RECORD OF SOCIETY OF ACTUARIES
1986 VOL. 12 NO. 3

CURRENT TOPICS IN FINANCIAL REPORTING

Moderator: JAMES D. WALLACE
Panelists: WAYNE KAUTH*
MARK SEVER**
KIHONG SUNG
Recorder: ANTHONY J. TOKARZ

- An update on the committee activities and interests of the:
  - National Association of Insurance Commissioners (NAIC), including results of the December 1985 meeting and 1986 Annual Statement Blank Committee meeting
  - American Institute of Certified Public Accountants
  - Financial Accounting Standards Board
  - American Academy of Actuaries
  - Canadian Institute of Actuaries
- A review of the status of specialized topics:
  - Revised nonforfeiture and statutory reserve standards of Universal Life
  - Generally Accepted Accounting Principles (GAAP) for Universal Life
  - Should cash values in excess of reserves be pre-funded?
  - Should minimum nonforfeiture values be required (e.g., term to 100 in Canada)?
  - Initial implementation of the valuation actuary concept
  - Reporting for Variable Universal Life

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PANEL DISCUSSION

MR. KIHONG SUNG: While I don't have on-line access to the NAIC meeting which is being held this week and is supposed to end today, I have an idea as to some of the meeting items, because I met a couple of people who had flown from Boston yesterday.

Each Spring, the Blanks Task Force meets to review the proposed changes in the Annual Statement for the current year. While the Blanks Task Force's recommendations are not final until the following June when the EX(4) Committee meets, they have a great deal of influence on the final outcome of the changes in the Annual Statement. There were a number of minor changes and editorial changes done in March at the Blanks Task Force meeting. There are some major items which you might be interested in:

1. Reformatting -- The primary purpose of this proposal is to facilitate future data capture via diskettes. The proposal involves reformatting Pages 2-15, Page 46, Schedule A, Schedule B Part I, and Schedule T. Essentially, this will require the consolidation of all write-in lines in each category into one line. While there is no immediate requirement for diskette filing, it is expected in the near future. Furthermore, some states indicated this will be an additional requirement. Companies are still required to file annual statements on the basis of current format, including write-in lines.

2. Reporting of Uninsured Accident and Health Insurance Plan -- This includes Minimum Premium, Cost Plus or Stop Loss Plans. There will be additional lines on Pages 2 and 3, Exhibits 5 and 13. Companies will be required, essentially, to bypass the income statement and only report assets and liabilities for this type of business.

3. Reporting of Deposit-Type Business -- This includes guaranteed interest contracts, deferred annuities and other deposit-type annuity business. There will be additional lines for Page 3, Line 10; Page 4A, Line 9 and Pages 4 and 5, Line 17A, as well as the reporting of withdrawal amounts on Line 12 of Pages 4 and 5.

4. Reporting of Schedule M -- Starting with the 1986 Annual Statement, stock companies which have outstanding participating business will be required to file Schedule M.

5. Elimination of Schedule G and Schedule of Examination Fees -- While I was skeptical about this being approved, my understanding is that this is approved.

My understanding is that all five items mentioned above are approved by the EX(4) Committee. I must emphasize that this is only hearsay information. I am not 100% sure.

While these are the only *major* items approved by the Blanks Task Force, there are a number of items which were either deferred or referred back to authors, for resubmission with revisions. They are:

1. Page 5 of the Life Blank will be expanded to 4 parts to allow for the reporting of direct business, reinsurance assumed, reinsurance ceded and all business combined. This will create not only work load problems, but also problems in allocating expenses, federal income taxes, and net investment income. My understanding is that this has not been approved in June but will be resubmitted in 1987 with some revisions. Some objectionable features such as the allocation problems are supposed to be eliminated. So, essentially, we may have some kind of reinsurance schedule next year.

2. Page 6 will be expanded to 2 parts by adding the analysis relating to direct business only. While this is not a major problem, it will also add to the work load. My understanding is that this may be approved next year.

   Another topic which was not considered by the Blanks Task Force, but might have been brought up at the EX(4) meeting this week, is the proposal by the Securities Valuation Office (SVO) of the NAIC to subject Schedule BA assets to the MSVR requirements similar to those of common stocks. The SVO contends it is very difficult for it to evaluate the reasonableness of valuations currently shown in Schedule BA, and that it might be necessary for the SVO to add a substantial number of employees to its office to make such an evaluation. Since such an addition is not practical for cost reasons, the SVO is proposing to make the Schedule BA assets subject to MSVR requirements. Furthermore, the SVO is proposing to have an initial contribution of 10% to the MSVR. Of course many of you are aware that the valuation shown in the Schedule BA is, in general, substantially below the market value. If this proposal is approved, it may have serious implications for some companies.

