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CURRENT TOPICS--FINANCIAL REPORTING

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Panelists: CAROLYN J. GOODALE*
DONALD M. KEITH
PAUL F. KOLKMAN
Recorder: ALAN H. TREECE

- *Financial Reporting Section meeting*
- National Association of Insurance Commissioners (NAIC) activities
- Financial reporting environment in Canada
- Standards for valuation actuaries
- Financial Accounting Standards Board (FASB) activities with respect to accounting for universal life and annuities

MR. WILLIAM J. SCHREINER: I will start with a report on the Financial Reporting Section activities of the past year. First, I have the results of the annual election of Section Council members: Stephen L. Smith was elected to complete an unexpired one-year term; Arnold Dicke, Richard S. Miller, and Robert W. Stein were elected to three-year terms.

On October 13, 1985, the Section Council met and elected officers for the coming year:

Chairperson	- William J. Schreiner
Vice Chairperson	- Robert W. Stein
Secretary	- Richard S. Miller
Treasurer	- Stephen L. Smith

For the first three years of the Section, the Chairperson was Richard K. Kischuk. Mr. Kischuk, although he will continue on the Council for another year, chose not to run for Chairperson this year. I would like to express my own personal thanks to Mr. Kischuk for the guidance that he gave the Council and the Section during its formative years. He did a marvelous job, and I'm delighted that we will have the advantage of his assistance on the Council in the coming year.

* Ms. Goodale, not a member of the Society, is Manager of Insurance Services for Packard Press.

OPEN FORUM

During the past year, the Council has concentrated on four main areas:

1. Developing sessions for Society meetings

2. Developing seminars

3. Producing a Section newsletter

4. Establishing a committee structure and broadening participation in Section activities

Perhaps the highlight of the year was the St. Louis specialty meeting in May 1985 on Life Insurance Company Financial Reporting, developed by the Section. Over 600 Society members attended the two-day meeting, which featured 48 panels and workshops. In addition, a Section-sponsored seminar on Asset Liability Matching was available in St. Louis the day preceding the specialty meeting. Also, a one-day open forum on the Role of the Valuation Actuary in the U.S. was held in October 1984.

A Section newsletter was started with three issues published to date and with the fourth issue currently in preparation. We would, however, like to see greater participation by Section members in the newsletter. The newsletter is an opportunity for Section members to ask questions or express their views, and we welcome your participation. Controversial topics and opinions are, of course, welcome. We are also at this time seeking a new editor for the newsletter.

During the past year, two committees were formed: the Program Committee and the Education and Examination Advisory Committee. The Education and Examination Advisory Committee is chaired by Richard Tank and has seven members. They will assist the Society's Education and Examination Committee in the maintenance of a modern syllabus on financial reporting issues and topics. The Program Committee is chaired by Stephen L. Smith who is seeking members for the committee.

MS. CAROLYN J. GOODALE: The NAIC was organized in 1871 and is the association of the chief regulatory officials of the 50 states plus U.S. territories. The main objective of the NAIC is to promote uniformity of regulation among the states.

The NAIC achieves its goals by working through a committee structure. The NAIC meets several times a year. Commissioners or someone from their staff are appointed to a committee to study or review various regulatory issues.

The subcommittee responsible for financial reporting issues is the Financial Condition Subcommittee. This subcommittee is one of the largest committees of the NAIC, having seven task forces and over fifteen working groups studying different issues reporting to it. This past year has been one of its busiest. I will summarize its 1985 adopted changes and give you an update on the current activities and probable 1986 proposals.

CURRENT TOPICS--FINANCIAL REPORTING

The Administrative Services Only (ASO)/Cost Plus study group has been meeting for over two years with the charge of reviewing, defining, and suggesting accounting and reporting procedures for ASO/Cost Plus and related business as it concerns accident and health benefits. This area is becoming increasingly important as recent trends in hospital and medical costs, cash-flow considerations, and the needs of business to reduce expenses have combined to accelerate the trend toward alternative funding arrangements. The group is proposing changes that are intended to reflect the insurer's expense risk with regard to the contracts which it administers. The proposals also provide a summary of the gain or loss from the operations of this business which is included in the income statement of the insurer. In the proposal, administrative service fees are to be shown separately in the general expense exhibit as negative expenses. The risks which concerned the group fell chiefly into the C-2 category, with the possibility that certain risks might fall in the C-4 category as defined by the Society of Actuaries Committee on Valuation and Related Problems. The work of this study group is virtually completed. It is expecting to submit its final report at the upcoming NAIC December meeting. Proposed changes to the annual statement blanks, blanks instructions, and accounting manuals are to be considered for 1986.

The Study Group on Reporting of New Investment Vehicles has developed new language for the accounting manuals for put and call options and financial futures. Since hedging is preferred in most states, the language for options contract accounting segregates hedge versus nonhedge transactions. Further, hedged items that are amortizable are differentiated from those that are carried at market. The group has also been studying the reporting and accounting issues involved with municipal bond puts, asset transfers with put options, and security lending transactions which have several attributes similar to asset transfers with puts. At the September 1985 meeting of the NAIC, the industry was successful in getting favorable revisions to the exposure draft on accounting for put-bond transactions. The exposure draft will no longer require loss recognition if the transaction qualifies as a financing transaction.

The study group on accounting and reporting of deposit-type business over the past year has been discussing the liability structure and related C-3 risk analysis of annuities. A proposed adaptation of the actuarial opinion of Interest-Indexed Universal Life policies and, as an alternative, a footnote disclosure for the maturity structure of liabilities have been reviewed. An adopted proposal for 1985 is the disclosure of annuity business on a state-by-state basis to include those group annuity contracts for which individuals are specifically identified. Optional reporting for 1985 but mandatory in 1986 is the disclosure of annuity reserves and deposit liabilities, separated by withdrawal characteristics. The note will show the detail for reserve amounts prior to reinsurance with a one-time adjustment for reinsurance. With the adoption of this proposal, the group is now addressing the drafting of remaining annual statement instructions and accounting-manual language. At the group's recent meeting, suggested changes would "gross up" the reporting of annuity and other fund deposits, which could have significant ramifications for the reporting of group annuity and pension products.

