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INTERNATIONAL OPERATIONS ACCOUNTING

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- o Foreign currency fluctuations
- o Foreign taxes and tax credits
- o Offshore subsidiaries
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- o Variation appropriate for United States and Canadian companies

MR. MICHAEL R. TUOHY: Mr. David Atkins is in the Toronto office of Coopers and Lybrand. He read Law at Oxford University and moved to Canada in 1962 and is in the thick of the Canadian insurance industry. He is chairman of the Canadian Institute of Chartered Accountants (CICA) Research Study Group on the extent of audit testing and also chairman of the Research Study Group authoring the audit guide for insurance companies. He is a consultant to the Insurance Bureau of Canada and a member of the Combined Accounting Actuarial Task Force on the roles of the auditor and the actuary.

MR. DAVID ATKINS: There are many life insurance companies in Canada with international operations, which is unusual for a country with a relatively small population. Typical of such companies are Sun Life, Crown Life, Great-West Life, Imperial Life, and Canada Life. We have a number of foreign-owned corporations with branches and subsidiaries in Canada, so we see it both ways.

With this internationalization, we should have a sophisticated life insurance accounting system in Canada. That really isn't the case, although it is undergoing some tremendous changes. Until recently, life insurance accounting in Canada looked to solvency, and the methods of accounting were dominated largely by the views of the big mutual

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companies, so there wasn't pressure to move toward generally accepted accounting principles (GAAP) for securities exchange purposes.

Canadian life companies prepare their accounts on a statutory basis, which is prescribed by our Department of Insurance, and this basis integrates foreign branch operations but treats the investment in subsidiaries on an equity basis. In other words, there is no consolidation. Generally, the foreign branch operations are converted onto the Canadian statutory basis of reporting with the exception that the foreign actuaries are given a fair amount of leeway in the computation of the actuarial liabilities outside Canada. As a country, we are going through an interesting process of change, and we are well qualified to talk about life insurance accounting because of these innovations.

In about 1984, a CICA research study called "Accounting for Portfolio Investments" was published. That research study addressed not only life insurance accounting but all enterprises owning portfolio investments (banks, savings and loans, trust companies, mutual funds). That study also recommended the accounting for investments should be recognition of unrealized gains and losses on a gradual basis. That is only a research study, but it authoritatively (although not authoritatively enough) allows for GAAP to apply to unrealized gains and losses.

In 1978, the Federal Superintendent of Insurance and Federal Department of Insurance introduced some very important changes into the Canadian statutory accounting scene issuing some progressive accounting concepts, which probably should have been adopted by the CICA many years ago. For example, the old formula regarding rigid interest and withdrawal rates and mortality tables was dropped, so companies could adopt their own experience in those areas. Modified bases of reserves were allowed. Although deferred policy acquisition costs were capped at 150 percent of first-year premiums, certain previously disallowed assets (like agents' advances) were allowed to be shown as assets, even though there was an appropriation of surplus on the other side of the balance sheet for these things.

A measure of unrealized gains and losses on stocks was allowed to be included in the income statement which was a major breakthrough. It was a very slow amortization -- a 7 percent diminishing balance basis. That balance included realized gains and losses on stocks as well. It was a complex formula. The main point is that unrealized gains and losses became entrenched in the life insurance reporting scene in Canada in 1978.

Shortly after those changes, the CICA and the Canadian Institute of Actuaries (CIA) formed a joint task force to examine the various ways in which life insurance companies were accounting and reporting and to see whether such accounting might be brought closer to GAAP and yet meet the needs of actuaries and regulators.

That task force reported in 1982, and it expanded and improved upon the 1978 changes by the Federal Superintendent of Insurance. The task force agreed that there should be recognition of unrealized gains and losses on stocks and extended that scope to real estate. It recommended a slightly faster rate of recognition through the income statement of, I believe, 20 percent.

The task force stated that both the net valuation premium method and the full gross premium method had merit in calculating actuarial liabilities. Some of the recommendations with regard to actuarial liabilities were:

1. They should include a provision for adverse deviations.

2. Evaluation of assumptions were to be reviewed, and any resulting material adjustments were to be made as often as practicable.

3. Changes in valuation assumptions should be accounted for prospectively, and if changes in these assumptions result in the reduction or elimination of previous deficiency reserves, the adjustments should be recognized as income immediately.

4. The costs included in the actuarial liability are to comprise not only policy benefits but also policy expenses and taxes.

5. All recoverable acquisition costs should be deferred and amortized without arbitrary limitations, so that they don't object to 150 percent capping and should begin on the first policy year not the second.

In some respect, the task force recommended changes that moved closer to GAAP. In regard to coinsurance and reinsurance, the concept of transfer of risk was strongly recommended. It also recommended that life insurance companies follow consolidated reporting.

What has happened is that the accountants and actuaries practicing in the life insurance industry are developing some firm views of their own and are following the principle that there should be equity among generations of policyholders. If you recognize that principle, then it becomes apparent that you should recognize unrealized gains and losses. Also, actuarial liabilities should be recognized as dynamic, not static, and changed conditions must be carried through the accounting process. Those are the two guiding forces occurring in Canada.

Unlike the British, Canadian accountants and actuaries are not keen to give immediate recognition to market values. Due to their volatility and impracticality, it is recognized that basic values tend to change over longer periods of time. These gradual changes should be recognized in the accounts.

Fixed-term securities are the bulk of the securities of a life insurance company. The joint task force and the Federal Superintendent of Insurance have concluded that a deferral and amortization basis should be followed for realized gains and losses on securities having a maturity date when not in a liquidation mode. This is in recognition of the two key criteria of securities -- yield and equity -- and I couple security with equity.

Now the problem is that the CICA Handbook is the standard setting document in Canada. It recognizes the deferral and amortization basis for realized gains and losses on bonds but still adheres to the cost method for securities without a maturity date. One is not able either in the U.S. or in Canada to treat the recognition of unrealized gains and losses through the income statement as being GAAP. Unfortunately that is directly contrary to the good GAAP principle that one should provide equity among generations of policyholders.