3. Another topic which requires your attention is New Mexico's proposal to require the filing of annual statements by December 31 based on 12-month results ending October 31. If this proposal is passed, any company doing business in New Mexico might be required to complete two annual statements.

4. Another area which you may want to offer your opposition to is Maine's requirement for the filing of audited financial statements of all affiliated companies. I emphasize ALL -- no matter how insignificant the company may be. Furthermore, even though the company is one of a consolidated group for which an audited financial statement was filed, the company must file another audited financial statement for that individual company.

There are several further developments after March, so I will mention them briefly.

1. Proposal for Revised Quarterly Statements -- There is a proposal for the elimination of certain interrogatories and the reporting requirement for acquisition and disposal of securities in the quarterly statement. But it will be necessary to show net gain by line of business, as well as detailed reporting of capital gains and losses similar to Exhibit 4 of the current annual statement. It will also require the additional reporting of affiliated company transactions.

2. New Disclosure Requirement on Interest Swaps -- Starting with 1986, if the proposal is approved, companies will be required to disclose certain items in their financial notes. Items to be disclosed would be:

   a. Business purpose of swaps.

   b. Description and nature of transactions.

   c. Disclosure of accounting treatment.

   d. The present value of the potential financial risk in case of termination of the contract. There is some question as to what is meant by "the present value of potential financial risk in case of termination."

   e. Finally, if the company is an intermediary or a broker in the transaction, additional disclosure is required.

3. Holding Company Schedule -- The NAIC Technical Task Force is looking at this. While this is not an immediate requirement, at some point this may become an additional schedule in the annual statement. It essentially involves showing the consolidated assets, liabilities and income statements, further subdivided by life insurance group, fire and casualty group, other insurance group and noninsurance group. While the proposal is still in a discussion stage, it is unlikely to be adopted in the near future.

MODEL REINSURANCE REGULATION

Most of you are aware that at the NAIC meeting held in December 1985 a Model Reinsurance Regulation was adopted. It prohibits an insurer from taking credit on reserves or assets on reinsurance ceded unless there is a bona fide transfer of risk. Essentially, the regulation nullifies the financial effect of surplus relief-type business. There are 3 transitional rules. Companies having a substantial block of this business may have a problem with a number of states in the near future. New York adopted a similar Regulation last year.

PANEL DISCUSSION

At this week's NAIC meeting, there was a discussion of the new Universal Life Model Regulation with respect to the valuation and nonforfeiture laws. My understanding is this is still in the discussion stage and nothing has been resolved. The proposal prescribes minimum cash values based on the prospective formula, whereas, up to now, the retrospective formula was used. The proposal's initial expense allowance is the same as that for a whole life plan under the minimum valuation rate and nonforfeiture mortality rate specified in the policy.

The minimum reserve requirement has two versions. The first version compares two quantities, (1) the present value of all guaranteed future benefits assuming no further premium payment and (2) the actual cash value plus the difference between the minimum reserve and the minimum cash value for a similar fixed premium policy. The greater of the two is the minimum reserve. The second version substitutes actual cash value with minimum cash value. I do not know what impact this will have on Universal Life statutory reserves. A company's premium structure and cash value structure will determine this effect.

ACTUARIAL OPINION GUIDELINES

In March 1986, the NAIC adopted a guideline on actuarial opinions. The guideline contains twelve points which were clarified by the American Academy of Actuaries in its advisory notes. In addition, the New York Insurance Department appointed an advisory group to recommend regulations on the actuarial opinion and memorandum. More in-depth discussions were held in a session yesterday regarding the "Valuation Actuary."

MR. WAYNE KAUTH: I am going to try to cover quickly the SEC and the AICPA function and how those two organizations have affected the insurance industry, specifically the life insurance industry, in the past year or so.

THE SEC

There has been more action at the SEC than there has been at the AICPA within the past year. Its particular efforts or pronouncements have affected the life insurance industry, and it is very curious about what is happening in the insurance industry. I do not think it is because of the attractive income statements and revealing footnotes that you put out. I think there has been a little concern about regrettable instances of nondisclosure, inadequate reserves, and some other unfavorable rumors.

Obviously you are familiar with the interest the SEC had a couple of years ago in SPDAs. That issue seems to have been abated temporarily. Mark Sever will pick that up when he talks about Universal Life. Since then, there have not been a lot of pronouncements or actions taken by the SEC that are receiving daily newspaper attention. That is not to suggest that it is complacent or content with the life insurance industry.

Loss Reserve Disclosures

While not particularly appropriate for this group, you are probably familiar with the pronouncement that came out last year affecting most property and casualty companies that are registered with the SEC. These property and casualty companies had to make an extensive disclosure for the first time in their 1984 financial statements. Depending on how you read those financial enclosures, it would suggest that the property casualty industry was grossly under-reserved for the last 10 years. I don't think that comes as any great surprise to anybody in the insurance industry. While the 1985 disclosures have not been tabulated or surveyed, there is no doubt that under-reserving continues to exist. I think that type of situation really concerns the SEC, because it is the watchdog of public reporting, interest in shareholders, and protection. I think all that these situations have done is whet the SEC's appetite to learn more about the life insurance and the casualty insurance industries. With that in mind, it behooves all of us to pay some attention to what actions are being taken by FASB.