Moving to the topic of reinsurance, various aspects are being explored by the NAIC. There are four different study groups reviewing reinsurance, and results of the various study groups are to be released at the December 1985 meeting of the NAIC. Proposals for life insurers include the reporting of their summary of operations (Annual Statement page 5) separated by direct, assumed, and ceded business. This would require the allocation of such items as investment income, general expenses, and federal income taxes among the three components. Significant accounting and actuarial questions are raised, as well as questions regarding investment income. Another item under consideration is an analysis of increase in reserves (Annual Statement page 6) for direct business only.

Work continues on a model act which prohibits surplus-relief reinsurance. The model act is in the exposure draft stage. Its purpose is to identify certain troublesome reinsurance treaty provisions and to limit the reserve credit taken for treaties with those provisions.

A newly appointed working group on emerging issues held its first meeting in September 1985. Its purpose is to provide interim accounting and reporting guidance on new issues. It will be looking into real estate transfers including intercompany sales, sale/leaseback transactions, and interest rate swaps.

The following are the adopted changes for the 1985 year-end statutory annual statement. This coming year offers insurers no relief from the burden of additional reporting. As usual, no items were deleted from the annual statement reporting, but there are many new requirements.

A very politically sensitive item within the NAIC that has been opposed by the insurance industry is the reporting of market value of bonds and preferred stocks. The Blanks Task Force adopted a supplement, labeled Schedule DM to be filed only if required by the insurer's state of domicile or by any other state in which the insurer is licensed. The schedule asks for the aggregate statement (admitted) value, the aggregate fair market value, and the aggregate difference, if any, between them for all bonds and preferred stocks. The sources or methods utilized in determining the fair market value must also be disclosed.

Another significant change is the adoption of the new cash-flow page. This new page which has been under development for a few years will replace the current statement of changes in financial position page. This page has received wide exposure during its development. During the exposure period, many insurers prepared the new page and indicated no major problems in preparing it.

A new Credit Life and Accident and Health Experience Exhibit, disclosing data on a state basis, was adopted. The form was recommended by the NAIC Advisory Committee on Credit Insurance which wants all separate filings and forms used by the different states to be consolidated into one form. The filing is optional in 1986 and mandatory beginning June 30, 1987. It is hoped that several reports will then be eliminated in 1987: the Credit Life Insurance Statistical Report, the Credit Life and Accident and Health Exhibit, the credit reporting on

the Accident and Health Policy Experience Exhibit, and the separate credit insurance data on the state page.

Schedule G, which reports salaries, was modified. The reporting threshold was increased from $60,000 to $100,000. Also, no reporting will be required for the ten highest paid officers and employees if their compensation does not exceed $50,000. Accordingly, the threshold on Schedule SIS (Stockholder Information Supplement) will also be increased to $100,000.

To allow analysis of short-term investment income by source and to provide adequate cross-checking to the investment income exhibit, two lines were added to Schedule DA-Part 2 to show income collected during the year and income earned during the year. Those of you who file in New York have in the past, had to file NY Supplemental Schedule DA showing all the ins and outs of the short terms. New York has now eliminated this supplemental schedule as a result of the addition of these two lines.

Instead of requiring the submission of a lengthy schedule, two general interrogatories requiring disclosure of assets loaned or pledged were adopted. In addition, assets owned at year end, which were not under the exclusive control of the company as shown in the interrogatory, are to be identified in the asset schedules. Again, for those of you in New York, Supplemental Schedule LS was eliminated as a result of the adoption of this item.

There is also going to be a new Medicare Supplement Experience Exhibit required this year; it is to be filed by June 30, 1986.

Also adopted is a new Supplementary Schedule DS which is to provide additional information from those companies that use the equity method of accounting for income of subsidiaries. The purpose of Schedule DS is to provide comprehensive supplemental information relating to the ownership of subsidiaries for which the reporting insurer has included equity in the undistributed income of unconsolidated subsidiaries in its net gain from operations. A change in the mandatory securities valuation reserves (MSVR) calculation was also made for such companies.

A change that affects Schedule S-Part 3B is a revision of a footnote to clarify that the acceptable valuation for securities held on deposit is the fair market value at statement date. Industry opposed this proposal because fair market value valuation does not guarantee assurance of an insurer's ability to meet its obligations. Also revised was another footnote to Schedule S-Part 3B to provide more detail on funding of amounts due from reinsurers. Amounts will now need to be identified separately as letters of credit, trust agreements, funds deposited by and withheld from reinsurers, and other.

More detailed reporting with respect to capital stock will be required on page 3. Also a new note to financial statements was added requiring companies to furnish interest rates, redemption or maturity dates, and description of assets received in exchange for any surplus debentures or similar obligations.

Exhibit 10 for supplementary contracts was modified to show reinsurance ceded and will allow for reconciliation to Schedule S.

Changes to the blanks instructions include the incorporation of the instructions for both the Separate Account and Variable Life Insurance Separate Account statements into the instruction manual published by the NAIC office.

The page 5 Analyses of Operations By Lines of Business instructions for both the separate account and variable life separate account blanks were modified to accommodate a corporate account column. A column or additional columns will record the earnings of accounts that are not attributable to any line of business. A similar item was adopted for the life blank two years ago.

Related to the activities of the Blanks Task Force are the ideas of John O. Montgomery, Chief Actuary and Deputy Insurance Commissioner of the California Insurance Department. Over the past year, Mr. Montgomery has tried to rekindle an interest in developing a new annual statement reporting format. He stated that the present NAIC annual statement is, "a product of the nineteenth century that has long outlived its usefulness." While the topic has not been greeted with open arms, the regulators have recognized certain deficiencies in the blank. Study areas which will be reviewed by various NAIC task forces include amounts payable on demand, an analysis of reinsurance operations, problems of multiplicity of lines of business, market value, surveillance of surplus, a market conduct statement, and items affected by the current changes in valuation principles and standards for health insurance.