A trend has been established in Canada to use the deferral and amortization method for realizing gains and losses on fixed term securities, and it is unlikely that it will be reversed. This trend is somewhat at odds with accounting in Canada and in other countries. This method probably would have problems in the United States, but it is likely that the trend will drive accounting in countries, whose subsidiaries report to Canada, causing a major effect because people will have to understand this method of accounting.

Starting in 1984, the Canadians, like the Americans, have experienced an aggregation of financial services. We are now seeing the formation of groups in Canada with holding companies normally being public companies owning and controlling life insurance operations, banking operations, trust company operations, and so on. These holding companies go to the market for new money; financial institutions are great consumers of funds and capital. They go to the market frequently entailing the issuance of a prospectus. For those prospectuses to pass, they must go through the regulatory authorities on the stock exchange, and the accounts therein must be in accordance with GAAP.

Life insurance company accounting is not in accordance with GAAP, and the only way GAAP recognizes the inclusion of life insurance company's figures in these situations is on an equity basis. Unfortunately, the equity basis fails to recognize the total assets, liabilities, and operations of the life insurance enterprise in the group, and also fails to recognize the basis of accounting whereby the achieved equity basis is totally or somewhat different from GAAP.

The two entities in Canada who presented their financial statements as a public offering in 1984 were Cronex and Trilon. They disclosed that life insurance company operations were not in accordance with GAAP, and indeed life insurance company operations were consolidated on a statutory basis, since there is no other basis of accounting in Canada.

Those statements ran into rough water with the Ontario Securities Commission. The Ontario Securities Commission allowed, however, those statements to go forward but told the CICA that they better produce some GAAP for life insurance immediately. In 1986, the CICA has to produce GAAP for life insurance acceptable to not only its own members but to actuaries, regulators, members of the industry, and the Ontario Securities Commission. The CICA probably will look carefully at the recommendations of the joint CICA task force on life insurance company reporting, which recognizes unrealized gains and losses and follows principles of equity among generations of policyholders and shareholders.

The same body of accountants in the CICA looking at this issue also is addressing the issue of portfolio investment accounting of all enterprises. Additionally, a new research study is being formulated by the CICA on the time value of money.

There are two specific areas that exemplify this challenge -- foreign exchange and taxes. For GAAP in Canada we follow the financial accounting standard approach to foreign exchange. There are some minor differences. The major one, actually with a life insurance company, is that we don't try to determine whether actual liabilities are temporal or not; we have decided that they are temporal, although I think that in the States they are not.

In any event, the CICA and CICA/CIA task force has determined that everything should be treated in the same manner. The foreign exchange gains or losses realized and unrealized are to be treated in an identical fashion to realized and unrealized gains or losses on those securities not having a maturity date. There should be a gradual recognition of trends through the income statement, and everything should be treated the same way.

Right now under GAAP, deferred income taxes are not regarded as a liability but as a credit in Canada. That is now being expunged. People are looking seriously at discounting deferred income taxes not present in accordance with GAAP.

The current debate in Canada is really the most interesting that accountants and actuaries have ever experienced. In a sense, it's a rehash of the old nineteenth-century debate regarding the definition of profit. Is profit the increment or decrement in value from one point of time to the next, or does it have to arise from a transaction?

MR. TUOHY: Mr. Charles Carroll is with Ernst and Whinney in their New York office. He started his career with nine years at New York Life, then had a couple of years consulting with a small firm, and about four years ago joined Ernst and Whinney. He's a principal at Ernst and Whinney, which actually equals a partner. Mr. Carroll also is a past president of the New York Actuarial Club.

MR. CHARLES CARROLL: This is a particularly difficult subject if you look at the statutory side and consider what is involved in consolidating the results of foreign operations into a U.S. company's statutory blank. One is faced with three particularly difficult problems, and when you put them all together in one problem, it's really daunting.

The first problem area is statutory accounting for subsidiaries. The published authority on this topic is limited. Subsidiary accounting applies not just to foreign subsidiaries but to all the domestic subsidiaries that companies own. You can look to a few cryptic pages in the National Association of Insurance Commissioners (NAIC) Accounting Manual and some material in the NAIC Examiner's Handbook. These sources specify a range of different options for valuation of subsidiaries and leave final decisions up to the company.

Because we are dealing with foreign subsidiaries, we also come upon the question of how to deal with foreign currency fluctuations in the statutory setting. Two directly contradictory statements on this question can be found in authoritative sources -- the NAIC Examiner's Handbook and the NAIC Accounting Manual. Concluding from an informal survey of some companies, it appears that, in practice, this contradiction has been resolved in favor of the Examiner's Handbook; however, some companies might be following the other approach.

After the problems of statutory subsidiary accounting and foreign currency accounting, the next problem involves the peculiarities of foreign products and foreign statutory accounting practices which are not always reconcilable to U.S. statutory accounting practices. With GAAP, at least there is some uniformity and some fairly specific rules to go by, with a minimum of alternatives. While one might question whether these are the right rules, there is a certain basic thread of logic to them. Moreover, the introduction of the Statement of Financial Accounting Standards (SFAS) No. 52 by the Financial Accounting Standards Board (FASB), has improved the situation at least in terms of foreign currency accounting. The real problem with GAAP is in the application of the accounting bases in the audit guide for stock life insurance companies to foreign products and accounting systems. The concepts of deferred acquisition costs, GAAP reserving techniques, deferred taxes, and asset accounting that are implicit in the audit guide just don't mesh with the environment in all foreign markets. Yet, in order to report the operations of a foreign subsidiary or branch in U.S. GAAP financial statements, you have to make them mesh, otherwise the resulting statements won't be GAAP and you won't get a clean accountant's report.

If we can master some of the nuances on the statutory side first, the peculiarities of the GAAP side will appear relatively easy in comparison. Exhibit A organizes the concepts in a grid. This grid is simplified and at least statutorily represents more or less common practice rather than a complete compendium of the alternatives. For various different types of entities, the grid specifies the method for including the entity's results in the financial statements, treatment of foreign currency translation problems, and the accounting principles to be used. For statutory accounting, the grid shows three types of entities: a branch, a subsidiary, and an investment.

A branch is an operation in a foreign country which does not have a separate legal entity involved. The most common situation might be a U.S. company that sells Canadian policies to Canadian consumers and collects premium and pays claims in Canadian currency.

