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CURRENT TOPICS IN FINANCIAL REPORTING

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Recorder: KEITH F. DEVINEY

- o Financial Reporting in Canada and the United States
- o Financial Accounting Standards Board (FASB) update -- accounting for annuities and universal life
- o National Association of Insurance Commissioner (NAIC) update -- annual statement changes for 1986
- o The role of the Valuation Actuary in the United States

MR. DAVID R. JOHNSTON: I have been asked to talk about what's happening in financial reporting in Canada as background. I would like to do so with an overview perspective and with an emphasis on the impact on the valuation actuary. The valuation actuary is one concept where Canada may be ahead of the United States. For nearly 10 years, we have abandoned the old, conservative statutory reporting and forced valuation actuaries to make some decisions and give opinions about actuarial liabilities. However, the concept is probably ahead of the reality, as a number of problems have surfaced. So consideration of financial reporting in Canada may be useful as the valuation actuary idea takes hold.

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There are perhaps three main streams of activity currently in financial reporting in Canada. These are income reporting, solvency reporting, and relations between auditors and actuaries. Since there are so many things going on, I will stick to the first two areas.

In Regard to Income Reporting

To get a clear picture of what's happening today in Canada, it is necessary to review developments over the last few years.

1978 Statutory Changes

The current state of financial reporting has evolved since 1978 when the legislation was dramatically changed. There were many innovations in that legislation, but a few of the important ones were:

1. Amortization of gains and losses on bonds, mortgages and stocks was required, rather than reporting the full gain or loss when realized. This spreading of gains and losses is an important difference from statutory or GAAP accounting in the U.S. It divorces investment considerations from accounting considerations.

2. Actuarial reserves were required to be the same in statutory and shareholder statements, so in effect, one form of accounting was forced.

3. Valuation assumptions had to be appropriate for the policies and the company's circumstances at the time of valuation and hence reflect the company's current experience. This non-locking-in represented an important difference from U.S. GAAP.

4. Acquisition expenses, up to a limit of 1 1/2 times the valuation premium, were deferred and amortized as a negative element of the actuarial liability, rather than as an asset.

5. The valuation actuary had to be appointed by the board and was required to give a report on the liabilities annually.

6. The liabilities were to contain a provision for adverse deviations, but to provide additional conservatism for solvency purposes, appropriations of surplus (primarily directed at investment risks and lapse risks) were required in prescribed form.

CICA/CIA Task Force

Once the legislation was in place, a joint task force of accountants and actuaries was formed to determine what should constitute GAAP for life insurance in Canada and whether further statutory changes were needed. This was needed because currently life insurance is exempted from GAAP in Canada.

Among the major recommendations in the 1982 report of this task force were:

1. The statutory method of accounting for investments, with a few minor changes, should be adopted as GAAP in Canada.

2. The statutory method of valuing liabilities should be adopted as GAAP. Any changes in assumptions, which could be either stronger or weaker, would affect current or future income.

3. There were also recommendations for tax allocation methods involving discounting, and for foreign currency translation involving the amortization of gains and losses.

In reacting to this 1982 report, the Institute of Actuaries produced a detailed response in 1984; the Institute of Chartered Accountants is still working on it but has just this year produced an exposure draft of principles.

CIA Response

A few of the more significant responses of the Institute of Actuaries were:

1. Liabilities appropriate for income reporting do not contain enough provision for adverse deviations to also serve as a suitable test for

solvency, so additional margins should be contained in surplus appropriations which the valuation actuary should determine separately from liabilities.

2. Matching of costs and revenues would be best achieved by recognizing in the actuarial valuation all future benefits and expenses and the full amount of future policy premiums, i.e., the policy premium would be used instead of a net valuation premium. This would be a major change. One implication is that any conservatism in the pricing in excess of what is deemed appropriate for valuation would be front-ended as profit at time of sale.

3. Any changes in assumptions, which may occur frequently, would impact income for the year.

CICA Response

The Institute of Chartered Accountants will not conclude its deliberations for another year or two so its final position is still very unclear, but early indications are that it may:

1. Agree with the principle of amortization of gains and losses on investments.

2. Agree with the policy premium method of valuation of liabilities.

3. Have trouble with the concept of discounting for deferred taxes and with the joint task force proposal for foreign currency.