The newly appointed Financial Reporting working group's first item is a holding company schedule. The nature and content of such a schedule is still in the early discussion stage. There is interest by the regulators in having more information on affiliate company transactions and the various assets held by each company in a holding company group.

We may see a change in the reporting of quarterly financial data. Some regulators feel that the current quarterly statement does not provide adequate information to monitor the financial condition of a company. The first version of proposed new quarterly reporting requirements was circulated in June 1985. Those requirements were essentially a full annual reporting. A second version is now being worked on, and it is my understanding that it is significantly scaled down.

The final issue is the means of submission of statutory data. Annual Statements have been submitted in the large 12 x 19 inch format to insurance departments since their adoption in 1871. Over the past decade, the NAIC office and several insurance departments have experimented in asking for this data in machine readable format such as punch cards and, more recently, on magnetic tape. These methods have not met with much success. With the introduction of the personal computer and many insurers currently preparing their annual statements on floppy disks, the NAIC is reviewing the feasibility of submission of data on diskettes. There are at least four vendors currently marketing annual statement preparation software packages. The NAIC Data

Capture Working Group is working with these vendors by providing cross checks and format specifications. Pilot programs for 1985 year-end data transmission are being authorized. Submission of diskettes will eliminate the need for departments and the NAIC Data Base to manually key information. The diskettes will also assist in the desk-audit functions of insurance departments.

MR. DONALD M. KEITH: This is the latest on what is becoming an annual series of reports on the financial reporting scene in Canada. These surveys would probably not be necessary if circumstances in our two countries were more similar. But things are very different in Canada, and we on both sides of the border have an opportunity to gain from the experiences, good and bad, of our friends on the opposite side.

Without doubt, the environment in Canada is more conducive to a quick settlement of financial reporting issues than it is in the U.S. There are several contributing factors:

1. Regulation. Life insurance companies can be either federally or provincially incorporated, but something like 90 percent of Canadian business is done by companies that are federally incorporated and regulated under the Canadian and British Insurance Companies Act. This means common and consistent regulation by an insurance department that is well staffed and that has a good understanding and appreciation of the industry's problems.

2. Actuarial Profession. The actuarial profession is integrated in Canada within one professional body. The Canadian Institute of Actuaries (CIA) embraces all of the responsibilities expected of such a body except education, which is carried on through our relationship with the Society. This leaves no doubt who is an actuary and what is required to practice as one.

3. Recognition of the Profession. The Act calls for appointment by each company of a "valuation actuary" to take responsibility for the company's policy valuation. The valuation actuary must be a Fellow of the CIA who has all of the consequent professional obligations relating to taking on actuarial duties. The public is thereby assured of sound and consistent actuarial practice in policy valuations and of actuarial judgment remaining within a controllable range.

4. Contact with Accountants. The actuarial and accounting professions are in regular contact with one another. Members of the two professions with relevant responsibilities meet annually and rather informally to deal with and follow up on matters of common interest. A number of specific projects out of these meetings have emerged and the progress accomplished in recent years has been notable.

5. Financial Statements. Both financial reporting and solvency purposes demanded of government statements are met through one set of financial statements. The extra amounts deemed to be required

> for solvency are appropriated out of retained earnings. The ultraconservatism required to ensure solvency is thereby prevented from distorting the measurement of yearly earnings. Requirements are also the same for stock and mutual companies, promoting uniformity and facilitating intercompany comparisons.

The present framework for financial reporting in Canada was established by major legislative changes taking effect in 1978. That was when the responsibility for valuation was first vested in the "valuation actuary," appointed by the directors of the company and recognized as such in the Act.

It is important to understand the extent of freedom given the valuation actuary in the Act. There are no longer any prescribed experience bases or interest assumption limits. The valuation actuary can use his own judgment in selecting assumptions that are "appropriate in the circumstances." The word "appropriate" makes the actuary's judgment a two-sided matter: to be appropriate the assumption margins can be neither too large nor too small. The previous requirement was one-sided: any assumption was acceptable as long as it was at least as conservative as those approved by the Superintendent. The added responsibility this places on the actuary is obvious.

The valuation actuary is also free to select his own valuation method, but the freedom afforded in the Act is still one-sided: the liability using the actuary's method must not be less than that produced by a method prescribed in the Act--but it may be greater.

The Act also stipulates that the policy liabilities determined for government statement purposes must be used in any other financial statements published by the company. This ensures consistency of all financial information dependent on the valuation. The prescribed valuation techniques, however, are still not recognized as conforming to generally accepted accounting principles (GAAP), and this fact is made clear in the auditor's report.

Soon after this Act was passed, the Institute issued a set of "Recommendations for Insurance Company Financial Reporting" governing the conduct of a member of the Institute acting in the capacity of a valuation actuary. The Recommendations deal with verifying source data, developing assumptions, choosing a valuation method, and wording of the valuation actuary's reports. The implications of the wording of the text are also considered in detail.

The Recommendations actually go further than the Act in a number of significant ways:

1. The Act permits the valuation actuary to ignore withdrawal assumptions and substitute cash values where they are greater than reserves. The Recommendations require him to make appropriate assumptions about any contingency that materially affects net income. Hence, the Recommendations do not permit the actuary to ignore withdrawal assumptions without first testing their materiality.

2. The Recommendations also say that a valuation should not cover abnormal adverse deviations from expected experience, or catastrophic events, or major unexpected alterations in mortality or morbidity. This suggests that events could occur that are not provided for in the policy liabilities. It is clear that a valuation carried out in accordance with the Recommendations is directed more to the purposes of financial reporting (i.e., the measurement of earnings) than to solvency. There has been an increasing tendency for valuation actuaries to favor financial reporting considerations over solvency considerations, evident particularly in the narrowing of valuation margins.