A branch's assets, liabilities, revenue, and expense items are "consolidated" with those of the related U.S. business for statutory

Exhibit A

Accounting for Foreign Life Insurance Operations In The Financial Statements of U.S. Parent

S T A T U T O R Y

(Note: Practices listed here are not uniform for all states nor from company to company, but rather represent common practice.)

Type of Entity	Method of Inclusion	Foreign Currency Translation	Accounting Principles
Branch	All asset, liability, revenue and expense items are consolidated with those related to U.S. business at some fixed "book" exchange rate. No effect on mandatory securities valuation reserve (MSVR).	Changes in the value of surplus of foreign currency assets over liabilities reported in Exhibit 4 of the annual statement as unrealized capital gain. Asset (liability) held for cumulative amount of increase (decrease) in surplus at current exchange rate.	U.S. Statutory
Subsidiary	Value of subsidiary (adjusted to reflect subsequent operating results) held as an asset. Changes in value reported as unrealized capital gain or loss. MSVR may not be affected.	See above under Branch. Alternatively, change due to currency translation might be included with changes in value due to other causes.	Foreign Statutory (?)
Investment	Market value if publicly traded; adjusted cost, if not. Only dividend income will affect gain from operations. MSVR will be affected.	See above under Subsidiary	National Association of Insurance Commissioners (NAIC) value or Foreign Statutory

purposes, generally at some fixed, nonfluctuating exchange rate. Most U.S. companies with Canadian branches will include the Canadian premiums with U.S. premiums with one Canadian dollar equaling one U.S. dollar.

This creates a somewhat distorted net gain from operations, and certainly the individual items, the premium account (if there were significant operations in the other company) would be quite distorted. To compensate for this, at every financial statement date, the value of the surplus in the branch (the excess of the branch's assets over liabilities at each point that a financial statement is being prepared) are translated using the current exchange rate. This is accomplished through exhibit 4 of the annual statement. The company would show the change in the value of the surplus due to the exchange rate as an unrealized capital gain or loss. It then would record an asset or liability based on the cumulative difference between the surplus at the fixed exchange rate versus the current rate. Although the balance sheet, income statement, and net gain from operations are all distorted by a fixed exchange rate, the surplus at the end of the day is adjusted to reflect current exchange rates. It would seem that U.S. statutory accounting principles are to be applied to branch accounting. The minimum reserve basis, accounting for assets, mandatory securities valuation reserve (MSVR), all of those things for the Canadian branch are consistent with what is in the U.S.

The foreign operation may be a subsidiary -- an entity over which the parent company has substantial control. In statutory accounting for U.S. subsidiaries, the subsidiary is like any other investment. If a subsidiary's stock is traded in a public market, one of the ways to reflect that subsidiary's value would be to hold market value. If it's a 100 percent owned subsidiary, of course, there isn't a public market. In that case, the value of the subsidiary adjusted to reflect subsequent changes in operating results is held as an asset. Changes in the value of the subsidiary are treated as unrealized capital gains or losses, and there may or may not be an MSVR component held for that subsidiary depending upon whether the subsidiary has an MSVR or something similar of its own.

Foreign currency translation for the subsidiary is basically the same as for a branch, that is, everything is marked to the current exchange rate at the end of the day. Alternatively, two separate entries aren't required to value the subsidiary at a fixed exchange rate combined with an adjustment for foreign currency translation. You can have both of those translations combined into one number, i.e., the change in the value of the subsidiary.

It would appear as if foreign statutory accounting principles are inappropriate for foreign subsidiary accounting. If you had a foreign subsidiary whose statutory accounting principles were at significant odds with the U.S., I'm not sure what the accounting statements would mean, since you have elements of them involving different accounting principles for different entries.

In practice, at least U.K. companies are consolidated into the U.S. on their foreign statutory basis rather than being converted in some way to U.S. statutory. This is an area where there is no clear guidance.

A pure investment is an ownership position that the company holds in some entity. It is generally characterized by lack of direct control over management. In this case, the item is included simply as an investment. Again, there would be an MSVR component related to the investment. Foreign currency translation would be the same as for a subsidiary, and there aren't any accounting principles involved. Simply, the subsidiary's value is included in the parent company's statement.

A recent change in the NAIC Accounting Manual permits what I would call a modified GAAP equity method approach to including a subsidiary in the annual statement. Essentially, under this method the parent company includes its equity in the undistributed earnings of its subsidiary in its net gain from operations. However, the undistributed earnings which are going through net gains from operations, interplay with the MSVR so that if you have gains coming through your subsidiary, even though they are a net gain from operations, they are treated as if they were unrealized capital gain. Thus, if you have room in your MSVR, they are added there rather than falling right down to surplus.

If you are concerned particularly about net gain from operations (for rating purposes, for example), you could convert to this method of treating your wholly-owned subsidiaries. Under statutory, regardless of how the numbers flow through the annual statement, you end up with the value of the subsidiary (or branch) in surplus but at current exchange rates. The only possible option is between how much you show in gain from operations versus how much you show as a pure surplus adjustment.

Exhibit B is a GAAP grid, which turns out to be simpler than the statutory grid. The GAAP grid shows type of entity, method of inclusion, foreign currency translation, and accounting principles. For GAAP, however, the entities are somewhat different. GAAP doesn't recognize the difference between a branch or a consolidated subsidiary. That is, if you have a subsidiary that you control, that's the same as a branch under GAAP. GAAP recognizes the reality of management control versus the artificial legal distinctions between a branch and a subsidiary. All of the accounting principles in these cases are U.S. GAAP.

For a branch or a consolidated subsidiary, all the assets, liabilities, revenue and expense items are consolidated. The subsidiary or branch's premium income is included with the parent's premium income; however, they are not included at a fixed exchange rate (as under statutory) but rather at the average exchange rate during the year -- technically, the rate in effect when the transaction occurred during the year for income statement items.