Department of Insurance and CLHIA

While these broad discussions have been going on, the Federal Department of Insurance and the Canadian Life and Health Insurance Association have been active in financial reporting, too, in some fairly specific ways:

1. In 1984, they agreed to require that realized and unrealized gains and losses on stocks should be amortized into income at 15% of the declining balance, instead of the 7% adopted in 1978.

2. Just this spring they agreed (perhaps subject to further discussions with other interested parties) to require that realized and unrealized gains and losses on real estate be amortized into income in the same way as stocks, although initially at a lower rate.

In addition, the Department of Insurance pointed out last year what it felt were problems in assumptions being set for certain policies such as renewable term, lapse supported products, reinsurance and adjustable products. This paralleled a general concern being expressed that recommendations for financial reporting were not being followed consistently by valuation actuaries. As a result, the financial reporting committee of the CIA has reacted with a new type of assistance to the valuation actuary, called "technique papers" which are quite detailed and can be very specific. So far technique papers have been developed or are being developed on these four products and others are planned. In addition, the financial reporting committee has set up a subcommittee to study the problem of provision for adverse deviations. The institute has never provided adequate guidance on the provision for adverse deviations, with the result that practices vary considerably.

Taking all these positions into account, it appears to me that GAAP may finally come to Canadian life insurance by the end of 1988, and I think it may have the following general characteristics:

1. There is continuation of the accounting for investments that began in 1978, but which has recently been updated for stocks and real estate.

2. Valuation of liabilities is used for the purpose of income reporting using:

   - A policy premium method,

- Assumptions which are not far from U.S. GAAP in the degree of provision for adverse deviations, and

- Assumptions which can change frequently.

3. There will be more specific guidance given to the valuation actuary in problem areas, to reduce the lack of comparability.

4. There will be accounting for deferred taxes, probably with discounting.

5. There will be accounting for foreign currency translation, probably with some form of amortization of gains and losses.

It is presumed that legislation will be changed to permit the same statutory accounting, but this is also an issue.

The other matter I wanted to talk about was solvency reporting. In the last couple of years, there has developed in Canada a sharp focus on reporting the solvency position of companies. In part, this has come from concerns that liabilities which have been calculated for income reporting do not give enough protection from a solvency perspective. In part, the failure of several banks and trust companies has raised the obvious questions about insurance company surplus.

Activity in the area of solvency has come on three fronts:

Industry Formula for Minimum Capital and Surplus

In 1984, the Department of Insurance asked Dr. Allan Brender of the University of Waterloo to study the question of required capital and surplus for life insurance companies. Dr. Brender produced a report, including a formula to define minimum continuing capital and surplus requirements.

During 1985 and 1986, as part of the development of a guarantee fund for insurance companies, the CLHIA used Dr. Brender's formula as a starting point

and has refined it to the point where the CLHIA is hoping to put it into use by year end as a testing mechanism for the fund.

It is not yet clear when or whether this process will be put into place, or whether the Department of Insurance will adopt this particular formula for its purposes, but in any event the development of this test formula has been a considerable achievement.

Role of the Valuation Actuary

Another development occurred when a special committee was asked in 1985 to consider whether the Institute of Actuaries should seek a broadened role for the valuation actuary.

The committee concluded that the role of the valuation actuary should be broadened in three general ways:

1. His opinion should encompass the ability of the company to meet its future obligations with respect to both existing and anticipated future new business.

2. His monitoring of the financial situation of the company should be re-defined as continuous and ongoing.

3. He should report to the board as often as necessary and at least annually.

In commenting on these conclusions, the committee noted the example of the appointed actuary in the U.K as a good model. A critical path for implementing the specifics of the recommendations has been laid out, reaching to 1988. It appears from CLHIA discussions that the industry generally is prepared to accept the broadened role, as least, in principle.

Committee on Solvency Standards

Bringing these two solvency developments somewhat together has been the creation of a new CIA committee on solvency standards.

This committee, which I chair, has been charged with studying the actuarial aspects of solvency testing and developing recommendations for the actuary practicing in this area.

We feel we have been given a very big challenge, one that will not be solved in a hurry.

We feel a formula approach to a solvency position may be a practical approach for an industry fund, but that it cannot be an appropriate way to determine any given company's position, so we want to develop the methodology to apply to any situation and to provide education for valuation actuaries.