3. A third departure of the Recommendations from the Act is the requirement that the valuation actuary use a valuation method that is "in accordance with the law and good actuarial practice." He must be able to say in his report that the policy liabilities make "proper provision," and it is explained that this means that the method must be consistent with sound actuarial principles or "where more rigorous, applicable statutory requirements" exist. The valuation actuary is therefore not free to use any method he wishes. Except for the limitations imposed by the Act, the choice of methods under the Recommendations is two-sided: it may be neither too liberal nor too conservative. The Recommendations, then, increase the actuary's responsibility in respect of both assumptions and method.

Little has changed in any formal way since 1978. But there is a lot going on:

1. Joint Task Force on GAAP. First, there is the question of GAAP for the life insurance industry. In this respect, Canada is behind the U.S. Valuation techniques prescribed in the Act and CIA Recommendations have not been approved as GAAP by the Canadian Institute of Chartered Accountants (CICA). There are other accounting practices with a similar status, the main ones being the treatment of income tax and the valuation of equity investments. The auditor, in making his formal report, states that the financial statements have been prepared in accordance with principles prescribed by the Superintendent of Insurance (rather than GAAP principles).

   Published financial statements are a formal communication to the public regarding a company's financial condition and ability to generate earnings. The financial statements clearly should be prepared in accordance with accounting principles. It makes sense that actuaries and accountants should get together and decide what practices should be generally accepted. We are likely to find that some practices should be changed to accord with GAAP practices in other industries, while other practices are correct under the special circumstances of our industry, and GAAP should embrace them.

   The two professions formed a joint task force in 1979 to identify all differences in life insurance accounting practices and to

reconcile these practices with GAAP. Their report was released in 1982 and has been studied at some length. The Institute's response was generally favorable and supportive, although it reflects a thorough rethinking of what constitutes a valuation method appropriate for accounting purposes and how a change in assumptions should be treated in financial statements.

American actuaries might like to take a closer look at the Institute's solution regarding the valuation method, because it addresses many of the problems that they are grappling with now. We have abandoned both the artificiality of net methods and the unreliability of the pricing basis. All of the conservatism is provided for in the assumption margins, over which the valuation actuary has total control and responsibility. Profits emerge, not as premiums fall due, but as the risk passes and assumption margins are released. The risk profits, therefore, are spread over the full term of the policy rather than the premium period only.

If there is a residual gain or loss after appropriate valuation margins are established, the gain is taken or loss charged to income at time of sale. This recognizes the sale as the vital business transaction that creates any residual gain or loss after policy risks have been properly provided for. It is also a natural consequence of making the valuation actuary responsible for valuation of the business on a basis he can independently say is sound. Making the sale automatically neutral in the financial statements runs counter to the need to appropriately provide for future uncertainties created by the sale and ignores the possibility that the sale itself was either a profitable one or a loser. The point is, if unsound products are being sold, readers of financial statements are entitled to know what the valuation actuary knows and not find out years later when losses occur.

This method of valuation permits entirely consistent treatment for single-premium annuities and provides a practical approach to valuing the revolutionary products coming on the scene in recent years. Perhaps even more important is the fact that the method conforms precisely to accounting principles governing the making of accounting estimates and the emergence of profits in financial statements. That, of course, is what GAAP is all about.

I would expect some action on the report of the joint task force by the CICA in consultation with the Institute, within the next year, at which time changes in the Act will have to be formulated, and the Recommendations will undergo a major rewrite.

2. Relationship with Auditor. A second recent development has to do with the relationship between the valuation actuary and the external auditor in the preparation and review of financial statements. Accountants have argued that the company auditor cannot give a clean bill of health unless he scrutinizes everything that goes into the financial statements, including the policy valuation. He must therefore review the valuation actuary's methods and

assumptions as he would the work of any other specialist. Actuaries responded that their expertise encompasses financial reporting of life insurance companies and that only the valuation actuary of the company is competent to report on the policy valuation and its effect on earnings.

Another joint task force was put together in 1983 to resolve this question, and that group reported in 1984. In addition to life insurance companies, this group considered all of the situations where actuaries interface with accountants, including general insurance companies, company sponsors of pension and welfare plans, and the financial statements of such plans themselves.

The compromise reached by the task force was that the auditor should be able to give a clean report (i.e., the auditor should not have to state that he has relied on the valuation actuary's report) but that, in doing so, he should not have to carry out a detailed review of the valuation actuary's work. Three necessary steps are substituted for this detailed review:

a. The CICA as a profession would make a study of the CIA Recommendations as to their appropriateness for GAAP purposes.

b. The auditor would develop a general understanding of the content of the Recommendations.

c. The auditor would satisfy himself regarding the qualifications, competence, and authority of the valuation actuary and then accept a representation by the valuation actuary that the valuation was carried out in accordance with the Recommendations.

The roles of the professional who is the specialist and the one who does the reporting are reversed in the situation where the valuation actuary relies on the audit of company data on which the valuation is based, and this reverse situation is handled in exactly the same way by the joint task force.

3. Solvency Appropriation. A third problem currently being addressed is that of ensuring ongoing solvency. The Act requires that the government statement and published statements must be based on the same policy valuation. If the latter are to be prepared primarily for financial reporting purposes, how does the Superintendent satisfy himself that the company is solvent and can expect to stay that way? Indeed, how did he do this before 1978, when all he had to go on was an unknown element of conservatism in the valuation?

The Superintendent can require the valuation actuary to report the sum of all such differences, and the government statement requires an appropriation of retained earnings to cover this amount. Other items, such as the investment valuation and currency reserve and

a reserve for what you would call "nonadmitted assets," require an additional appropriation.

But there is more to solvency than providing for a few isolated contingencies. The Department of Insurance is currently considering how a company should be required to demonstrate its solvency. The Institute has formed a committee to study the actuarial responsibilities and ramifications of this question and the Canadian Life and Health Insurance Association is also looking at it. It is likely that the present very specific appropriations of retained earnings will be generalized, in one way or another, to cover all perceived threats to solvency.