Exhibit B

Accounting for Foreign Life Insurance Operations In The Financial Statements of U.S. Parent

GAAP

Type of Entity	Method of Inclusion	Foreign Currency Translation	Accounting Principles
Branch or Consolidated Subsidiary*	All asset, liability, revenue and expense items consolidated. Cumulative translation adjustment reported as separate component of equity. Changes in cumulative translation adjustment do not affect net income.	All balance sheet accounts translated at exchange rates current at date of statement. All revenue and expense accounts translated at average exchange rate for period.	U.S. GAAP
Unconsolidated Subsidiary or 20 - 50 Percent Owned Investments*	Equity Method -- Same as consolidated except all entries are collapsed.	Same as above.	U.S. GAAP
Less Than 20 Percent Owned Investment	Cost Method -- Investment is carried at cost unless there is a permanent impairment.	Translation not necessary.	Not Applicable.

* Distinction is based on degreee of control exercised by parent.

Assets and liabilities are converted at the year-end exchange rate. Owner's equity is translated at historical rates. You will see that once you do this translating, your basic equation -- owner's equity at the beginning of the year plus net income equals owner's equity at the end of the year -- will not be satisfied, because the assets have been translated at the year-end exchange rate. This gives rise to a foreign currency adjustment treated as a separate component of equity rather than as part of the income statement. In other words, the change in the value of the entity, due to changes in the exchange rate related to the beginning equity, are considered directly in the equity. They don't go through income. This relates to the basic debate, is income the change in value or does it have to relate to a transaction? GAAP states that it has to be related to a transaction. The advantage is taking some of the fluctuations out of the income statement due to currency exchange rate fluctuations. Another advantage is making the consolidation meaningful as compared with a meaningless fixed exchange rate used for consolidation in statutory.

An unconsolidated subsidiary is one you have only 20 -- 50 percent control over. In this case, you don't often have access to all of the information necessary to do a full consolidation, so an equity method approach is used. In other words, you try the same thing you're doing with a full consolidated subsidiary, but you collapse everything into one entry to achieve the same result in net income but without the detail of a full consolidation.

You have the possibility of a less than 20 percent owned company which would be treated as an investment under GAAP and not consolidated. The cost method would be used and the value of the subsidiary would be included in the statement. There is no accounting principle involved; it's purely an investment. The translation automatically is handled through the change in the value of the investment due in part to currency fluctuations.

The history of foreign currency translations under GAAP has changed from the pre-1982 basis where there was a distinction made between monetary and nonmonetary assets. Essentially, prior to 1982, you went through your balance sheet and income statement to decide whether each item was monetary or nonmonetary. A monetary item's value was fixed in terms of a unit of currency. For example, a loan would be monetary; it's value stays fixed in relationship to the currency in which it's denominated. A nonmonetary asset might be inventory.

Also, prior to 1982 (the time that SFAS No. 52 was promulgated), all of these fluctuations caused by foreign currency differences went through income. Not only did you get the fluctuations affecting the operations of the current year, but the changes in the value of equity due to foreign currency fluctuations also moved through income which made many international conglomerates unhappy.

The monetary assets were to be converted at the current exchange rate, and the nonmonetary assets were to be converted at the historical rate in effect when they were created. For example, inventory was translated based on the time at which the inventory was created.

One aspect of this method was particularly illogical. Based on a specific interpretation, deferred acquisition costs of life insurance companies were considered nonmonetary under the theory that they are like inventory. On the other hand, reserves were considered to be monetary. The claims and the premiums involving the policyholder were denominated in the foreign currency -- they were fixed.

SFAS No. 52 lists assets that are to be translated at historical versus current rates. (This is not generally relevant to foreign subsidiaries of life insurance companies, since their functional currency is the currency that they operate in, but it is relevant to some foreign subsidiaries where the functional currency is not the same currency in which the transactions are being processed.) There is a specific statement in SFAS No. 52 that deferred acquisition costs of life insurance companies are to be translated at current exchange rates.

As the U.S. market begins to develop products similar to foreign products (particularly, U.K. products), some of the techniques used in those foreign environments are becoming more relevant, specifically the treatment of unit-linked business in the U.K. There is a direct relationship between that and variable life insurance in the U.S. As companies get into variable universal life (UL), they will be able to use some of that experience.

We have seen many companies interested in treating guaranteed investment contract operations similarly to separate account business with assets continuously marked to market. A lot of people feel that this is the right way to measure that particular type of business.

There are significant practical problems in fitting foreign products and tax systems and accounting models into the GAAP mold, and there is significant expense in maintaining an additional accounting system for a foreign subsidiary -- if it's an important part of the U.S. subsidiary.

There is an interesting provision of the new tax law concerning contiguous country branches (like Canadian or Mexican branches of U.S. companies) that basically extends the prior law provisions for mutual companies. Under the prior tax law, mutual companies were able to exclude foreign operations in contiguous countries from the tax return in the U.S. The theory was that the foreign policyholders actually owned the foreign branch, and therefore, if you maintained separate accounting for that branch, you could exclude its transactions from the U.S. tax return. You still can do that under Stark-Moore.

There is an interesting provision that, when you make this election to exclude, if there is a net excess of current market value of the assets in the branch over your adjusted basis, you must recognize the gain as of the first day of the year that you make the election. By the way, it specifically says excess. In other words, if it's a gain it's recognized. The implication being that losses are not recognized. Stock companies also have a similar provision; however, they have to set up a foreign corporation. The setting up of that foreign corporation is done on a favorable basis so that other tax consequences are not triggered.

These provisions might give rise to some tax planning if you are a mutual company with a subsidiary in Canada or Mexico whether or not it's possible or feasible to make that a branch, since you might be able to exclude surplus tax, for example. If you do have a branch already, the question of how much surplus you want to maintain in that branch versus how much you want to maintain in the U.S. comes into play in tax planning.

The accounting implications aren't particularly significant for foreign reinsurance. On ceded business, the question is whether or not the foreign company that you ceded to is licensed, which is no different than if it was a U.S. domestic company.

To sum up the accounting issues, the statutory basis does allow for some choices but the bottom line in the surplus area is probably the same on all of them. Under GAAP, you know what you have to do but doing it can be very expensive and time consuming.

MR. TUOHY: Mr. Richard P. Burrows is in the London office of Tillinghast, Nelson and Warren. He's been there since 1973 and now heads up the Tillinghast Life Insurance Operations in London. Later on in the fall of this year, he will be moving to New York where he will be coordinating all of the Tillinghast international life insurance consulting practice.