We see a number of issues such as the relationship of solvency reserves to income reporting liabilities: how much future business should be considered? What sort of public opinion on solvency from the valuation actuary is feasible?

We think the work of our committee will put into place many of the specific recommendations of the report on the role of the valuation actuary. We also think if we are successful, the standards we develop can either replace in due course the CLHIA formula, or can be combined with it to permit reflection of individual companies' situations.

If we can produce solvency standards by 1988, we will be more than pleased.

MR. WILLIAM D. WARD: I am going to talk to you about the developments with respect to the NAIC, and I will divide my talk into four principal subjects:

1. The NAIC's data capture project and its ramifications upon all of us.

2. The most significant changes that will be occurring in this year's annual statement.

3. Some changes of some lesser significance.

4. What the future holds for us.

If you have not made preparations for the completion of the 1986 statement, it may be too late.

In future years, the year 1986 may be remembered as a historic milestone in the evolution of the annual statement format, the process for completing and filing of the annual statement, and its utilization by regulatory bodies. Let us see why I made that assertion.

The NAIC's data capture project is the most important project that the NAIC has undertaken with respect to financial reporting in several years. The considerable ramifications of this project upon the annual statement will be seen in this year's change of format and in the preparation of the annual filings. The NAIC undertook this project in order to reduce the time between the filing of information and its being accessed by the departments. Currently, the NAIC experiences upwards to nine months' time between the time of the completion of the accounting period and the time that the data in the annual statement can be used by regulatory authorities. To reduce this time and to achieve its goals, the NAIC has divided this data capture project into three phases.

The first phase is to complete the development of the specifications for diskette preparation and data to be captured by June 1986. In addition, it is requesting that those life insurers, which entered 1985 annual statement data on diskettes, voluntarily provide copies to the NAIC's data capture study group.

The second phase is to implement the demonstration project in 1987, using the 1986 annual statement data. At the end of this year, the NAIC is going to require essentially all companies currently filing with that office to file on diskette. New Jersey is going to require all of its licensed companies to file also with the NAIC, and the New York and Texas departments are going to require all licensed companies in their jurisdictions to file diskettes using countrywide annual statement information with them. In other words, we are not going to be required to provide New York with New York basis information for those companies which are foreign, and similarly for Texas.

As a part of this project, the New York department is engaged in undertaking an extensive review of its own annual statement requirements. I think we may expect that the New York Department will follow the NAIC model more closely, with perhaps supplemental requirements. Furthermore, in the second phase, there will be a further refinement of specification statement format. In phase three, to begin in 1987, there will be a further modification affecting requirements as necessary, and the NAIC hopes to implement the same process for all of the remaining blanks; that is, the HMOs, the titles, and so forth.

For this demonstration project, insurers are going to be required to provide the following information from their annual statements on diskettes: the first seventeen pages, totals from the invested assets schedules, the state pages, and schedules H, O and S. Probably in 1988, we may expect to see considerably more detail. This detail will be required to be edited and cross-checked prior to its submission. An extensive list of cross references has already been provided. An affidavit will have to be completed to ensure that you have performed specified cross-checks and notified the departments of any defaults in these cross-checks.

As you are all aware, the annual statement is an important foundation for our tax reporting, our shareholder reporting, our policyholder reporting, and, of course, our internal reporting. The reformatting that is also a part of this data capture project may significantly impact the preparation of these other reports due to an extensive need for reclassification and reconciliation. The reformatting is going to be accomplished largely through the elimination of the flexibility to disclose separately items that cannot or should not be included within printed captions in the annual statement. The regulators believe that the write-ins, which the regulators think result from immaterial and unusual transactions, are capable of classification within preprinted lines. They are going to require us to delete all of such write-ins, in favor of including them in the footnotes of the annual statements. They hope eventually to go back and review the detail and, presumably, will establish preprinted lines for material items.

As an incidental part of this reformatting project, they will also require that separate lines of business be established on pages 5, 6 and numerous other

exhibits to provide disclosure information on ordinary variable life products, group variable life products, as well as an aggregate of all additional products such as group legal, aviation, and reinsurance.