Staff Accounting Bulletins (SABs)

Two things that did come out officially from the SEC in the last year or so were two SABs that do affect the insurance industry. The first was SAB #59. It was effective for the first time in 1985 and, basically, pertains to the valuation of marketable equity securities. What that really said was, if you have marketable equity securities whose decline is "other than temporary" you should write those down, and not just write them down like you do on your convention statements, through Exhibit 4. They should be written down permanently through the income statement in the GAAP financial statements. There are some uninformed accountants and some other people in the industry who thought "other than temporary" meant permanent. There is a big difference between those two terms, and a number of situations did occur where companies had to review their financial statements and take substantial write-offs.

By coincidence, it was a great time for SAB #59 to become effective -- the stock market was almost at an all-time high at the end of 1985; interest rates were coming down dramatically. But, that rule is not just in effect for December 31, 1985. That rule stays in effect, and it could hurt a lot more in future years when the stock market is not quite as accommodating.

The other pronouncement by the SEC last year was SAB #60. It dealt with financial guarantees. It does not affect the insurance industry too much, but we did find instances where life insurances, for one reason or another, have issued financial guarantees. Basically, it is a type of credit enhancement to improve the credit rating and the salability of certain securities. However, financial guarantees come in all shapes and sizes, and, to the extent that you have them, there are a lot of disclosures that you are now required to include in your financial statements.

Discounting

Discounting is always in front of the SEC. I suppose we have more discussions with respect to discounting than anything else. While the whole balance sheet of life insurance companies is generally discounted, that is not true in the casualty field. The SEC is very, very interested in discounting; when companies discount, what lines they discount, what rates they use, and whether the principles that are applied in the SEC filing are consistent with the NAIC filing. I would say the SEC is not opposed to discounting. It's just that it doesn't think you should use it to make up reserve shortages.

The SEC has apparently initiated a new paper. We have not seen a draft of it yet, but it's probably going to come out in the form of an SAB. Those, basically, are very important documents and they have to be followed by anyone reporting to the SEC. This paper will probably include a current position of the SEC on discounting. That paper could come out any time within the next several months. Exactly what it will say we don't know. We suspect it may say, "If you discount, you have to do it for the same lines that you are allowed to discount in your statutory convention statement and at the same rates."

Reinsurance

Another topic that the SEC continues to be interested in is reinsurance. Again, this is more of a property issue, but it certainly has a lot of life overtones. The SEC is very intrigued with what is going on in reinsurance. Anything from loss portfolio transfers to commutations, which are much more prevalent now than ever before. There is a lot of concern that certain companies are taking advantage of commutations to accomplish something they cannot do quite legitimately -- postpone the recognition of some type of a loss on some reinsurance. Mostly, the SEC is concerned with troubled reinsurance companies, but, of course, there are some life implications.

Enforcement Activities

Another front at the SEC is the enforcement activities. This is basically the SEC's police arm or its threatening arm. There has been a lot of activity there. As a matter of fact, over the last three years there have been 80 separate enforcement actions. Almost half of those occurred in 1985 -- almost one a week. Those enforcement activities are focused against the company and against the independent accountants associated with that company. I think you should be also aware that there are a lot of individual company officers involved in those proceedings. Penalties involved range from censure to jail. While I don't know for sure, I would suspect there have to be some actuaries involved in that select, elite group.

There are enforcement actions in a lot of fuzzy areas, where the rules are not as specific and authoritative as we might like them to be. The SEC is very concerned with shortcuts that are taken. "Cookbooks," "Gaps in GAAP," and "clever accounting" are of interest to the SEC. In these instances, there stands to be some recrimination.

Congressional Hearings

One other topic at the SEC is the congressional hearings. You probably have heard some overtones about Representative John Dingell and the congressional hearings he has been holding. They are very important hearings, and while a lot of them are directed at accountants, I don't think that actuaries are too far behind in his prospective list of targets. He is a very important, persuasive and powerful representative. He has been batting the accounting profession around pretty well with respect to how it reports and how it reacts with industries. There are some implications as to how rules will be set should he continue along his course. I think both the accounting and actuarial professions should be watching his activities.

In summary, the SEC is very interested in the insurance industry. It is going through an educational process, and I would say we are going to hear more and more from the SEC.