MR. RICHARD P. BURROWS: Why is it important for U.S. companies to have a feel for what's going on internationally? There are a number of reasons. There is a growing awareness among U.S. companies that to be taken seriously in the financial services and insurance industry, you have to look internationally because that is the way of the world. The major companies are going international. This may involve either acquiring or chartering a life insurance company. In order to do that, one has to understand the accounting basis and the implications that this will have on your particular company's accounts.

I'm not sure that I agree with Mr. Carroll that all subsidiaries of U.S. insurance companies could be consolidated using the U.K. statutory basis. If that is the case, the U.K. statutory basis is particularly important for U.S. mutuals because they can't have any form of upstream holding company. When they look at the U.K. company's accounts, they have to decide what adjustments, if any, they need to make to incorporate and consolidate the subsidiary's accounts within their U.S. financial statements because there is no GAAP in the U.K.

U.K. insurance companies, which are subsidiaries of U.S. stock companies, will prepare statements on a U.S. GAAP basis. Obviously if the parent is a U.S. mutual, there is no particular desire for the mutual to have U.S. GAAP statements prepared for the U.K. subsidiary. In fact, I recently was involved in a potential acquisition situation in the U.K. where a mutual insurance company was looking at a U.K. stock company and was attempting to acquire this company. One of their problems was how this U.K. company would look in their U.S. statutory accounts. It wasn't clear to them that they would actually consolidate using the U.K. statutory statements.

The environment in the U.K. is split between traditional and nontraditional business. It probably has developed its nontraditional business over the last twenty-five years comparing the U.S. to the U.K.; the U.K. was into nontraditional products much before the U.S. came into them.

The environment and products have been generally savings oriented because of some favorable tax advantages for life assurance companies. The traditional products over there are similar to U.S. traditional products, endowments, and whole life participating and nonparticipating. But in the participating business, the premium rates rarely change and the dividend scale (or what the U.K. calls a bonus scale) forms a major part or can form a major part of the policyholder's benefits at maturity.

The dividends are expressed as a form of paid-up addition to the face amount, and the maturity value of a twenty-five year endowment easily could be four to five times (maybe even greater) then the original face amount after writing on dividends. The dividends form a large part of the participating business. Nonparticipating business and term insurance are similar to the U.S., but the U.K. never has had the same sort of price war on term products that was seen in the U.S.

The major nontraditional product over the last twenty-five years has been what the U.K. calls unit-linked business -- variable life business in the U.S. This has really taken off since the mid-1960s and is now a major product line. In fact, practically all insurance companies (both mutuals and stocks) in the U.K. would have a variable life product of one form or another. There have been a multitude of different designs -- back-end loaded products, front-end loaded products, and many other unique ways of getting the loads out of products -- as the product has developed, but there are now various standard designs.

We also have interest-sensitive products such as single premium deferred annuities (SPDAs), and it's important on this basis that we can use market rates of interest when we look at the valuation of the interest-sensitive products.

The traditional products give a greater first-year statutory loss than the nontraditional products. The nontraditional products are designed such that the first-year statutory loss is much less than under the traditional products.

A comparison of the emergence of profits of a typical variable life product compared to that of a typical conventional product shows a large first-year loss followed by a series of reasonably increasing profits under the conventional product. Under the variable life product, a smaller first-year loss is followed by a big second-year gain and fairly small profits thereafter.

This is due mainly to the product design and the U.K. statutory valuation basis. The U.S. statutory basis may be more conservative than the U.K. statutory basis for some of the nontraditional products using GAAP. Actually, it could be more conservative once past the first couple of years because all the profits emerge on a statutory basis in the first two years on the variable life plan.

The statutory valuation environment in the U.K. is that we have two sets of accounts. Accounts prepared for the Department of Trade and Industry (DTI) -- the supervisory authorities in the U.K. -- are the DTI or statutory accounts. The sole aim of these accounts is to demonstrate solvency to the statutory authorities.

The second set of accounts is called the Companies Act Accounts. All insurance and noninsurance companies have to produce these Companies Act Accounts to show a true and fair view. However, these Companies Act Accounts are a little different for insurance companies than the statutory accounts that are produced for the DTI. There are a few minor adjustments to fixed assets, an accelerated basis of depreciation for computers, cars, and so on for the DTI statutory accounts, and one or two admitted assets.

We have no GAAP statements in the U.K. The majority of the rules and regulations for the U.K. are contained in three basic booklets that are similar to the Insurance Company Regulations prepared in 1981. We have a similar size book which contains the Insurance Companies Act of 1982, and we have a slightly larger book containing the 1983 Account and Statement Regulations, which shows how to fill in the statutory accounts.

These accounts then are monitored by the DTI with some help from the Government Actuaries Department who act as consultants to the DTI in interpretation.

The statutory reserve basis for traditional products is a net premium reserve. The maximum rate of interest allowed is a 7.2 percent interest gross, which nets down to 4.5 percent because of the peculiar tax basis on life assurance products. The mortality table generally is the A1967-70 Tables for Assured Lives -- Ultimate -- the latest U.K. mortality experience from the Institute and Faculty of Actuaries. It was prepared on lives between the period of 1967 to 1970. However, any other published table is allowed and a Zilmer adjustment, which is similar to the commissioners reserve valuation method (CRVM) in the U.S., is allowed.

Generally, participating business is valued at a rate of interest as low as 2.0 -- 2.5 percent. This is a peculiarity of the U.K. reserving basis allowing implicitly for future dividends to emerge. There is no implicit allowance in the U.K. valuation basis for future dividends. Nonparticipating business generally would be about 4.5 percent.

The valuation basis for nontraditional products like interest-sensitive products, such as SPDA policies, would be nonguaranteed; there would be no guaranteed cash values although there would be a guaranteed maturity value. The rules for valuating these would be 92.5 percent of the earned rate on matching assets as the interest basis. Assets generally are held at market value, so that's the market yield. An up-to-date mortality table will show that mortality is fairly immaterial.

On unit-linked variable products, there are essentially two components to the reserve basis. The first is the value of the separate account or the unit reserve. The unit reserve is held at market value and the unit funds often are valued on a daily basis, so there is always an up-to-date value for this particular piece of the reserve.