Now let me turn from the brief review of the reformatting of the data recapture project to the very significant changes in the 1986 annual statement. First on my list is the accounting for deposit annuities. This is a culmination of a couple of years' effort by a study group which was looking at dovetailing the auditing requirements for guaranty fund assessments and at providing an illustration of the potential exposure for interest sensitive products. Accordingly, the instructions for page 4 line 1A, the deposit line, have been amended to provide that deposits be reported gross of surrender and withdrawals. In addition, the surrenders line will no longer have the exclusion for annuity surrenders and withdrawals and a new line 17A on page 4 has been added to provide for reporting the change in deposit fund liabilities. This is now going to be separately reported on lines 10.1, 10.2 and 10.3 on page 3. The separation will allow the distinction to be made between the GIC liabilities, deferred liabilities and other deposit fund liabilities.

Another significant change that will be seen this year is in schedule M. Those stock insurers which also write participating business are going to be required to provide the supplement on dividend determination and also to provide a separate actuarial opinion.

There is a third item which is perhaps of some interest to the students in our midst. At this point, the salary schedule G has been recommended for deletion. However, I expect that in June, unfortunately, it may very well be added back to the annual statement. However, New York will continue to have its legal requirement for a schedule G. However, we are hopeful that the legislature will favorably report out an increase in the salary limit to $100,000.

Among less significant changes to the annual statement, for those companies which participate in administrative services only, are health insurance contracts. There will be several additional requirements throughout the statement. I think the most noteworthy item within that category is the new

requirement in the notes that the gain or loss for uninsured and the uninsured portion of partially insured ASO plans be disclosed.

Another change I want to call to your attention lies within the reinsurance schedule. We are now going to be required to develop the IBNR for all unauthorized reinsurance and to display that amount within the reinsurance schedules and, therefore, to develop the unauthorized credit.

I might add that we also have received some relief for those of you who are the contact person in your company. The regulators have finally remedied the problem that many of us face when people perceive the contact person to be the complaint person, the person one writes to receive information for his high school senior class paper, and so forth. These people will now be responsible only for those questions regarding the annual statement process.

Further, there is a new bond quality schedule that has been added so that we must now display our securities by quality rating and by duration within schedule D.

Two additional notes have been added. One relates to interest rate swaps. This new note will require a description of any interest rate swap programs, its business purposes and the company's accounting practices. In addition, insurers are going to be required to quantify the amount at risk if all contracts in the loss position are replaced at current market rates. An additional note has been added to supplement information in the interrogatories relating to asset transfers with put options, particularly those programs which relate to financing asset transfers.

What lies on the horizon? First, let me talk about some of the invested assets and valuation changes that may very well occur as soon as June 1986. For those of you who have a significant amount of subsidiary assets on your balance sheet, I would alert you to the fact that there has been, and probably will be, a curtailment of the use of unaudited statements for affiliate valuation. The NAIC securities valuation office will no longer accept self-certified financial statements for any material subsidiaries' holdings. Beginning with 1986, such filings, we expect, must be supported with independently audited financials.

Omission of the audit opinion may very well result in non-admission. Furthermore, there is a possibility, perhaps a little less likely, with respect to assets included in other invested assets, that we may also have to provide audited financials for those invested assets.

A significant change to the quarterly annual statements has been proposed and will be considered in the NAIC June 1986 blanks meeting. If this is adopted, it will affect 1987 quarterly reporting. This proposal will not only incorporate additional and new disclosures, and interrogatory disclosures, it also will require us to provide gain from operations similar to that which is found on page 5, line 31. It will also require us to separate on the balance sheet the affiliated information, as if we were combining two separate entities. And lastly, it has been proposed that pages 5 and 6 in the life annual statement be separated into their direct, assumed and ceded components. Thus we may very well find that page 5, by the end of 1986, is not only expanded in depth, breath, but also in width. The considerable effort that will be needed to make this come to pass, I hesitate to contemplate.

MR. JAMES B. MILHOLLAND: The first topic I want to speak about is accounting for income taxes. FASB is proposing new rules for deferred income taxes. Under present rules, the objective is to match tax effects of timing differences and related revenues and expenses in the same financial reporting period. The emphasis is on the income statement. The deferred tax liability is the credit balance resulting from the net charges to income which arises from calculating the tax expense as if book income were taxable income. In the calculation, permanent differences are excluded from income. Under the proposed rules, the emphasis will be on the balance sheet.

The deferred tax is the company's effective tax rate multiplied by the cumulative timing differences, based on when and how they are expected to effect the tax return. The intent is to hold the amount of tax which will be payable when timing differences reverse. Indefinite reversals will not be excluded from the calculations.