In September 1985 representatives of the Institute appeared before a Parliamentary committee to discuss the role of the actuarial profession in guarding against insurance company failures. The appearance was most timely, because Canada recently experienced its first bank failure in 60 years, and it is at least possible that the profession's responsibility could extend to other segments of the financial services industry.

4. Valuation Technique Papers. Another problem has surfaced recently, prompted by the proliferation of lapse-supported insurance products. Through lack of specific guidance in the Recommendations, valuation practices for these plans vary widely among valuation actuaries. This has given the Superintendent some concern, and he referred the matter to the Institute.

   The conclusion reached within the Institute was that this type of problem was too technical to cover in the Recommendations and too important to relegate to explanatory notes, which are not binding on the actuary. A new medium of guidance was proposed, namely "valuation technique papers," which would address specific technical problems one by one as they arise. The first paper has already been written and deals with the problem at hand, the valuation of lapse-supported products. Others will follow on the subject of valuation of renewable term insurance and on reinsurance, and there are many other potential topics.

   The Institute will be formally considering this new medium of professional guidance at its general meeting next month, and if adopted, these papers will be incorporated by reference in the Recommendations.

I am an optimist about what will eventually happen in all these areas, but a pessimist about how quickly it will happen. The CICA is twenty times the size of the CIA, but the number of its members really interested in the highly technical problems of the insurance industry is more like one-twentieth of the CIA membership. This means that the accounting profession as a whole doesn't get very excited about such things as actuarial valuations. It is frequently slow to deal with the issue, and those accountants who are involved have a difficult time selling anything new to the great preponderance of disinterested

members. After that, we still must work with the Superintendent and eventually the legislators to get the Act changed.

On the positive side, it is my view that the attempt to make the policy valuation serve both for financial reporting and solvency was a serious impediment to progress, because a suitable compromise between these two objectives is impossible. The idea of an appropriation of retained earnings for the additional provision a going concern should make to ensure its solvency satisfies all parties as to the information the statements should convey, and it does so without the confusion of two sets of financial statements bearing different messages. We can now focus separately on the liability valuation to generate the right charge to income for the measurement of earnings and on the retained earnings appropriation to protect the company from experience catastrophes.

MR. PAUL F. KOLKMAN: I have two unrelated topics to discuss today. The first is related to the recent Discussion Drafts on Standards for Valuation Actuaries, and the second is a summary of current developments in the area of GAAP accounting, particularly the developing accounting guidance for universal life and deferred annuities.

The final report of the Academy and Society Joint Committee on the Role of the Valuation Actuary in the United States was submitted to the two respective Boards in October of 1984. Part of the process of establishing the position of a valuation actuary in the United States, as recommended by the report, will be the setting of both qualification standards and standards of practice.

Although this process will ultimately require changes in the legal and regulatory framework, there is a strong desire within the profession to be ready when this time comes. And to this end, the Academy sent two Discussion Drafts to the membership last July--one on qualification standards, drafted by the Committee on Qualifications, and the other on standards of practice, drafted by the Committee on Life Insurance Financial Reporting Principles (COLIFRP).

My brief comments will focus solely on the Standards of Practice Draft which was a major project of the COLIFRP during the past year or so.

The Discussion Draft on Standards of Practice represents a complete revision of the Statement of Actuarial Opinion, Recommendation 7, and its Interpretations. If adopted, the revisions would require a valuation actuary to perform extensive scenario testing of both asset and liability cash flows for all of the company's products and to prepare both a Statement of Actuarial Opinion and a separate and more detailed Report to Management. In addition, the draft specifies that, if an actuary chooses to use methods other than those it describes, he should be prepared to defend his choice of methods.

Comments on the two Discussion Drafts will be collected and reviewed as part of the preparation of Exposure Drafts which should be sent to the membership in early 1986. Obviously, the new standards would result in a substantive change in the role, responsibilities, and legal liabilities of many actuaries, and they deserve our careful consideration.

In early 1984, the Securities and Exchange Commission strongly urged the American Institute of Certified Public Accountants (AICPA) to look at and provide more explicit guidance in the area of accounting for universal life insurance. The AICPA in turn asked the Academy for its input.

In response to this request for input, the Academy's COLIFRP produced a paper dated August 31, 1984, which discussed four possible alternatives to universal life accounting. These alternatives were (1) the traditional method, (2) the composite method, (3) the prospective deposit method, and (4) the retrospective deposit method and can be briefly summarized as follows:

1. The traditional method was the name given to the full application of traditional Audit Guide principles to universal life accounting. This method would typically result in recognizing a significant proportion of total universal life profits as universal life premiums were received.

2. The composite method was the name given to a modification of the traditional method. A modification that resulted from an arbitrary increase in the margins for adverse deviation so as to result in less profit being recognized in proportion to premiums received and, therefore, more profit being recognized in proportion to the underlying risk characteristic such as mortality, interest, and expense.

3. The prospective deposit method continued the process that led from the traditional method to the composite method by essentially loading up margins for adverse deviation to such an extent that no profit is realized in proportion to premiums, and thus, all profit is released as excess margins for adverse deviation.

4. The retrospective deposit method holds accumulated policyholder account balances as reserves and amortizes deferred acquisition costs in a manner that may or may not be consistent with the reserve accumulation.

Of the four methods described in its paper, the Academy Committee recommended that the composite method be adopted for universal life accounting.

The AICPA received this Academy input and made it part of the broader position paper which recommended, among other things, that a somewhat limited form of the composite method be used for universal life accounting and that the retrospective deposit method be used for deferred annuity accounting.

In late 1984, the AICPA paper was sent to the FASB for its consideration and final action. Throughout 1985, the FASB and its staff have carefully considered the universal life accounting issues presented to it. In fact, I have been impressed with both the quality and thoroughness with which they have addressed these issues.

In January of 1985, the FASB staff met with representatives of the American Council of Life Insurance (ACLI) to discuss industry concern over the AICPA paper. At that time it was clear that the staff was leaning toward the retrospective deposit method of accounting for both universal life and annuities.