The second piece of the reserve values other benefits, other policyholder benefits, any maturity guarantees, and any expense reserve for inflation. This part of the reserve generally is computed on a gross premium basis and a loss of future deficits -- maintenance expenses, inflation, and so on.

However, the newer products are designed so that often this certain component is zero, because the design of the product passes all or most of the risk back to the policyholder. There are few new products issued now with any sort of maturity or expense guarantees. In the past, these were incorporated into unit-linked or variable products, and this led to more sizable second component reserves.

As a practical matter in the U.K., the appointed actuary has much flexibility in fixing his particular reserving basis for establishing possible liabilities, although this is diminishing, particularly since the U.K. joined the European Economic Community (EEC).

There are regulations for valuing assets in the U.K. Generally, assets are held at market value or less. This is a major difference in the U.K. and it also appears to be a major difference from the situation in Canada. Often companies will hold assets at the lesser of historical cost and market. The traditional companies writing participating business often may hold these assets at historical costs, and the difference between the market value and historical costs is sometimes expressed as an investment reserve.

In the U.K., the investment reserve can be up to 40 percent of the total funds or assets of the mutual company. There is an interesting paradox, dubbed the Anderson paradox, and Mr. James Anderson mentioned it when he said that most U.S. companies would be insolvent on a U.K. statutory basis, and most U.K. companies would be insolvent on a U.S. statutory basis. This has to do with the asset valuation regulations in the U.K. At a time where interest rates were extremely high, U.S. companies moving to the U.K. asset valuation basis would have been forced to realize large losses (that is, moving from an amortized book value to the market value), and hence, they technically would be insolvent on a U.K. statutory basis.

Correspondingly, U.K. companies, which are active traders in government bonds, would get very little relief by moving to an amortized book basis. They probably would have to hold more conservative statutory liabilities and hence, be insolvent on the U.S. basis. Which particular regulatory authority would win this battle?

An important principle of valuation in the U.K. is matching assets and liabilities. I am in favor of actuaries taking a leading role in matching assets and liabilities, particularly for interest-sensitive products.

If the assets and liabilities are not matched, the actuary in the U.K. has a duty to calculate a mismatching reserve. Additional reserves are held if this matching doesn't take place. Interest-sensitive products can be matched quite accurately in the U.K., because we don't have guaranteed surrender values, guaranteed cash values, or policy loans, so the actuary always can reduce the cash value basis, if he finds that his bonds at any particular time seem too low when interest rates are very high.

One other interesting item of legislation in the U.K. is the Actuaries Certificate, which is similar to the statutory statements. The actuary has to sign a statement that proper and adequate records are being kept by the company for the valuation of long-term liabilities and that long-term business assets are adequate to cover all long-term liabilities. Due account must be taken of the relationship between the nature and the term of the assets and the nature and term of the liabilities. This is effectively a matching statement.

In the disclosure of earnings by U.K. insurance companies no GAAP basis or accounts are involved in the U.K. The Companies Act Accounts (which are the accounts that are supposed to give the true and fair view) are similar to statutory DIT accounts. Essentially, we have no true and fair view, and to a certain extent, it is arbitrarily up to the company to decide what earnings are disclosed.

To illustrate, consider a fairly new U.K. subsidiary of a U.S. industrial or insurance company. The U.K. subsidiary will prepare statements on a U.S. GAAP basis for the U.S. parent, but these U.S. GAAP statements are meaningless in the U.K.; nobody looks at the earnings, they are not even distributed to shareholders if there are other shareholders in the U.K.

The U.S. parent has no real interest in U.K. statutory unless it is an insurance company which needs to consolidate to a U.K. statutory. The U.K. statutory shows that the U.S. parent may need to put in more capital and the parent may want some further explanation on why this capital is necessary. This U.K. subsidiary is caught in a position where it has reported all its important reporting statements as far as it's concerned on a U.S. GAAP basis, which has no real meaning except to the U.S. parent, and it will tend to neglect the U.K. statutory statements unless it needs to ask its parent for more capital.

The only function of the statutory statement is to show that the company is solvent and that it has sufficient capital to carry on the business. Therefore, any earnings that come out of this statutory statement are of no value to anyone in particular; nobody can make any deductions about how the company is performing or operating from this particular set of statements and the earnings that are disclosed therein.

A traditional U.K. company, which is quoted on the U.K. stock exchange, often is heavily into participating business, and equity dividends are very relevant to these quoted companies. Therefore, the statutory statement is quite relevant because it will determine the equity dividends for these companies.

The equity dividends depend upon the total surplus. In the U.K., the surplus generally is split 90%/10% -- 90 percent of the surplus gain toward policyholder dividends by way of paid-up additions, and 10 percent of the surplus going to the shareholder generally distributed as equity dividends. Some companies might be at 95%/5% proportion, and there may be certain sections of the business which go 100 percent to the shareholders.

The surplus for the year will depend upon the reserving basis chosen by the actuary plus the level of the investment reserve, that is, the difference between the market value of the assets and any other value at which they are held. As both the reserve basis and the level of the investment reserve can be adjusted to give those desired levels of surplus, the equity dividends paid over will be affected. Really the dividends or the earnings of this company are arbitrary.

These two combined examples illustrate the completely arbitrary nature of the U.K. statutory accounts and the danger of reading anything into a stream of statutory earnings because there are no rules for disclosure in the U.K.

However, one or two companies in the U.K. are waking up to the fact that the accounts show a poor picture of the progression of life insurance companies. There are two theories which are currently available. They are not statutory, but some companies are adopting these voluntarily. The theories are appraisal value accounting and cost deferral accounting.

The Royal Insurance (a major quoted insurance company in the U.K.) includes as an asset albeit a nondistributable asset in its group balance sheet -- the value of the long-term insurance business. This is a calculus value including appraisal value techniques. So it will discount all future surplus accruing to the shareholders expected to emerge for the lifetime of the policy and set this up as an asset in the group balance sheet.

One or two other companies also have followed this approach, and on year-by-year basis, feel this gives them a more sensible progression to the company's disclosed earnings and the normal statutory accounts.