Now cumulative timing differences for life insurance companies mean, primarily, the difference between tax reserves and benefit reserves for deferred

acquisition costs. One of the serious consequences of the proposal to life insurance companies would be the requirement to approve a liability for 46% of the policyholder surplus account. This part of the proposal is still being carefully reviewed and considered and may not survive intact.

Financial statement presentations and disclosures generally will not change. The new rules are planned to be effective for fiscal years beginning after June 14, 1987 -- in other words, for most of you, for 1988. If you have not already done so, you should estimate the effect of the proposal on your balance sheet and provide your comments to FASB. That was a greatly simplified condensation of the proposal.

The second topic is deferral of loan fee income. FASB has released an exposure draft on accounting for loan origination fees. Beginning in 1987, companies will be required to defer loan origination fees and recognize the income as an increase in the yield of the asset over the contractual life of the loan. Under current accounting rules, only the excess of fees over loan acquisition costs is deferred. The revised rule would allow only incremental expenses, which are mainly out-of-pocket, to offset fees. The result will be a significant flow of income for many financial institutions. Naturally for your insurance company, it will depend largely on the extent of your loan activity.

The next topic is HMOs. The AICPA health maintenance organization task force has prepared a draft issues paper regarding accounting for HMOs. The draft report has four advisory conclusions. The first is that HMOs should accrue health costs as they are rendered. This would include an expense for costs incurred but not reported, but would exclude any liability for future services on continuing clients, except for terminating cases. The second advisory conclusion is that loss recognition should be required when future health care and maintenance costs are expected to exceed revenues. The third is that reinsurance premiums should be reported as a health care cost, and reinsurance recovery should be reported as revenue.

The fourth is that acquisition cost should be expensed as incurred. The Task Force has decided that insurance accounting should not apply to HMOs, but has favored accounting more familiar to health care entities. This may pose some

problems for actuaries who are asked to certify claims liabilities for statutory purposes, if they believe the liability based on costs as rendered does not make good and sufficient provision for nonmatured obligations. It may result in statutory and GAAP liabilities being different from each other. In a similar release, the ACLI Health Care Subcommittee has developed a draft issues paper regarding accounting for continuing care retirement communities or CCRCs. This paper has three advisory conclusions. The first is that refundable fees should be recorded as a liability and transferred to a deferred revenue account when the contingency making them refundable is removed. Advance pay is the second conclusion. Advance pays should be deferred and amortized by a systematic, sound, actuarial method; and third, a liability should be reported, if the deferred revenue is not greater than the amount of the present value of future benefits in excess of the present value of the future of period phase; in other words, if the deferred revenue is not greater than an actuarially determined minimum liability. From an insurance accounting perspective, the proposals are what would be expected, but they may significantly affect many CCRCs when they are adopted.

The AICPA has a task force considering the broad issue of discounting. Discounting will affect property/casualty companies more than life companies, because it may result in the discounting of loss reserves. The task force is expected to produce an issues paper in the fall. Early indications suggest an inclination to agree with the concept of discounting, though practical problems may prevail and discounting may not be implemented, at least in specific instances. Practical problems would include the SEC's position that loss reserves should not be discounted, unless allowed by insurance regulators. At this point we will have to wait and see what is proposed.

The final topic is that the FASB is considering a project to address accounting for financial assets. Financial assets is a broad generic term which includes the ordinary kinds of financial assets, such as stocks, bonds and CDs, as well as less common assets such as repurchase agreements and interest rate futures. The SEC has expressed to the FASB concerns about the adequacy of the historical cost standard, which is the current standard. The increasing variety and complexity of financial transactions is creating problems of measurement and income recognition, and the project would include, for example, consideration

of a requirement to carry all readily marketable financial assets at market value, regardless of management's intent to hold them to maturity. If such a proposal is adopted, it would have far reaching implications for insurance companies. Many people consider that such a project would be the FASB's most ambitious project to date, and it is safe to assume that the timetable for the project would be a very long one.

MR. WAYNE S. UPTON, JR.: I am a project manager at the Financial Accounting Standards Board and am currently assigned to the Board's project addressing insurance accounting issues. Bill has asked me to give you a brief summary of the FASB's current project on insurance accounting issues. I am sure that you recognize that this issue could take all day, at least. I will try to give you an overview of the project and our work to date.