In February 1985, the Board formally put the universal life accounting issue on its agenda and authorized its staff to form an informal Advisory Group composed of accountants, actuaries, and industry representatives to assist the staff with issues and act as a sounding board.

In addition, the FASB staff organized a couple of educational or background sessions for the Board during June 1985. At the first of these sessions, AICPA representatives discussed the basic theory of GAAP for life insurance companies, and at the second session, the ACLI presented its views much more completely than it had on previous occasions.

Since the views of the ACLI seem to be having a major impact on the deliberations over universal life accounting, it's worthwhile to summarize them. The major points that the ACLI has made to the FASB are:

1. If possible, there should be a single accounting model for all life insurance products because the development of product by product accounting guidance is both inefficient and ultimately unworkable.

2. The traditional method has worked well for traditional products. Reported earnings are more consistent and comparable than was the case with statutory accounting, and there have been few audit problems.

3. Universal life should be viewed as an evolutionary development in the life insurance industry, a development in a process that may not yet be complete. Hence, it would be desirable to continue to use traditional accounting principles with some modifications for the prospective unlocking of valuation assumptions and clearer guidance with respect to single-premium transactions.

The views of the ACLI as well as the views of others have been heard and, I believe, well understood by both the Board and its staff. This process is now nearly complete, and we expect an exposure draft to be issued prior to the end of 1985 with a final effective date in 1986.

What will this exposure draft say?

While the final outcome is clearly impossible to predict, it seems clear that the staff has backed off from its initial preference for the retrospective deposit method and has been focusing instead on the concept of "release from risk." This would imply that it is leaning toward either reconfirming traditional GAAP with some more explicit guidance related to margins for adverse deviation and single-premium transactions or that it is learning toward adopting the Composite Method.

While such a result seems both likely and desirable, speculation is just that, and there have been enough questions and concerns expressed

along the way that it is possible that the Board will conclude that the issues raised by universal life accounting are sufficient to throw the entire life insurance accounting model into question and then proceed with major and sweeping revisions. But whatever the FASB's views are, we should have a clearer picture within the next couple of months.

MR. SCHREINER: Let me make one comment with respect to the material that Ms. Goodale discussed. She mentioned Schedule G having its threshold changed to $100,000 and also pointed out that New York had made a number of accommodations to make its reporting requirements more nearly like most of the other states. However, with respect to Schedule G, New York's requirement for the threshold level is currently part of the insurance law, and that law is now $60,000. For those companies that would report to New York, the Schedule G requirement for New York State will remain at $60,000 until they change the law, which presumably will be next year.

MR. BRIAN R. LAU: Mr. Kolkman, when the original GAAP came out, they addressed individual life insurance fairly well, but they seemed to ignore most of the problems with health insurance, particularly loss recognition. For example, can you have loss recognition on a policy that is nonrenewable or on which you can increase the rates? Does the FASB intend to address those issues or let the industry run along as it has so far?

MR. KOLKMAN: There has been no discussion, to my knowledge, about health insurance within the last year or so.

MR. LAU: I believe many health writers face this issue regularly. That is if you have a block of individual health policies and set it up on a GAAP basis, when do you recognize losses if you can raise rates? How can you measure whether your initial assets are recoverable or not? If the policies are nonrenewable, then you'll have all that asset come back, or if you raise rates, will that recover? It's never been a clear issue. I know everybody has a practical solution and follows it, but I don't think there are any standards for it.

MR. SCHREINER: I haven't detected any demand within the accounting community to identify a problem in that area which has required it to take action.

MR. STEVEN H. MAHAN: I think some of the new life products provoked that action and that thought. However, a lot of those principles are applicable to health products and maybe address some of the issues that Mr. Lau was getting at.

MR. SCHREINER: I might mention the reaction of the FASB staff to the major conclusion of the AICPA paper that reserve assumptions can be unlocked when a pricing change takes place and that there is thought to be a material effect on future earnings streams. The one issue that the industry, the accounting profession, and the actuarial profession agreed on is that unlocking should take place. The FASB staff's initial reaction to that is not to go along with that recommendation. Its concern is presumably that this could lead to reopening the

reserve calculation each year and to creating an audit problem and perhaps the opportunity for manipulation of earnings. Whether that will be the final decision of the FASB remains to be seen.

MR. JOHN O. MONTGOMERY: A lot of projects are being worked on by various groups of the NAIC. We're continuing to review the progress. The computerization of the blank is one of the most significant developments coming in the next few years. By using software, developed by various software companies, the financial statement can probably be prepared, especially by smaller companies, at a savings in expense. This is one of the real breakthroughs that certainly is possible with the development of the personal computer (PC) This is going to be a significant development in providing the NAIC with a data base covering all financial reporting blank information. There are a few areas which remain to be cleaned up. One is how do you get all of the bond details when you can't even identify the bonds because we have no index system for the private placements? The NAIC now does have linkage by direct line between its New York securities valuation office and the central office in Kansas City. This is another significant development. Down the line there could be a lot of things which the valuation actuary might be interested in when developing information he needs to support his statement. These can be developed through the computerization process which is now under way and which will probably be available within the next three or four years. I can easily see computer software companies vying to provide the information that the valuation actuary needs to support his analysis of cash-flow projections.

MR. LARRY J. BRUNING: Mr. Montgomery, do you envision, at some time, a central bureau where all statements come in, or is each state still going to have to have PCs aboard?

MR. MONTGOMERY: We are in the process of discussing that at the NAIC. We're not sure at this point what is going to be feasible, but I would think that the floppy disk method of transmission is probably going to be used at least presently. That seems the most feasible, as a company could submit one copy of a floppy disk to its state of domicile and another to the NAIC at the same time. We're trying to set up the mechanism within the NAIC for those states that don't have their own PC system, so that they could use the NAIC transmitted blank. They can have those blanks prepared because the software includes a printout. The PCs can also be used to develop printed blanks, because they have a mechanism to set type from a computer record to produce a printed document. All of this is feasible in the future, but the problem is getting it at a reasonable price so that it will result in a cost savings in the operation of collecting the financial data for the insurance companies and the NAIC.