Cost deferral accounting has been adopted by a number of companies. Save and Prosper Insurance (a unit-linked variable company also with the unit trust company) includes as an asset in the group accounts something that they call new business development. This new business development represents acquisition expenses and is amortized over thirty-six months. Again, this approaches a very crude form of U.S. GAAP -- there is no adjustment to the policyholder liabilities -- however, there is no legislation on this matter.

Many features that we have seen in the U.K. are common to overseas countries, particularly where FIAs, as opposed to FSAs, are involved in the insurance world, that is, Australia, South Africa, and so on. One interesting feature that is present in a number of overseas countries, which is not present in the U.K., is that companies have the compulsory direction of assets by the authorities. They have to invest a certain proportion of their assets in government bonds.

In South Africa, they are called Part 1 Asset Requirements, and 50 percent of the pensions assets have to be invested in government bonds, and 30 percent of the nonpension assets have to be invested in South African government bonds. It used to be that the yields on these government bonds were not issued on a particularly attractive rate and often companies had problems getting up to their Part 1 requirements. Asset direction can be a major problem for companies operating in certain territories.

There are no asset valuation rules in Australia. Effectively, this means that Australian insurance companies (in particular, the Australian mutuals), can store up large hidden reserves by holding assets well below any sort of market value. Australian companies have even larger hidden reserves than some of the U.K. mutuals.

The South African reserving basis has moved over the last four or five years to what they call a proper valuation basis -- a quite liberal valuation basis.

The U.K. is probably the most flexible country in Europe and maybe in the world with regard to a lot of its regulations. More rules are being made since we joined the EEC; all EEC countries have to show a minimum surplus requirement called the EEC solvency margin. Crudely, the gross solvency margin is calculated as $3.00 per $1000 of the face amount and four percent of any reserves. There are some offsets for reassurance, so the escape is for U.K. insurance companies to reduce their surplus requirements for EEC solvency margins by reassurance.

Many other EEC countries, however, have stringent valuation bases, and countries such as Germany, Sweden, and Denmark also have tariff premium rates. The basis on which you can calculate your premium rates, reserves, and how you should hold your assets are defined by law, leaving little room for any sort of maneuvering or innovation -- either in products or the creative accounting.

MR. TUOHY: This question on how a foreign subsidiary gets consolidated in the U.S. statutory accounts is important. Mr. Carroll believes that you can hold foreign statutory, although he hedged it a bit. In practice, most companies have been holding foreign statutory; I suspect in some cases this is on ground of materiality. The question is whether it is the letter of the law that one can hold foreign statutory reserves. Mr. Carroll, do you have anything on that?

MR. CARROLL: I don't think it is at all clear. It's done in certain cases and it may be a materiality consideration. There is, based on my readings in the NAIC Examiner's Handbook and the Accounting Manual, a reference to statutory type accounting, but it is couched in terms of this other basis of accounting and must be reconcilable or reasonably consistent with the aims at least of U.S. statutory accounting. Frankly, if you had to look at a U.K. company, and the state authorities would not let you use U.K. statutory, I don't know what you would do.

MR. TUOHY: You would get some nasty shocks. It would bounce around all over the place depending upon what that particular company has written. Some of the traditional business in the U.K. would have a reserve basis considerably more lenient than the 58 or 80 CSO and the relevant U.S. interest rate.

One topic worth briefly discussing is offshore subsidiaries. Mr. Steven W. Fickes can update us a little bit on that topic.

MR. STEVEN W. FICKES: The type of things that we see with offshore subsidiaries are U.S. companies going to the offshore including Bermuda, the Bahamas, and the Caymans. In the U.K., they have the Guernsey Islands and the Isle of Man, which are the equivalent to U.S. tax havens.

We first saw surplus relief, which was just the use of reserve basis differences, in Bermuda, the Bahamas, and the Caymans. Next, we saw the grandfather of life insurance to the Caribbean -- credit life. Basically, U.S. agents could set up a life insurance company offshore for a lot less money than they could domestically. They'd have another U.S. company front for them and send the business down there.

Agent-owned captives are life insurance companies allowing their agency force to participate in the profitability of their own business. Salary savings business to offshore captives is similar to an agent-owned captive; you want the producer of salary savings business (i.e., the employer) to share in that business's profitability. So they are sending salary savings business to offshore subsidiaries in part or wholly owned by the corporation who employs the salary savings business.

When you're dealing from the U.S. down to the Caribbean and Bermuda, you must avoid becoming a controlled foreign corporation (CFC) because then you get subjected to Subpart F income. Subpart F income is the income of all U.S. insurance risks-related business in the offshore captive. You will get Subpart F income if over 25 percent of the voting stock of the offshore captive is held by what is termed as U.S. shareholders, defined as any U.S. shareholder who owns more than ten percent of the voting stock of the offshore company. So you may have, say, eleven people each owning approximately nine percent of the voting stock, but for purposes of determining whether the company is a Subpart F income CFC company, none of those shareholders would be classified as a U.S. shareholder.

The lower limit is that you don't want 25 percent of the voting stock to the offshore company being held by U.S. shareholders, and the upper limit is that you are going to have to sell stock one way or another. If you get much over thirty shareholders in the company, you have to go through a public offering with the Securities and

Exchange Commission (SEC). You also have the Blue Sky Law of the SEC departments in the fifty states. Those are about the same as our national SEC, but some of them are lower. In order not to be a CFC and not to have to do a public offering your range for the number of shareholders per company would be nine to twenty-five. Most life insurance companies that set up these offshore captives for purposes of deferred compensation use the preferred stockholdings as a balancing account.

Taking the stock of a company and subdividing it into little cubbyholes makes using one company for numerous deferred compensation arrangements possible. Each of the cubbyholes, which would be owned by one agent or corporation, can be treated in essence as a totally separate insurance subsidiary. If one Class Z stock, owned by agency, goes under, those losses would be folded into the Class A through Class Y. If you have a preferred stock account, you can set up the charter for losses from any individual voting stock account to get rolled over into the preferred account before hitting the other stockholder's account.

One of the objectives is to avoid having anybody own more than 25 percent of the voting stock. This creates a problem if you get twenty-six or so trusted agents together and an insurance company puts, say, $500,000 into a preferred stock account. What's to prevent the agents from all voting the life insurance company out and subdividing the $500,000 and going off to find a new company to sponsor?