Having introduced myself as a member of the FASB staff, I should also point out that I am neither an agent of an evil empire that is out to derogate actuaries or the platoon leader in a turf battle. Those of you who have read, "Lauver Derogates Actuarial Role," in the March 1986 issue of *The Actuarial Update*, will recognize what I am speaking about. I hope that all of you will have an opportunity to read both the March issue and FASB chairman Donald Kirk's response.

While Bill did not invite me to discuss perceptions of conflict between our two professions, it is important that we at least touch on the assertions made in Mr. Friend's article. Actuaries were involved with the FASB in the Board's work on pensions. Indeed, the recent implementation meeting on pension accounting was very much a joint effort between the FASB, AAA, and other groups. Actuaries will also be involved as the Board addresses life insurance accounting issues.

Two points need to be made regarding the speech by Board member Ray Lauver and Mr. Friend's response to it. First, it's safe to say that Mr. Lauver's remarks were taken out of context -- terribly so -- by the reporter covering the story. If anything, Mr. Lauver's comments chided accountants, not actuaries. His remarks ran to the clearly articulated responsibilities of corporate accountants and independent auditors. Second, the Board does not intend to preempt the responsibilities of actuaries. The accountant's and

auditor's responsibility for financial reporting is clear under the securities laws. Responsibility for other aspects of pension administration is, and will remain, with sponsors, actuaries, lawyers, and others.

The Board is not motivated by a desire to promote -- or diminish -- the responsibilities of any professions, whether they be actuaries, corporate accountants, independent auditors, or others. The FASB is an independent standard-setting organization with no more allegiance to any one of our diverse constituent groups than any other.

What we all need to recognize, accountants and actuaries alike, is that the objectives of what we do are sometimes different. The FASB is charged with the development of standards for external financial reporting. None of us should be surprised if, from time to time, answers and approaches designed to meet the needs of users of general purpose financial reporting might differ from those developed for other purposes.

The actuarial profession is by no means unique in this situation. The Board's standards for disclosure of oil and gas information are not necessarily what a petroleum engineer would use for valuation or decision making. Oil and gas disclosures rely heavily on the work of professional engineers. Pension and life insurance accounting will continue to rely heavily on the work of professional actuaries.

The FASB project on insurance issues came to the Board in 1984 with the AICPA paper titled "Accounting by Stock Life Insurance Companies for Annuities, Universal Life Insurance, and Related Products and Accounting for Nonguaranteed-Premium Contracts," a formidable title if ever there was one. Many of the questions raised by the issues paper were recognized, however, when the FASB extracted existing accounting guidance into FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, in 1982.

The FASB added a project to address these issues in its agenda in February of 1985. Immediately after that decision, the staff moved to form a broadly based advisory group from industry, the actuarial profession, and the public accounting profession. Our advisory group members were chosen, to an extent,

with malice aforethought. We intentionally chose individuals who held widely differing views on the accounting for universal life and related products.

The FASB staff met with the advisory group in May of 1985. This meeting was followed by educational presentations to the Board in June conducted by the Insurance Companies Committee of the AICPA and by members of the advisory group.

The Board and staff met to discuss preliminary staff views and identify areas that needed more work in October. Effort began in earnest in January of 1986. Indeed, our two new Board members were faced with insurance accounting as the first issue at their first Board meeting. Educational Board meetings regarding the existing accounting model for long-duration contracts and the issues raised by universal life-type products lasted through the end of March.

I would like to review with you the tentative decisions that the Board has reached to date. In doing so, I must warn you that tentative decisions are just that -- tentative. The positions of individual Board members can and do sometimes change between the early development of a project and the preparation of Exposure Drafts and FASB Statements.

The Board's first tentative conclusion regards the scope of the project. The Board has tentatively concluded that the existing accounting model for what might be called traditional life contracts should not be reconsidered at this time. Traditional contracts include those with terms that are both fixed and guaranteed, and with premiums that are collected over substantially the same period that benefits are provided.

No one should mistake the importance of this first conclusion. Many commentators have suggested flaws in the existing accounting model. By deciding to leave that model alone, the Board members did not necessarily reject such views. Instead, the project will be narrowly focused on the particular problems presented by the new generation of insurance products.

