you much if your concern is being considered over the life of a block of business. One of the arguments the C-3 Risk Task Force heard early on was what should we measure? The measure is not necessarily that a block of business should mature itself satisfactorily, but you have to remain solvent at each duration along the way. That is a much more stringent requirement.

MR. THOMAS G. KABELE: I just have a couple of comments. One on Separate Accounts. Some of them have amortized values and, it seems to me, that they should be included in the MSVR. Also, in New York, controlled subsidiaries must be carried in the MSVR. In New York State, apparently you can carry a subsidiary at cost. I am just wondering what the other states have.

MR. SCHREINER: I do not know the specific rules of each state and, obviously, anything that the NAIC adopts, can be changed by any particular

state. New York, however, has a requirement on their books that requires them to utilize the NAIC Statement. I suppose, however, that would not prevent them from requiring you to do that calculation twice.

MR. ROBERTSON: There are many of us who believe the best solution would be either for New York to secede or be kicked out of the union.

Let us move on to interim reporting. We had a seminar here Wednesday talking about management information systems and it turned out that the hottest subject on the agenda that day was the issue of whether the value of monthly financial reports for an insurance company is such to justify the considerable cost. IDS Life does have a very fine monthly reporting system so I asked Paul to tell us about it and to lead the discussion of the relative value of such a system.

MR. KOLKMAN: My role on this morning's panel is to discuss interim financial reporting. I volunteered to do this knowing full well that I am not necessarily an expert in this area. However, my company, IDS Life, does extensive interim financial reporting and I thought that a discussion that included some of our procedures and experiences would be of interest.

Companies do interim financial reporting for various reasons. Some companies are required to file quarterly statutory reports with certain states and most stock companies that report on a GAAP basis make regular quarterly filings with the SEC. Beyond these required interim reports, most companies do some form of internal interim financial reporting and other companies, due to turbulent economic conditions or rapid growth of new lines of business, are, or should be, thinking about it.

I will illustrate one approach to interim financial reporting by describing what we do at IDS Life. IDS Life is a wholly-owned subsidiary of IDS, a diversified financial services organization. IDS, in turn, is a wholly-owned subsidiary of Alleghany Corporation, and Alleghany's other major subsidiary is a fabricated steel products company.

Our parent requires high quality GAAP financial information to be produced on a monthly basis, along with written comments on any significant variances between actual and planned results.

Final GAAP income is due by the fourth workday of the month. Written comments are due by 11:00 the following morning, and the collected information is mailed to the Board of Directors on the sixth workday of each month.

Obviously, our timetable is very tight. There is little room for error and little time for analysis of results prior to their release. Our parent has little sympathy for the supposed problems of interim financial reporting by a life insurance company. Meeting the corporate timetables and producing consistently high quality results has required the coordinated effort of many areas of the company. Obviously, organization and preparation are essential.

Our preparation begins prior to the beginning of each year when we assemble our corporate plan for the coming year. The plan is prepared in October and November, and extensively reviewed and approved. The approved plan is then allocated by month for the coming year and becomes the standard for comparison of actual results during the year. We do quarterly updates of

our plan but the original plan remains the standard of comparison throughout the year.

We maintain the quality of interim reports by treating each month end similar to a year end. In a lot of ways, we go through a year end each month. The investment system and the full GAAP reserve system are run and all accounting entries, except taxes, are final by the third workday of the month.

Statements are prepared and results distributed starting on the fourth workday. Some of the statements produced are:

1. GAAP income by line of business including an allocation of investment income and general expense.

2. Comments on any variances from plan for the month and year-to-date.

3. Balance sheets and budget variance reports.

4. Sales, termination, and inforce reports and claim analyses.

5. Cash flow (including liquidity ratios), investment yields, duration of investments purchased and of the entire portfolio.

Some additional reports are prepared for historical comparison purposes and various statistical analyses are prepared, such as actual to standard expense comparisons.

Not all of these reports are produced by the fourth workday. For example, since statutory results are of only limited use, they are normally prepared later in the month and are obtained by adjusting the GAAP results. In addition, our investment income allocation and effective GAAP tax rates are calculated on a month lag basis.

Over the years, our most troubling area has been the allocation of general expenses and getting incurred expense and GAAP expense deferrals on a synchronized basis each month.

Our reporting schedule allows little or no time for the detailed reviews that are normally necessary. To overcome this problem, we have a system of checks and reviews of our valuation data to remain certain that the valuation system is working properly. These reviews are done after results are released. In addition, all those involved with the monthly reporting process meet after results are reported to review our reports on a line-by-line basis. All variances from plan on a monthly or year-to-date basis are discussed and possible problem areas are assigned to someone for follow up.

Problems, if any, may be with either the plan or actual results, but, at least, variances are investigated and potential problems solved before they get large. This leads to general comfort with the reporting of the following months' results subject to only a limited review.