THE AICPA

I will touch briefly on the AICPA now. By and large, I think I can report good news. It has not done anything that affects you in the last year. Its main activity was two years ago, when it was trying to prepare a paper on Universal Life which was forwarded up through the hierarchy in the AICPA Insurance Companies Committee, which is now at FASB. There was also some AICPA input with respect to the Life Insurance Tax Act of 1984 in trying to determine what type of accounting would be appropriate, preferable or mandatory. There has been very little activity at the AICPA Insurance Companies Committee level that would really have an impact on you. The AICPA Insurance Companies Committee is a group of about 12 or 15 that meets almost every month for a couple of days and shuffles through what is happening in the insurance industry. If it comes across anything that is important, it tries to get it formulated and committed to paper and then determines whether it will warrant some type of publication.

MR. MARK SEVER: I am one of the project managers at the FASB involved in the Insurance Accounting Issues project. In addition, I handle some other areas of the Board, including financial instruments and emerging issues task force. I am also the project manager assigned to Congressman Dingell's committee. My remarks today are going to center on the Board's insurance project and, specifically, the portion of the project that deals with accounting for interest-sensitive and flexible premium insurance products. There are a number of projects on the Board's agenda that are going to affect a number of enterprises, including insurance companies: income taxes, stock compensation, consolidations, loan fees, financial instruments, cash flows and postemployment benefits other than pensions. Recognizing that many of you follow the Board's activities with varying degrees of intensity, I will not discuss each of the projects. Each of them is worthy of a multiple hour discussion.

INSURANCE PROJECT

The insurance project addresses three areas:

- Accounting for interest-sensitive and flexible premium insurance contracts and single premium annuities.

- Consideration of the time value of money in the determination of a premium deficiency on short-duration insurance contracts.

- The loss portfolio transfer question.

Universal Life Products

Accounting for Universal Life products is the most significant of these three issues and the one that today has received the majority of the Board and Staff attention. As you know, in response to financial deregulation, increased interest rates, and a more competitive marketplace, insurance enterprises developed a variety of insurance products allowing increased flexibility to both the consumer and the company. The development and subsequent marketing of these products involved an unbundling of traditional life product attributes.

Some companies stressed the tax and investment aspects of insurance products more than had been the case with traditional products.

With the increased flexibility given policyholders to select benefit and investment options, many in the accounting and actuarial professions began to question the use of the accounting model used for traditional products to account for profit recognition of this new generation of products. The SEC, as Wayne said, specifically focused on the accounting methods utilized by some SPDA writers.

History of Project

The Board's project on insurance issues came to the Board in 1984 with the AICPA's issues paper with a rather ominous title of "Accounting by Stock Life Insurance Companies for Annuities, Universal Life Insurance, and Related Products and Accounting for Nonguaranteed-Premium Contracts." Now you know why we call it "Universal Life." The issues paper addressed certain questions that had been the subject of debate in the accounting and actuarial professions when the FASB extracted the existing accounting guidance in Statement No. 60. This extraction process took place in 1982. With the Board considering the issues paper on Universal Life, the project was expanded to also consider two other AICPA issues papers that had arrived at the Board, on (1) accounting for premium deficiencies and (2) loss portfolio transfers. The project was added to the Board's agenda in February 1985.

Following the Board's decision to add the project to the agenda, the Board directed the staff to form a broadly-based advisory group from the insurance industry and the actuarial and accounting professions. The Advisory Group members were selected with malice aforethought. We were not trying to select people that we thought would disagree with the staff time after time. We sought and obtained what we think is a rather diverse group with very differing views on how to account for Universal Life products. The staff met with the advisory group in May of 1985. Following that meeting, there were two educational presentations made to the Board, one by representatives of the Institute's Insurance Companies Committee and one by representatives of the ACLI. The staff presented its initial views to the Board in October of 1985, and then pension accounting came, and the Board cleared its agenda to make sure that the pension documents would get out by year-end. So these efforts resumed in January. General Board meetings regarding the existing accounting model for long-duration contracts and the issues raised by Universal Life type policies continued through March.

Tentative Decision to Date

I would like to review with you the tentative decision that the Board has reached. The operative word in that sentence is "tentative." The positions of individual Board members can and do change between the early development of a project, the exposure draft stage, and the final FASB document.

The Board's first tentative conclusion relates to the scope of the project. In that regard the Board has tentatively concluded that the existing accounting *model for long-duration traditional life contracts should not be reconsidered* at this time. The traditional life contracts include those that have terms that are both fixed and guaranteed and with premiums that are collected over substantially the same period that benefits are provided.

In many respects, this first decision is the most significant. Many commentators have suggested that flaws exist in the current accounting model and not just when enterprises start trying to account for Universal Life policies. Keep in mind that Statement 60 was the result of the FASB's extraction process, a process designed to codify existing specialized accounting and reporting principles from various AICPA statements of position and audit guides. Board members assented to the issuance of Statement 60 on the basis that it was an appropriate extraction of existing specialized practices and principles. A comprehensive review of those principles was not contemplated when the Board went through its extraction process. In one respect, this is really the first document out of the extraction process that the Board has been asked to re-examine in some detail.