At the same time it agreed not to reopen the accounting for traditional products, the Board tentatively rejected the composite method suggested by the

AICPA and AAA issues papers. Board members have tentatively concluded that approaches that would allow income to emerge as a residual percentage of premiums received are not appropriate for universal life and related products.

The recognition of income based on a cash flow stream is not unique to insurance accounting. There are similar approaches used in accounting for other transactions; for example, installment sales and certain types of leasing transactions. Such approaches seem to produce an acceptable (though not always the best) accounting result when relationships between contracting parties are fixed. When contract terms are not fixed and instead one or another party can exercise some measure of discretion, these accounting approaches begin to break down.

In rejecting the composite method, Board members pointed to the significant discretion that many new contracts grant to insurance companies and policyholders. Several Board members also expressed a desire for a measure of the liability for future policyholder benefits that is more consistent with the definition of a liability found in FASB Concepts Statement No. 6, *Elements of Financial Statements.*

The Board next defined the scope of products for which the accounting should be different from that in FASB Statement 60. Board members tentatively accepted the staff recommendation that the focus of a separation should be the contractual relationship between insurer and policyholder. With that in mind, the Board tentatively concluded that the project should address policies that grant discretion to either party.

This notion of discretion is different from the concepts of flexibility and nonguaranteed benefits that some others have suggested. In the Board's view, a flexible product with an interest rate tied to an external index does not alter the contractual relationships between parties. It is only when one or the other party to the contract has the discretion to alter some part of the agreement that the relationships have changed.

The Board has tentatively accepted the retrospective deposit approach for contracts that meet the criteria I just described. In doing so, however, the

Board has also tentatively concluded that the contract value is a minimum measure of the liability for future policyholder benefits. When evidence indicates that the terms of the policy will lead to a liability that is greater than the balance of contract value, then some additional amount of liability would need to be recorded.

The Board's tentative conclusions on the retrospective method and the need for some additional measure of liability recognize an observation made by supporters and opponents of this method alike. The retrospective method can be "form-driven" and might, in some instances, lead to a liability that does not represent the probable future sacrifices to which the company is committed.

On Wednesday May 28, 1986, the Board and staff will meet again to discuss the amortization of deferred policy acquisition costs, or DPAC. I believe that the Board members and staff recognize that, by following the retrospective method, we have decoupled the measurement of DPAC from the measure of liability. Having done so, we are obviously left with the need to develop a means to amortize the DPAC balance.

I have long since given up predicting how the Board might respond to this or any question. That is a measure of my inability to "crystal ball" rather than a reflection on the Board. I would point out, however, that the amortization of costs incurred in relation to service-type and financial contracts has been a difficult problem for accountants. Amortization of DPAC promises to be difficult as well.

The decisions I have described are obviously only part of the issues that need to be addressed by this type of a project, and three other significant issues come to mind that the Board has yet to address. Having discussed the notion of a Universal Life or a discretionary type of a policy, the Board has also recognized the need to address limited-pay policies that are otherwise guaranteed; for example, the settlement annuity, the old fashioned single premium whole life, many of these kinds of policies. In addition, the issue of internal replacement transactions that was addressed in the AICPA issues paper will be addressed. Finally, the Board will need to discuss transition methods for those companies that are not following the proposed method to move to the new

method. Our timing indicated that we would release an exposure draft of accounting standards on this issue late in the third quarter of 1986. Based on our process to date, I would suggest that late in the third quarter ought to be defined as September, and that, in fact, it will be much closer to the fourth quarter before we get something done.

In wrapping up, I'd like to just touch on one point that Mr. Milholland made, just to avoid confusion and talk briefly about the Board's due process procedures, specifically regarding the Board's income tax project. The work that is being done today on that project is designed to lead to an exposure draft of the standard, not to a final standard and because this area is of critical concern to the insurance industry, when that exposure draft is released, I would suggest that all of your companies get it, study it and respond to it. The Board does listen to the comments received from its constituents; that is what exposure drafts and due process are designed for. So the standard on income taxes is by no means final at this point, and when that exposure draft is released, we hope late in June 1986, again I would strongly suggest that you pursue it.

MR. WILLIAM J. SCHREINER: I'd like to bring you up-to-date on a few items regarding the valuation actuary in the United States. The ACLI's Board of Directors appointed a Task Force several months ago to study the issue of the valuation actuary. At this point there is agreement among the Task Force on the basic form of the recommendations to the Board. I will describe those recommendations, but I would like to add the caveat that this has not been finalized yet, and the ACLI Board will not receive the report until its September 1986 meeting. Of course, what the Board chooses to do with that report is unknown at this time.