Having described what we do and how we do it, we come to the question of whether or not the information produced is worth the effort.

The principal benefit of good interim financial reporting on a timely basis is as a management tool. Trends can be spotted early and the impact of any corrective actions can be seen. Especially, in a situation like IDS Life's where both sales and surrenders of certain products are highly sensitive to interest rates, good interim financial reports are essential.

In addition, good monthly reporting can help eliminate the surprises that can often occur at year end. Good interim procedures allow problems to be caught and corrected early. Detailed calculations, analysis, and actual-to plan comparisons are essential here, along with a determination to track down any troubling variances.

As for disadvantages, the principal one is cost. There is additional cost associated with carrying the extra staff needed to produce good interim financial reports. Each company must decide whether the information produced is worth the added cost.

Another disadvantage is the distraction that can be introduced by focusing on monthly results. We sometimes find ourselves explaining monthly variances that are not significant on a year-to-date basis. This tends to divert management attention from more important areas.

Overall, I view interim financial reporting as highly desirable and, if properly done, it can be an excellent management tool. Adapting to the tight time frame under which IDS Life operates has not been easy, but the results of the effort have been quite beneficial in managing our business.

MR. ROBERTSON: The reason you did it is clearly because your owner told you to do it. But, setting that aside, if you had a choice now knowing what you do about the benefits and costs, would you do it?

MR. KOLKMAN: We probably would not do it on the fourth workday. But, yes, I think we would do it. If it were my choice, I might go with good calculations quarterly and, possibly, estimate the intervening months. There are a lot of computer scheduling problems when you have to run, what is, essentially, your year-end system at the end of every month.

MR. ROBERTSON: I have a question for the audience. Of those of you who are employed by companies, how many of you produce full financials monthly? About half the people in the room and, probably, that is more than half of the people who are employed by insurance companies. That is more than I would have expected, although it is consistent with the response we had at the seminar last Wednesday. Are any of you people who put your hands up employed by mutual life insurance companies? One. There were four out of 50 at the seminar.

MS. PAMELA S. WOODLEY: We do pretty much the same thing as IDS although it takes us until about the end of the month to get out the reports for the previous month. Another difference is, even though we are only interested in GAAP earnings, we do start with statutory and make adjustments there. You may not want to answer this question, Paul, but I was wondering how often you find yourself throwing in manual adjustments to get rid of embarrassing problems?

MR. KOLKMAN: That varies by line of business. That is the importance of having a good plan allocated by month and checking out things as they come

along month by month. We had a problem two or three years ago with the single premium deferred annuity business in which we would book premiums, but the reserve master file had not been set up properly. It was going to be set up the first workday of the following month, but it had not been done at the same time the premium was applied. We had quite a few problems with that for a long time. The procedures were such that it should not have happened but, as long as it was manual and there was still room for error, errors were made. You track those down and you realize what the errors can be and where they are likely to occur. If your monthly results come out and there is a large, unexplained variance in one number, then your natural reaction is to presume that it is what you have seen before, plug it, and have somebody find out what it is. You then try to find a way to keep from having that happen again.

MR. ROBERTSON: Pray a little.

MR. KOLKMAN: Again, if you are doing that quarterly or annually, you have more of a problem because you do not know if what you are doing is right or not. But, when you are doing things monthly and, if you do put in a plug like that but track it down and find out for certain what it was, some of those concerns go away. We have since solved our problem with the single pay annuity line. Things are synchronized there. Now the problems have spread to the group pension line. I would say two or three times a year we get something that we find troubling and have to put in an adjustment. Hopefully, never at year end.

MR. ROBERTSON: Clearly, one of the big advantages of a monthly system is that you get 12 shots at something rather than just 4. You have 12 opportunities to find the problem.

One observation I have is that, historically, there have been two types of companies which have gotten into monthly reporting. First are companies whose business is such that there is a need to make frequent decisions based on current data. For example, property-casualty--you cannot run a property-casualty company without having good monthly data. You have to make pricing decisions and underwriting decisions in a very short time. That is probably also true for the group life and health areas. You do not have quite as much flexibility as to decision-making as you do in the property-casualty area, but many of the same considerations apply. So, it is not unusual to find companies which are predominantely property-casualty or predominantely group on a monthly cycle, possibly just for the lines affected, but, perhaps more commonly, for the whole company. This is especially true if they tend to be dominated by management that came up through those other two branches.

The other category of companies which are generally on monthly are those like IDS where there is a non-insurance parent not used to getting all the excuses we give as to why monthly is not appropriate for a life insurance operation. I think most companies which are predominantly individual insurance, historically have not seen the need for monthly information because there is not that much we have to do on a month-to-month basis or can do on a month-to-month basis to affect our results. Our pricing decisions are in a much longer time frame and there is not a great deal we can do in an underwriting area that is affected by current data. But, as you point out, that is changing. As we move to products where we have flexibility as to interest rates, mortality, or whatever, we now have a need to make deci-

sions much more promptly than in the past; even in a term insurance company. We are having a lot of problems in the term market and I suspect many of you are too. It would have been nice to know about those problems a little sooner than we found out about them. We probably could have saved ourselves whatever the cost of putting a monthly system together would be.

