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CURRENT TOPICS IN FINANCIAL REPORTING

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- o Report on Financial Accounting Standards Board (FASB) project on accounting for Universal Life
- o Update on American Institute of Certified Public Accountants (AICPA) activities
- o Report on Canadian financial reporting issues
- o Update on FASB and National Association of Insurance Commissioners (NAIC) activities, including:
  - 1986 Annual Statement requirements
  - Securities valuation issues
  - Valuation actuary

MR. GEORGE R. WALLACE: The current financial reporting scene for life insurance companies in Canada provides a natural subdivision into two general categories: the development of solvency standards for life insurance companies and the considerations impacting income statement reporting. Although there is a tremendous amount of activity in both these areas, virtually all the work is still at the development stage. Final conclusions have not yet been reached or agreed upon. It is hoped that agreement will be reached in the not too distant future, but at present we can only consider the situation in its present state.

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In the area of solvency standards, the most concrete development has been the design of a formula for solvency testing by a Committee of the Canadian Life and Health Insurance Association. This formula was designed for the purpose of setting acceptable standards for companies in anticipation of the introduction of a Policyholders Compensation Plan. Although the present formula is expected to be the final one, it is yet to be tested over a period of years by individual companies. By this time, the industry association should have received the test results as compiled by the various companies, and if satisfactory, it is the intention to officially submit this formula to the regulatory authorities in the hope they can see fit to adopt it. It is anticipated that legislation will be introduced to give the Superintendent of Insurance-Canada the authority to establish such a formula by regulation.

The presently designed solvency test formula is of the add-on type, calling for additional amounts of surplus over and above actuarial reserves as reported on a statement basis. Failure to meet the standards set out by the formula would provide an early warning which, it is hoped, would provide a signal long before a company got into serious financial difficulty.

Before proceeding to consider the general outline of the solvency formula, it is first necessary to consider the type of actuarial reserves to which this would provide supplementary security. As I am sure most of you are aware, actuarial reserves in Canada are not prescribed by law, but are the responsibility of individual Valuation Actuaries for the various companies. Certain limitations are included in the law, such as the deferrable acquisition expense limitation of 150% of one year's premium. The primary guidance received by Valuation Actuaries is from the Recommendations and Explanatory notes of the Canadian Institute of Actuaries.

In this connection it is useful to note that actuarial reserves for statement purposes are not intended to cover:

1. Abnormal adverse deviations from expected.
2. Catastrophic events.
3. Major unexpected alterations in mortality or morbidity.

It, of course, follows that the additional margins required to cover these contingencies must come from capital and surplus. Accordingly, the formula which has been developed for minimum capital and surplus has specific provisions to cover such contingencies with respect to these additional mortality and morbidity risks. Other specific provisions deal with the interest margin (C2) risk, the asset default (Cl) risk, as well as the risk covering changes in the interest rate environment (C3). It is recognized that a general formula of this nature may or may not provide for such elements as catastrophes, war, changes in legislation, etc., for a particular company, so that additional surplus may very well be required.

At this juncture, it is interesting to note that the proposed formula is rather similar in form to that adopted by the European Economic Community. As well as proposing a formula for minimum capital and surplus, the industry Committee made various recommendations. Among these recommendations is that the Canadian Institute of Actuaries be encouraged:

1. to develop solvency standards for insurance companies;

2. to consider the desirability of requiring actuarial certification of the adequacy of capital and surplus, and

3. to consider the feasibility of an actuarial certification as to the likely ability of the assets to meet the liabilities in a timely manner.

I am pleased to report that at least a year prior to the emergence of these recommendations, the Canadian Institute of Actuaries formed a Committee to study solvency standards for insurance companies. Based on the reports of this Committee to date, it has been tackling the problem of developing standards which would take into account various future scenarios, including new business levels, and, thus, have a dynamic rather than a static system for testing solvency. The Committee has been addressing the problem of establishing standards which take into account individual company factors such as:

1. the level of matching of assets and liabilities,

2. underwriting standards,

3. the distribution system and market, and

4. retention levels.

In addition, there remain the general problem areas of mismanagement, catastrophe, war, etc. Representatives of this Committee will be reporting on their program at the Symposium for the Valuation Actuary to be held in Washington in October 1986. I would certainly expect at that time we will get more up-to-date and detailed information as to the direction of their research and deliberations.

Turning now to the income statement -- and, in that context, I might say we are really talking about actuarial reserves for income statement purposes -- we should first review developments which have occurred over the last few years as a background to the current situation. Some five or six years ago, a joint task force was set up consisting of equal representation from the Canadian Institute of Actuaries and the Canadian Institute of Chartered Accountants (CICA). This task force was formed in order to try to agree on a basis of GAAP reporting for Canadian Life Insurance Companies which would also be acceptable for regulatory purposes.