The draft recommends that the ACLI generally should support the strengthening of the role of the valuation actuary by the profession and through regulatory requirements to the extent that such strengthening does not infringe on proper management prerogatives or generate costs that are out of line with potential benefits. Secondly, the ACLI should support regulatory requirements that would require a life insurance company board of directors either to appoint or to designate someone to appoint a qualified actuary who is an employee of the

company or someone hired by the company to perform the duties of the valuation actuary. Third, the ACLI should support regulatory requirements that the valuation actuary make a public statement of actuarial opinion as to the adequacy of the reserves of a life insurance company. Fourth, it should oppose, however, any regulatory requirements that the valuation actuary report on the adequacy of surplus. Fifth, the ACLI should not oppose any reasonable regulatory requirements for the valuation actuary to test a minimum number of specified possible future scenarios in developing a statement of actuarial opinion on the adequacy of life insurance company reserves.

The Task Force's recommendation is based on the following conditions: first, that the regulatory authorities would be no more involved in the overseeing of company surplus levels than they are at the present time; second, there should be appropriate exemptions from extensive testing requirements for products with a volume of business or a nature of risk that indicates that such testing is not warranted; third, the development and imposition of standards of practice for determining the methodology and techniques used in developing an actuarial opinion should be developed by the profession.

Also on the valuation actuary scene, the NAIC considered a proposal at its March 1986 meeting to add to the annual statement requirements with respect to a report to management by a valuation actuary. The NAIC Blanks Task Force, which is responsible for annual statement changes, chose not to add that requirement to the annual statement. The fundamental reason why it chose not to do so was that, of the eight requirements in the proposal, the first two were already required in the actuarial opinion in the annual statement and the following six addressed an actuary's report to management, which the NAIC Blanks Task Force felt was outside of its jurisdiction since its interest is solely in the public annual statement. In place of that, an actuarial guideline, No. 14, was developed, which contained the essence of that proposal, and was adopted by the actuarial task force. The guideline provides suggestions to regulators on situations in which they might wish to ask for an actuarial opinion or require an actuarial report on the condition of a company; this proposed actuarial guideline will be considered by the higher levels of the NAIC in June 1986. There presumably would be little opposition either within the NAIC or outside of it to the adoption of the proposed actuarial guideline.

For the first time, the Conference of Actuaries in Public Practice has scheduled a number of sessions on the valuation actuary at its annual meeting, September 1986. In the Society of Actuaries, the Committee on Valuation Principles has been active. I am sure all of you received a draft of its proposed valuation principles, which requests comments by interested parties. I believe July 1, 1986, is the deadline. In addition, that committee is also working on developing a valuation handbook to assist the valuation actuary.

MR. DANIEL J. KUNESH: I have a comment that's directed to Mr. Upton. I think I speak not only for myself and a number of people in this room, but probably for many actuaries. I am a bit upset and concerned about the direction that FASB has taken on the current proposals for Universal Life and similar products. I am not going to go over a number of things that disturb me. I will do so in a follow-up letter as an individual to you, and I would encourage members of the Society to also take the time to write their comments to you and to your committee. I would like to submit that the proposals that you have are not going to achieve what you want to do. First, I think they are going to create an erratic earnings pattern. I think you will find that as you study earnings patterns more that the results do not really represent the economics of the contracts and it's probably inappropriate. Second, I believe that you are not going to gain the degree of consistency between various insurance companies that you desire. I think you will find that by looking at various contract designs and various combinations of assumptions. Third, I think probably the worst thing is that your accounting model is going to drive the design of products, and it's like having the cart pull the horse. Fourth, a corollary of that is, if you drive the design of products, you are going to impair the competitiveness of the industry as a whole. I just want to throw out one example. I really don't understand the basis of coming from a liability that's based on the contract value. First of all, contract value has different meaning to different contracts. What is contract value? If you die, the value of the contract is the face amount. If you surrender, the value of the contract is a predetermined amount which starts with an accumulation maybe of a premium less some charges, minus a surrender charge. There are scenarios where I've seen contracts where the contract values are defined differently, so I don't know what the basis is of defining contract value as the basis of liability.