By deciding to leave the Statement 60 model intact for those traditional products, the Board did not necessarily reject the views of those who suggested that model is flawed. Rather, the Board decided the current project should have a narrow focus and, accordingly, address only the accounting problems caused by this new generation of life products.

While agreeing to not reconsider the traditional model, the Board did tentatively reject the composite method that had been suggested in the AICPA and American Academy papers. Board members have concluded that approaches that allow income to emerge as a percentage of premiums are not appropriate for Universal Life products. In rejecting that method, Board members pointed to the significant discretion that many new contracts grant to both the insurance enterprise and the policyholder. Several Board members also expressed the desire to measure the liability for future policy benefits in a manner more consistent with the definition of a liability that the Board came up with in its conceptual framework project (FASB concepts Statement No. 6).

Discretion Is the Key

With Statement 60 accounting left intact for traditional products, the next question dealt with the characteristics of products that would receive accounting treatment different from Statement 60. Board members accepted the staff recommendation that the dichotomy should focus on the contractual relationship of the insured and the insurer. The Board concluded that the project should address only those policies that grant discretion to either party.

Examples of discretion include policies that allow the insurer to vary amounts charged or credited to policyholder accounts or that allow policyholders to vary the amount or timing of premiums paid. Discretion does not equal flexibility. A Universal Life product that credits interest of some external index such as the one year constant maturity treasury rate is flexible, but there is no say in the payment -- it's linked to an index. Discretion focuses on the ability of either party to alter part or all of that contractual arrangement.

Liability Measurement

Initial Board attention has focused on the liability measurement. In this respect the Board has tentatively accepted the retrospective deposit method for contracts that meet the scope definition. However, the contract value is the minimum value. The Board recognizes the insurance company has committed itself to a long-duration contract. The company cannot cancel the contract. It must provide insurance protection, a mortality benefit, for an extended period as long as the insured performs by paying a premium or by having sufficient contract value to keep his contract operational. When evidence indicates that the term of the policy will lead to a liability that is greater than the balance of contract values, some additional amount of liability will need to be recorded.

The tentative conclusion on the retrospective method and this additional liability recognizes an observation made by both supporters and critics of this method. The retrospective method can be "form-driven" and could, in some circumstances, result in a contract value liability that is not indicative of the probable future sacrifice to which the insurance enterprise is committed.

DPAC Amortization

Currently, the Board and the staff are addressing the other side of the balance sheet, i.e., how to amortize the deferred acquisition costs. By selecting the retrospective method as the principal means for liability measurement, the Board has effectively decoupled the measurement of the liability and DPAC that is synchronized in the Statement 60 model. Thus, accountants and actuaries are left with a need to develop a means to amortize the DPAC balance. Amortization of costs incurred for a service-type contract or financial instrument has been a difficult problem for accountants in many industries, and we suspect that DPAC and the accounting for surrender charges will present similar concerns.

Expected Timing of Project

The decisions reached by the Board to date are obviously only a portion of this project. Board meetings are likely to continue through the summer. Areas that remain to be explored in this portion of the project include (1) the accounting for single premium products and limited payment products, (2) how to account for internal replacements, (3) what the income statements display should be and (4) transition methods, as well as the property/casualty issues which I will briefly discuss. If things go well, the staff anticipates having an exposure draft out in the fourth quarter of this year, with a final standard likely in 1987.

Criticisms of Present Course of Project

Some have maintained that the Board's approach will lead to erratic earnings patterns and is not "conservative." It is true that the traditional GAAP model for long-duration contracts is very much income-statement driven. The model is characterized by a careful and steady matching of costs and revenues, a smoothing of the effects of annual variations or quirks of plan design, and a measure of conservatism through adverse deviation (a notion of conservatism unique to the insurance enterprise). One of your actuaries summed up an approach by stating that the problem with Statement 60 is that you first define income and then work backwards, rather than the other way around.

In my view, the Board has not abandoned matching. The Board has attempted to move toward a measure of liability that is independent of expected net income. Net income is defined in the Board's conceptual framework as a residual *derived* from changes in assets and liabilities. If net income is to be representationally faithful to that concept, then the assets and liabilities must be measured from year to year in terms of probable future benefit and probable future sacrifice.

Admittedly this shift in a view of net income from a smoothing and constant percentage notion may produce variability in reported net income. It's not intended to do so. The net income number is intended to present the accounting results from a contractual relationship of the parties. Stability and steady growth of reported earnings are management objectives that accounting should measure. They are not objectives of the system of generally accepted accounting principles.

Property/Casualty Issues in the Insurance Project

The majority of my remarks have focused on the Universal Life project. I am going to briefly discuss the casualty issues just so that you are aware of them. We have not spent a great deal of time on the casualty issues. We had one meeting back in October, and we are likely to have another meeting soon.