MR. BRUNING: Does it look like Recommendation 7, the proposal by the Academy, will be adopted yet this year? Would it be required for us to give an opinion in the 1985 statement or has that changed?

MR. KOLKMAN: No, the two drafts out now are discussion drafts, and the formal exposure drafts will be out in 1986. Current target for implementation is probably about 1987.

OPEN FORUM

MR. SCHREINER: Would it be fair to say, that the Academy Committee has not advocated the adoption of a new Recommendation 7, but rather, it is merely preparing one, in the event that a valuation actuary concept comes into fruition, and therefore, guidance is required by the valuation actuary? My view is it's more preparatory.

MR. KOLKMAN: Yes, that is exactly right. We didn't want to be caught unprepared as the process was going along. There will be an opinion required at some point. We didn't want to have to start working on it then. So we've done some of the work to make the process easier as it goes along. But, the committee hasn't been out pushing these developments.

MR. MONTGOMERY: This reminds me of actuarial opinions. The NAIC actuarial task force appointed a special advisory committee, chaired by Walter Rugland, to give us a set of guidelines to be used by the regulators in analyzing statements of financial opinions as an interim-type guideline, until we actually get the full mechanism of the valuation actuary in place. That committee has submitted its report. We're intending to recommend adoption of that report with minor revisions at the NAIC meeting in December 1985. We're not changing the format for the statement of actuarial opinion in the blank that's presented in the instructions for the blank. None of that will be changed; nor will any recommendation be made for changing that for the 1986 blank. We want to offer it with this for at least a couple of years to see how it's going to go and to see what problems we have with these guidelines in analyzing the statements of actuarial opinion.

MR. SCHREINER: Could you summarize some of the key suggestions?

MR. MONTGOMERY: One of them is the matching of assets and liabilities. Another is the analysis of cash flow. Those are the principal things that we're talking about in that guideline. It's a concise group of statements or requirements that the actuary has to consider. One of the other things that actuaries should consider is the reinsurance implication. Another thing, which was not in the Rugland proposal but which the actuarial task force is probably going to ask that the actuary consider, is whether or not the provision has been made for things such as cash-surrender values, for excess-interest guarantees, and for premium deficiency.

MR. BRUNING: Do you know any further information about the possible change of valuation of universal life for statutory purposes? I heard that the model regulation might be revised because of its complexity.

MR. MONTGOMERY: We're going to be discussing that in our actuarial task force meeting. We're planning to revise the model regulation for universal life with respect to both nonforfeiture values and the valuation.

MR. SCHREINER: Would you want to suggest the nature of those changes?

MR. MONTGOMERY: We're trying to simplify it if possible, because we've had a great deal of problems with the model regulation. Nobody can tell really what the regulation means. I hope we can change it, but I don't know what we're going to end up with.

MR. SCHREINER: My understanding is that you're proposing for valuation proposes a grading to the tenth-year value.

MR. MONTGOMERY: Well, that was the proposal at Syracuse. However, we ran some tests on that and found that the results didn't come out too well. So we're going to have to do something else besides that. Right now, we've proposed for discussion that we just take the difference between the minimum reserve and the minimum cash value and add that on to the cash-surrender value making it just a flat adjustment in reserves that way. You can develop tables of those factors for some principal things, like ordinary life, so that these could become easily calculated. It would greatly simplify the operation.

MR. SCHREINER: Would it be fair to say that you're still searching for this solution?

MR. MONTGOMERY: That's right.

MR. MICHAEL E. MATEJA: I'd like to make a few observations on Mr. Keith's description of the valuation framework that exists in Canada. Recent Canadian developments with respect to valuation and solvency provide some valuable insight into the likely regulatory response to a U.S. valuation framework where the valuation actuary has full responsibility for setting valuation reserves. In Canada, the valuation actuary has full responsibility for setting valuation reserves. In Canada, the valuation actuary has had complete responsibility for setting appropriate valuation reserves for several years now in much the same manner as anticipated by the recent Joint Committee recommendation. While I am not sufficiently familiar with actual Canadian valuation practice, I suspect that there has been a general weakening of valuation reserves relative to the level of reserves required when there were formal valuation standards. If, in fact, there has been a general weakening of reserve levels, this explains the response by the Superintendent which was to focus more attention on surplus levels. Earlier this year, the Superintendent proposed minimum surplus standards developed by Mr. Allan Brender.

There is an obvious trade-off between valuation reserve and surplus levels. High (conservative) valuation reserves permit lower surplus levels relative to low valuation reserves in order to have the same level of assurance that obligations can be matured. In the design of a new valuation framework in the U.S., we need to be mindful of the relationship between valuation reserves and surplus levels. Unless we are careful to define valuation standards which contain reasonable margins for adverse deviations, we will find regulators focusing on surplus levels as well as valuation reserve levels. I do not want regulators directly or indirectly involved with surplus levels except in the case of insolvency. For this reason, I am skeptical about the basic premise of the Joint Committee recommendation which anticipates that

the valuation actuary's opinion address both valuation reserves and "internally designated surplus." In my opinion, the valuation actuary should concentrate on setting realistic valuation reserves. My experience suggests that responding to this narrow charge will provide challenging work for both the valuation actuaries and the regulators. The problem of managing surplus levels belongs to management.

MR. WILLIAM T. TOZER: Having spent a few years with the ACLI task force on model regulation for universal life, I hope Mr. Montgomery's group has more success than we did. We found that universal life has so much flexibility in it that it was difficult to allow actuarial innovation when we wanted to simplify regulation. Our ability was limited to allow future development and flexibility. There is a problem in that you must develop a regulation based upon a legislative or statutory authority. There were a lot of things we wanted to do, but couldn't, because there was no statutory authority to do so.

MR. SCHREINER: The only item that I am aware of that has changed since your group was working on this is that the tax motivation 818(c) has been removed which influenced the format of the proposal. Since that is no longer an issue, does that hold the possibility for simplification?