What they have created offshore is referred to as supra-majority rights. This would apply even from Canada -- probably more so. You would establish the Board of Directors and the insurance company could either take a very minor interest in the voting stock or simply get rid of all voting stock and require that before any members of the Board could be replaced, there must be unanimous consent of all other Board members, or all voting stockholders. This way you can give up your voting rights without giving up control.

In going offshore, you also run into federal excise tax problems. When the U.S. 1984 Tax Act was coming out, there was a lot of talk about federal excise tax going up to four percent on reinsurance, but that had more to do with casualty reinsurance.

In the U.S., if you reinsure a casualty risk to a foreign company, you pay one percent of premium as federal excise tax. If a foreign company directly writes a casualty risk, you have to pay four percent. So needless to say, almost all casualty business to foreign companies is reinsurance. The original talk was to raise the reinsurance rates for casualty business to four percent of premium. Life insurance always has been one percent for both direct business and reinsurance.

Going offshore causes withholding tax problems. The U.S. imposes a withholding tax of 30 percent of investment income on investments from foreign corporations in the U.S. For example, if Japanese companies purchase Chrysler bonds, Chrysler is required to withhold 30 percent of the interest payments on those to the Japanese companies. A few countries are exempt from both federal excise tax and withholding tax by tax treaties. The two most notable are the U.K. and France.

MR. DAVID R. JOHNSTON: Because I am with Crown Life, I can see we obviously have Mr. Atkins' information to worry about. We have a parent that has to comply with U.S. GAAP on occasion, and we have U.K. subsidiaries. I am an appointed actuary in the U.K. on a sort of trivial basis, so I do have a few questions.

Mr. Atkins, your comments about the CICA trying to get GAAP going in Canada. That's an important problem for us. In fact, the Interior Securities Commission was pushing us to produce different liabilities based on what it considered to be GAAP assets. When it heard us say that if a company had a different value of assets, then it would have a different value of liabilities, we almost had to follow through and produce it. I hope they can come to some conclusion about what GAAP is in Canada.

Do you think that the CICA body studying GAAP in Canada is, in fact, going to follow through and accept the statutory type of basis of accounting for assets that we have had since 1978? It's regulatory. I keep worrying that the accountants may not go for that in the end. It sounded like you were saying that they would. If you could just comment a bit further on that.

Mr. Burrows, I have two or three questions for you. You mentioned on the interest-sensitive type products, the 92.5 maximum percentage of earned rate for valuation. Is that varied at all depending upon your position of being matched or unmatched? Also, you said that U.K. actuaries, in fact, do calculate extra reserves if they are not matched. How do you do that, because that's an important question both in Canada and the U.S.? Is it on a GAAP basis? We keep talking about how you deal with an unmatched situation. I have seen several suggestions of how you should have reserves big enough to cover a 200 basis point movement, but I don't think there is any answer.

You also mentioned the appraisal method that some companies were using. Is that similar to techniques used in the U.S. for appraisals of life insurance companies? Perhaps you are in a position to comment on differences between U.K. and U.S. in those processes.

MR. ATKINS: One of the problems, which you have identified Mr. Johnston, in any large profession like the accounting profession, is that not all of us deal with life insurance companies, and we have people dealing with mining companies, manufacturing companies, retail stores, and so on. The task of formulating these accounting principles for life insurance companies has being charged to what is called a "Central Section" (a geographic term which would include mainly Ontario where the bulk of the population is) of the order of the Accounting Standards Committee of the CICA. That section is headed up by an executive from Imperial Oil.

The first problem is that he is diligently seeking views from accountants and actuaries involved in the life assurance industry. He is aware of the magnitude of his task. He deals (along with me) directly with the Superintendent of Insurance as a member of a CICA liaison group with the Federal Department of Insurance.

I probably have been in the insurance industry too long to not be affected deeply by it and its views. I suspect with regard to investments, that, yes, there will be some measure of recognition of unrealized gains and losses; however, in the research study on portfolio investments, there was a minority report issued adhering to the cost basis. So even though there is opposition with regard to liabilities and assets, there will be a trend to grossing up. I think there will be a trend to count real estate as showing less incumbencies. There is not a strong move to show that growth. The lender has a covenant not only on the security of the real estate but also on the enterprise itself.

Unfortunately, the time value of the money concept, because it's only in research study form, may get enshrined in our handbook in the next five or six years. That presents a problem for the people dealing with life insurance accounting, so the discounting of deferred taxes will derive from the U.S. ultimately. Even though we are looking at it very closely, I think the Americans will be there first with discounting preferred taxes.

With regard to assets, I think there will be some recognition on the liabilities side. I'm not that hopeful about the discounting of preferred taxes.

MR. BURROWS: With regard to the interest-sensitive products and the 92.5 percent, I don't believe that this varies according to whether the company is matched or unmatched. They have to value the assets in accordance with the asset valuation regulations, then, from that, calculate the yield. From that, they reduce the yield by 7.5 percent.

In the interim period between these regulations being introduced and certain of these interest-sensitive products running off the books, there may have been some special dispensations granted, but I'm not aware of anyone overall being allowed to reduce the yield by anything less than 7.5 percent.

On the question of matching and mismatching reserves, we tend to look at laid-down rules. We would look at a projection of the asset proceeds and a projection of the liability outgo. The difference between these two is discounting the outer range of interest rates just to give you an idea of the exposure. The U.K. actuary then has flexibility to set up a reserve that he considers adequate. What extreme views he might have on the direction interest rates might take is a question for the actuary to justify within territorial bounds and to set up then a mismatch reserve on that basis. There isn't, to my knowledge, a defined interest rate differential.

Using a defined interest rate differential is not common because actuaries will insist that they are reasonably well matched, particularly for interest-sensitive products. The U.K. actuary will use the fact that he can set up substantial reserves if necessary as a deterrent from the company going mismatched.

MR. TUOHY: I agree with Mr. Burrows. Basically, the appraisers will look at the company's net worth, value of in-force business, and value of future business. When valuing the in-force business, the approach would be similar to appraisals done in the U.S. Some of the values that are used specifically do not include anything for future business, and sometimes they do. It depends on what particular rules are being used.