Premium Deficiency Calculations

The second portion of the insurance project deals with how the time value of money should be considered by enterprises in determining the existence and magnitude of a premium deficiency. For many years property and casualty (P/C) companies were able to price short-duration contracts to provide underwriting income. As both competition and short-term interest rates increased, the role of investment income and product profitability increased. Cash flow underwriting became prevalent, and that exacerbated the situation.

Until the recent dramatic rise in premium rates, more and more insurers appeared to be relying to an increasing degree on investment income in addition to premium revenue, to provide returns on policies. As a result, the inclusion or exclusion of the time value of money would be a significant factor in the ultimate determination of a product's profitability.

The accounting issue involved is whether an enterprise should consider the time value of money, and if so, whether the time value should be considered by determining investment income that will be earned during the settlement period or whether the liability should be discounted. Regardless of which method is used, what is the appropriate investment rate or discount rate to use?

The Institute, in its issues paper, proposed that the time value of money be considered in such a computation and proposed that the enterprise use a future investment income approach, that is, determine the amount of investment income the enterprise is likely to earn during the claim settlement period. The anticipated investment income will be calculated based on net cash available from premiums in force at the expected total portfolio rate.

Loss Portfolio Transfers

The last portion of the insurance project relates to the accounting for loss portfolio transfers. Reinsurance in the life and the P/C area has expanded from a risk-sharing concept to a technique enabling an insurer to achieve a variety of goals. While an insurance enterprise can continue to utilize reinsurance as a means to spread undesired concentrations of risks, reinsurance recently has been used as a financing vehicle or as a means to enable enterprises to meet regulatory capital requirements. Some reinsurance arrangements have resulted in favorable federal income tax consequences, although CFOs insist that the tax advantages were always a by-product and never the primary reason for initiating the contract. Reinsurance transactions that achieve more than the traditional transfer of underwriting risk attracted national attention when *Fortune* reported on the Fireman's Fund-INA transfer.

The guidance proposed by the Institute would establish various criteria. If a treaty failed any one of those criteria, the transaction would be considered a financing. However, the treaty's meeting all those criteria does not necessarily mean that it is a reinsurance transaction. There are a lot of double negatives in the guidance.

I want to follow up on one thing that Wayne didn't touch on. On the surface, it would not appear that it would affect insurance companies. The SEC staff recently issued an SAB on the "Purchase Accounting for Loan Loss Reserves and Bank Acquisitions." Basically, when bank "A" acquires bank "B", except for very limited situations, Bank "B" is presumed to have made a faithful evaluation of its loan loss reserves. If bank "A" comes in and has a different idea of how collectable those loans are, it cannot be run through the purchase accounting. It needs to be run through somebody's income statement -- either the acquired institution prior to the acquisition or the combined institution after the acquisition. Purchase accounting is not going to be used as a means to hang up a bunch of debits that should have been run through the income statement. There is a very short jump between this and P/C reserves in terms of faithful representation. The commission staff will not admit that it will be applied to P/C companies, but the potential is out there.

DEFERRED TAXES

With regard to income taxes, we are getting very close to an exposure draft. (We have been saying that for nine months now.) The project came to the Board because everybody was upset about deferred taxes. Deferred credits are growing and growing, nobody is going to ever pay them and they are making financial statements misleading. So we started looking at it. All of a sudden a flood of comment letters came in saying that comprehensive basis of accounting or deferred tax accounting is not all that bad. After analysis of the comment letters and discussion of the issues, the Board has decided to retain the comprehensive basis of accounting. So deferred taxes are here to stay.

However, there is a change from the deferred method to the liability method. The liability method calls for companies to establish a liability for their cumulative temporary differences times the tax rate. But, those timing differences will reverse. The major change to insurance companies has to do with the accounting for taxes on policyholder surplus. Under APB Opinion 23 the companies did not have to provide deferred taxes as long as they were able to indicate that they had the ability and the intent to indefinitely defer taxation of such amounts. The 1984 Tax Act effectively capped the policyholder surplus account, but a number of companies have rather large numbers floating around out there. Now, in line with the liability method that the Board has adopted, deferred taxes will need to be provided for on this amount of policyholder surplus. The Board's reasoning is that a liability has been incurred. The timing for the payment of that liability is some point out in the future, but the liability has been incurred today by the enterprise making income. The government stands in line before the shareholders with respect to getting that amount. And so, to report this amount in the policyholder surplus account, in the Board's opinion, results in an overstatement of equity.

Having said that, there are similar situations that are discussed in Opinion 23. One of those has to do with bad debt reserves of savings and loans, where there are some big numbers floating around. The question had to do with transition. Do you grandfather all this prior stuff? Certainly with regard to the insurance industry, grandfathering would take care of it, because the account is capped. What the Board has done, at this stage, is decided to delay the effective date for insurance enterprises until 1991.