MR. TOZER: I think that is true, and I think it can go even further, because our proposed model regulation had been basically finalized about six months before the tax legislation came about. It turned out that it finally was adopted by the NAIC soon after the tax legislation. Not only did the 818(c) adjustments change, but also a lot of work we did assuming that actuaries were going to have flexibility in establishing pragmatic valuation standards which would be simpler as long as they were higher than those mandated in the regulation also changed. The tax legislation changed that because it said that, for tax purposes, you are going to have to establish reserves that are the minimum specified by the NAIC. However, this regulation ended up being the minimum standard for tax purposes. This removed some of the flexibility that we thought actuaries were going to have to develop in-house reserve standards as long as they were above this minimum. So I think it's actually two aspects: the 818(c) has changed, and we now have a tax law that further complicates it by mandating minimum reserves for tax purposes.

MR. MONTGOMERY: I think one of the things that has prompted our problems is that there is much greater diversity in plans for universal life now than there was when you were developing it. We now have a whole new series of zero-mortality-charge and lower-interest-rate-type products which are becoming prevalent.

MR. LARRY WARREN: I believe that it was mentioned that, in 1986, there would be an exposure draft by the FASB at which time it would recommend either the composite method or another alternative. It seems to me that the composite method would base the reserves on margins that would be somewhere between the traditional approach, where you have the minimum margins, and the prospective deposit or full margin approach, where you'd have the maximum margin. Therefore, since the

composite approach is somewhere in between and profit would tend to emerge as a smaller percentage of premium and release from risk, I'm wondering what that second alternative is? It seems to me that the composite method is the type of recommendation we can expect and the only compromise that I can think of.

MR. KOLKMAN: The two likely ways they could go I described as either reaffirming traditional GAAP with some guidance on margins for adverse deviation and single-premium transactions or endorsing or adopting the composite method. Really those two give the same outcome; the difference is in the philosophical outlook of the Board. Is it adopting a new method for universal life accounting, namely the composite method and, therefore, setting a precedent for product by product accounting rules? Or in the first description, is it just reconfirming what is already there but putting in a few amendments to clean up some loopholes. I think the outcome would be identical. The real issue is philosophically which way is it approached?

MR. WARREN: Could you explain the concept of the limited composite method where there are some sort of restrictions?

MR. KOLKMAN: The final paper that went from the ACLI to the FASB, endorsed the composite method and then put in a limitation that said the percent of premium recognized couldn't exceed the percent of premium recognized in a 20-payment traditional life insurance policy. That was an initial recommendation by the ACLI that hasn't received much attention at the FASB level. I think that was put into that recommendation by the ACLI just as a safety feature. Some of the people were a little uncomfortable with the composite method and didn't know if it would give them the result they wanted.

MR. SCHREINER: Mr. Warren, you used the word "compromise." The FASB regards itself as a body that seeks accounting truth. It is grounded and trained to seek a conceptual framework within which all accounting truths can be arrived at. When the Board met with the staff last week to discuss its conclusion with respect to this, the Board was very tough on the staff from the standpoint of the conceptual basis of this composite approach. One of the Board members said that if you go to one extreme and have the traditional approach, you let things flow through after you have taken account of appropriate adverse deviation margins. But if you go to the other extreme and say premium has nothing to do with the recording of profits, you therefore ban that from happening. Now how do you intellectually get to the middle ground? The staff has some difficulty explaining the theoretical basis for reaching that "compromise" position.

Another Board member says that when you, in effect, ask the actuary to use a margin for adverse deviation beyond what is, in his judgment, an appropriate margin (which is the effect of the composite approach), aren't you asking the actuary to do a job that he is not trained for? Aren't you asking him to do the accountant's job, and is it appropriate to do that? Why should we ask the actuary to do what is the accountant's and auditor's task? The staff and the Board have tried to deal with what, ultimately, is a practical problem that needs a practical solution in an environment that relies heavily on theoretical solutions.

This is part of the reason why Mr. Kolkman suggested that it is a little risky to predict exactly what the FASB is going to conclude on this particular issue.

MR. TOZER: First, Mr. Kolkman, you said that at the last FASB board meeting, it had appeared that FASB may be moving toward the composite approach. Does the Board seem to be concerned about one of the other issues the ACLI brought up--the inconsistency between the treatment of universal life and the treatment of traditional products? How does it resolve this issue?

Second, using the composite approach and setting your actuarial assumptions so that you do not have any unusual profit generated at the time of issue, you can generate some actuarial assumptions that may seem unreasonable. Has the FASB staff or the Board been concerned about that possibility, or are they aware that the possibility may arise?

MR. KOLKMAN: I don't think the Board has moved necessarily toward the composite method; it has been mainly the staff. The people who have looked at it started with the retrospective deposit method, and the staff has clearly begun to move away from that. I don't think it is possible to read the Board right now.

There is concern about consistency between universal life and traditional life accounting. The Board and, probably to a lesser extent, the staff feel they should be setting accounting rules for life insurance products. As a theoretical body, it is looking for truth and it would be satisfied if it could come up with a single framework that handled everything. The staff is more pragmatic and may tend toward having a separate body of rules for universal life. I hope that doesn't happen.

Regarding the unreasonable assumption question, as we were going through the process of putting together the Academy paper, a lot of us were thinking that the margins for adverse deviation would be loaded up, in the actuary's judgment, to try to reflect the significance of the underlying components. You would try to reflect how significant the mortality component was, and how significant the interest component was. If you go to the composite method, you can say that you really don't have assumptions that have gone beyond the realm of reason. If you go to the prospective deposit approach, you can get them. You begin to arbitrarily load things up just to consume premium margin, and you can build in mortality margins that are unreasonable. Also, interest margins become unreasonable. So I think with the composite method the answer is probably "no," but with the prospective deposit the answer is probably "yes." I don't know that the staff or the Board is concerned about that. Again, they're looking for truth, and they're convinced that when they find truth, problems like this won't arise.