MR. NORMAN B. NODULMAN: How elaborate is your process for allocating the plan by month and, to what extent do you find that explaining monthly variances tends to get you into talking about limitations of that process rather than actual results.

MR. KOLKMAN: Again, that is something that has developed over the years. The process has become a little more sophisticated. That happens. If the plan tends to be spread, for example, to be front ended so that you fall short of planning in the early part of the year and then catch up in the latter part, that does get to be a problem. We tend to not fall back on that as an excuse unless it is really significant. But, if it happens, it happens. Over the years we have tried to get away from that. With a number of years of monthly results behind us, we have a fairly good feel for how most of the major components emerge. With two sales campaigns during the year we have a feel for how expense deferrals vary in certain months. We have a situation in which our expenses get allocated to us by our parent—for example, on a monthly basis, and we have to allocate those in proportion to the business issued so that in non-campaign months we wind up expensing some things that will then be deferred during the sales campaigns. On a year's basis, everything all washes out. But, the allocation of the plan by month does take this into account. And, again, by tracking down variances monthly if you find something that troubles you, you simply fix it for next year. And, after two to three years of this, you have a plan by month that is actually quite good.

MR. CHARLIE T. WHITLEY: Paul, could you say a few more words to briefly describe this monthly allocation process?

MR. KOLKMAN: Each piece is allocated by whatever we have found it to be most closely related. For sales, as long as sales campaigns do not vary, we tend to use three-year averages. In the group insurance line, we tend to spread, for example, claims in proportion to premiums. Most premiums come in fairly uniformly throughout the year--there does not seem to be a problem there. General expenses tend to be fairly level although the capitalizations tend to vary then with sales which were spread by another method. Each piece can be identified with something we suspect it varies closely with. And, we can spread it according to that. It is not uncommon to find something later that is a refinement and we will change to that. But, there is no one method for spreading each piece.

MR. CHRISTIANS: I got the idea that your monthly process was picked up from your parent and that you are copying them. The reason why insurance companies do not do this, I think, is because of the non-ledger items--insurance companies have ledger and non-ledger items--they just do not want to do this inventory process every month. You say you go ahead and do it every month. Does your steel company do its inventory every month, or do they just do an annual inventory of what they have on hand and then allocate the changes based on transactions through the year or something like that? Have you thought of putting reserves on your ledger or just accounting for transactions rather than doing your inventory of policies every

month or maybe doing it both ways for a check? Evidently, you have looked at your results fairly closely and have a good deal of accuracy. Have you thought of any other non-insurance type of accounting features that you might want to put into your system?

MR. KOLKMAN: We really have not. We have tried to stay with the insurance accounting and try to do that within the time that we are required to report results. You said our process was our parent's. It is the time schedule that is our parent's. The process is almost uniquely ours. Before we were wholly-owned by Alleghany we were part of IDS. We still are--but, with the mutual fund operation there and the simpler structure of the business, it was possible for them to put out their results very quickly and, as the life insurance company was founded and developed, it was required for us to do that too. We have done it all within a life insurance framework. We still run the reserve system just as if it were year end.

MR. ROBERT A. SABAJ: I was wondering what the time was from the time it was decided to do monthly reporting to the first monthly report to the time it became sort of routine.

MR. KOLKMAN: We have always done monthly reports. We were founded in 1957 and the business started quite slowly. Apparently, they could keep track of things on a yellow, legal pad at that time. It sort of developed from that. The thing that has changed is the time in which we report. That has consistently been cut back. Originally, it was a couple of weeks, then a week, and is now down to the fourth workday. By next year we will be on the second workday. However, I think the fourth workday is some kind of magic line because the life insurance company has concluded that we cannot possibly report on the second workday without cutting off before the end of the month. But, one of the things that has helped us get to where we are is that we got there in gradual steps. We have always reported monthly, but the time has consistently shortened over the years. If you try to go from a situation in which you are reporting annually or quarterly and try to go to third or fourth workday reporting, you are going to have some troubles. But, if you try to shoot for the end of the month or mid-month and then over a period of time consistently shave a day or two off of that as your techniques get a little more efficient and more practiced, it is doable.

MR. ROBERTSON: By 1985, you ought to be able to report before the end of the month.

MR. KOLKMAN: Well, by cutting off 5 days early, we almost think we could.

MR. ROBERTSON: We have come to the end of the time that has been alloted to us. I thank all the panel members for their participation. They have done a very fine job.