FASB'S DUE PROCESS

Because of the insurance project, taxes, and, in the next few months, "stock comp" and cash flows, consolidations, and other projects, I thought it would be useful to just spend a couple of minutes on the Board's due process. The Board operates, as we say, in the sunshine, with all meetings open to public observation. One of the most important parts of the Board's process in developing accounting standards has to do with the comment letters that are received at various stages of a project, whether that be in response to a discussion memorandum or whether it be in response to an exposure draft. I would encourage your companies to respond to the FASB documents. In doing so I would suggest that the response be a somewhat reasoned response and not an emotional one. This is partly because I have 800 comment letters on the loan fee project, all written by savings and loans saying that "you are going to destroy the economy by this document." The Board has been subjected to letter writing campaigns on a number of projects, and those lose their value after a while. In the exposure process, the Board is not looking for a popularity vote. What it is looking for is reasoned responses to potential problems in the standard. Has the Board gone off-base? Has it made it too broad, too complicated, or too narrow? Are there any landmines out there? Are there any huge implementation questions that we haven't considered? Are there any huge cost implementation questions? Is it worth the cost?

DINGELL COMMITTEE

Lastly, I would like to address the Dingell Committee. When it started, Dingell's focus was on the role of accountants. That was followed by some of the failures or near failures of institutions -- the Drivesdale, the Continental Bank, the Butcher Banks -- those situations where, shortly after accounting firms had issued unqualified opinions, the enterprises had financial difficulties. The committee was pursuing that for a while, and all of a sudden ESM and Beverly Hills Savings and Loan hit, and it really got off the track in terms of its initial focus. Then it started hammering on the savings and loan industry. Then the "Agg Banks" started having all their problems, and the regulators came to Congress and said, "Don't do anything, because we have all these nifty tools to get these people through their troubles." One of the tools is the Board's Statement 15 on trouble debt restructuring. We then have to testify on how Statement 15 worked.

This being an election year, I am not sure how much further the Committee is going to get because I think its attentions is going to be directed towards electioneering and the tax bill. Things that are likely to be on the agenda include (1) the role of consulting services and accounting firms, (2) some self-review initiatives that some of the firms have proposed and (3) defense contractor accounting. After that it may get into insurance accounting.

CONCLUSION

I hope the preceding summary of FASB projects and other things we have been doing has been helpful. Again, I would urge you to comment on the various exposure drafts that are going to be coming out of the printing press soon. As I mentioned earlier, because we do have a lot of projects on the agenda and because your interest in them may vary, I would welcome any questions, not only on the insurance project, but other projects at the Board.

MR. JOSEPH LEONARD TUPPER III: With regard to Schedule G changes, it looked like a schedule of fees for Part 1 was still in there, but Part 2 was eliminated.

MR. SUNG: I do not know what the final outcome was at the June meeting, because it was just held. My understanding is that the proposal went through.

MR. TUPPER: My question stems from a preprint of Proposed 1986 Blank that was circulated recently.

MR. SUNG: The Association Fees are still there. I am talking about the salaries in general.

MR. TUPPER: Yes, the salaries looked like they were gone. I have another question. There seems to be a real problem with current taxation of the surrender charge on back-loaded Universal Life products. In the early years of the contract, there appears to be a lot of income generated by the premium. This is because the CRVM reserve is extremely small in comparison to the accumulation account, and in the early years the back-end surrender charge makes the cash value virtually zero. The effect in the later years (say, 5 to 10 years down the line) is a massive jump in the cash value. Suddenly there's a massive tax expense in the change of reserves. Therefore, we have a refund in the later years of the taxes that we have been paying in the early years. But, because we paid them early, they aren't there to invest. In effect, the problem is one of a current loss on policies that are not lapsing. How should we be reflecting this current taxation (which is, in effect, future income) in our statements? It's a prepayment penalty. We are paying tax now for future income, because we are being told in the tax rules that the surrender charge on a continuing policy is current income.

MR. SUNG: From the statutory point of view, I don't think there is a deferred tax. It is not allowed in general. I do not know about the GAAP point of view.

MR. SEVER: I am not sure I can intelligently respond to your question. It seems, though, that the timing difference will reverse within a number of years.

MR. TUPPER: If the policy lapsed early it would not reverse. It is only if the policy continues that it will reverse. There is the interest loss in the meantime.

MR. KAUTH: I don't know how the Universal Life accounting model is going to pick that up. But, there is a general prohibition against setting up anything that looks like a deferred tax asset, since that one notable case appeared a year or two ago.

MR. SEVER: There's going to be a *real* prohibition after the income tax hearings.

MR. KAUTH: I don't think you'll be entitled to a net tax asset. Therefore, I suspect your income statement will suffer the consequences of this negative cash flow as a result of an early tax payment, which may or may not get refunded in a later year.

MR. BENJAMIN GEORGE PETERS: Why was it found necessary to make the proposed changes to Page 6?

MR. SUNG: It was not the industry's proposal. It is the state regulators' proposal. They are really concerned about the reinsurance transactions. In the past some companies have been misusing reinsurance transactions to hide their true financial status. State regulators have a very uneasy feeling about any kind of reinsurance transactions. So, if they have more information, they think they have more tools.

MR. LEER LAMBERT: This concerns the accounting for Universal Life. Having separated the liability and the asset into two different pieces, I would like Mr. Sever to comment on some of the possible directions the amortization of the deferred acquisition costs might go.

MR. SEVER: Under the Statement 60 model, premiums are deemed to be revenue or a surrogate for revenue. Under the Universal Life Products, the margins are the revenue streams. We are exploring situations where the DPAC would be amortized in some sort of relationship to the emergence of those revenue streams. One of the big stumbling blocks that we have seen in some products is that the DPAC tends to *grow* in the early years. This is due to the interest accretion that is sort of subtle in Statement 60. However, it blows itself out of the water in Universal Life, because the margins in the early years are so small. Everybody's notion of amortization tends to be "to make smaller," as opposed to "to grow." Letting it defer charge, because the DPAC is growing, is very troublesome to some Board members. Other Board members view it as a receivable on which interest accrues. We tried the margin approach at the May 28 meeting. We are going to come back to the Board on June 25, and to try and resolve DPAC amortization, but I would suspect that is going to be somehow margin related.

MR. LAMBERT: Do you see the possible removal of interest completely in the amortization?

MR. SEVER: There's a 50/50 chance. The Board, next Wednesday, will be discussing the accretion of nonmonetary assets. Now, certainly under Statement 33, DPAC is considered a monetary asset because it is so tied in the calculation to a monetary liability. The Board may prohibit interest accretion on nonmonetary assets, such as lease residuals. The Board tries very hard to have consistency in accounting principles. To allow interest accretion on DPAC and prohibit it on something like the lease residuals I think will trouble some Board members, unless they can jump to the notion that it's somehow a receivable. A lot of us at the staff view it as a prepaid expense, a charge that should not grow.

MR. PAUL J. OVERBERG: Is the Board considering the use of discounting on the deferred tax liability?

MR. SEVER: The Board specifically scoped out the discounting issue from the income tax project. This was partly because we wanted to get an ED (exposure draft) in this century and partly because the institute has a discounting project in place. Some Board members feel that income tax liabilities are already discounted. The implied discount rate is zero. If you want to pay them off, Uncle Sam does not give a discount on them.

MR. NORMAN E. HILL: I'd like to pursue this question of amortization. Is the Board concerned about this question of interest on the unamortized balance? Did you imply that there could be instances of total negative amortization? These are two different things. On one hand you can have a situation where there's interest growth on the unamortized balance, but you still have positive overall amortization. On the other hand you can have situations that we can dream up where there is actually negative amortization. I wasn't clear on which one was troubling the Board, one or both.

MR. SEVER: I think that one comes out of the other.

MR. HILL: But they are not the same.

MR. SEVER: We have seen situations where the interest accretion is more than the amortization. As a result, the DPAC grows. We are focusing on whether there should be interest accretion to begin with. Because of the present value mechanics of Statement 60, you have to have the interest accretion on the deferred cost. But, with that decoupled, I am not sure you do.

MR. JAMES D. WALLACE: A number of the members here are with mutual companies, and a number of mutual companies are generating internal statements based principally on GAAP. And, while I know the FASB will not cover GAAP, most of the business, obviously written by mutuals, is participating business and is similar to Universal Life, some would say. Has the Board given any thought to whether or not the new statement covers participating business for a stock company?

MR. SEVER: Right now the amendment to Statement 60 would address policies that grant discretion. Statement 60 applies only to stock life companies. Mutuals are excluded. So in that respect mutuals would not have to follow the accounting guidance. To the extent that a stock company issues participating business and if the policy provides for any degree of discretion, such as in crediting rates, then it would fall within the project. We understand (this is something that would help us in the exposure comment period) that par business is not that big a deal for stock companies. To the extent that mutuals would be demutualized, we may be walking on a land mine.

MR. RICHARD S. ROBERTSON: I'm a member of your Insurance Advisory Committee. My question is, Are you ever going to ask for our advice? Your last comment disturbs me greatly. Participating business is *very* significant in many stock life insurance companies.

MR. SEVER: We have throughout the project consulted with some members of the Advisory Group. We have had some of those people appear at Board meetings. We have had other members of the industry present their defense of the composite method or other methods to the Board. Right now we are planning on some sort of mini-exposure to the Advisory Group prior to the document's going out to the general public. Whether we would have an Advisory Group meeting in Stamford has not been decided at this point.