One has to be impressed by the dedication and open-mindedness of the various individuals who comprised this Task Force, as, in fact, they were able to produce a set of recommendations on which they could agree. These recommendations were then submitted to the respective professions for their consideration. As far as reserves are concerned, two important changes were introduced by the Joint Task Force. The first was the elimination of the deferrable acquisition expense limit for reserve purposes amounting to 150% of one year's premium.

The second provided that, on a change in reserve basis, the ending reserve on the old basis would be the starting reserve on the new basis, and future net valuation premiums would be calculated using revised assumptions, taking into account the ending reserve on the old basis. This had the effect of providing a smooth transition from the old basis to the new basis as long as a policy was in its premium-paying period. For single premium or paid-up policies, of course, a discrete change could not be avoided. The general theory behind the proposal was that profits should emerge during the premium-paying period, and the change in assumptions would merely serve to change the amount and incidence of such profits. The proposals of the Joint Task Force were then submitted to both professions. On the actuarial side, the proposals were submitted to the Financial Reporting Committee of the Canadian Institute of Actuaries for study and comment. The Financial Reporting Committee studied the proposal for a considerable period, and as time went on, there was a growing feeling of uneasiness with the proposed method. Several alternative methods were studied, and finally one method emerged which had the support of a majority of the Committee.

The important theoretical change introduced by this method was to recognize that a life insurance company is performing two fundamental functions. One is risk-taking and the other is marketing. Therefore, with respect to risk-taking, profit should be taken into income under the familiar release from risk concept, after providing initially for adverse deviations in the actuary's choice of valuation assumptions. Then any additional profit available in the premium should be taken into income at point of sale, rather than over the premium-paying period, recognizing the marketing function. In practice, the method is similar to net premium valuation methods which include provision for all future benefits and expenses, but substitute the actual policy premium for the net valuation premium. By this substitution many problems are avoided. It is no longer necessary to make decisions as to which acquisition expenses are amortizable. In fact, development expenses incurred in the creation of the policy could be immediately recovered as well, if sufficient provision is made in the premium.

The actual limitation on the amount of profit which can be taken is, of course, dependent on the margins in the premium, and it is very easy to visualize the situation where virtually all of the margins contained in the premium are used up in providing for adverse deviations, in which case, no profit would be front-ended. Indeed, it is quite likely that a loss would be incurred if insufficient margins are available. As experience emerged, profits would normally occur as risk was released. Time does not permit further explanation of the method at this forum, but I would refer those interested to the Symposium for the Valuation Actuary in Washington in October 1986, where a full presentation of the method and the reaction to it by the accounting profession will be made. At this juncture it is important to note that the policy premium method was recommended by the Financial Reporting Committee to the Council of the Canadian Institute of Actuaries. This method was accepted as the official position of the Institute for use in GAAP statements, provided suitable surplus appropriations are made, as required, for solvency requirements.

As recently as last week, the Accounting Standards Board of the CICA has endorsed the policy premium method for inclusion in its exposure draft outlining GAAP for life insurance companies in Canada. At the present time, the policy premium method is under consideration by the Department of Insurance-Canada.

Assuming agreement can be reached as to an appropriate method for actuarial reserves under GAAP in Canada, this will be but the first step in the process. Solvency standards need to be put in place. Disciplinary procedures need to be improved. Regulatory agreement will need to be obtained. Much work needs to be done in narrowing the range of actuarial assumptions. The original recommendations set out by the Financial Reporting Committee of the Canadian Institute of Actuaries in response to the 1978 legislation providing responsibility to Valuation Actuaries were necessarily broad in nature. But as time goes on and experience emerges, it is obvious that the apparent freedom under these recommendations needs to be subject to stricter definition by the profession in order to maintain credibility due to the current wide divergence of results.

The Superintendent of Insurance-Canada has expressed general concern to the profession regarding specific areas of practice. In order to preserve the principal of freedom within an environment of self-regulation, the Financial Reporting Committee of the Canadian Institute of Actuaries has evolved a concept of technique papers setting out quite precise standards to be used for specific reserving problems.

To date, there are five such technique papers in various stages. The first paper on Lapse Supported Products has been introduced and is in effect. The second paper dealing with the Valuation of Renewable Term Products has been exposed, and it is anticipated it will be in effect for year-end 1986. The third paper on Reinsurance is expected to be exposed in early 1987. A fourth paper on the Valuation of Adjustable Premium Products is expected by mid-1987. The last paper dealing with the Choice of Valuation Interest Assumptions and considering the broad subject of Asset/Liability Matching, will probably not emerge until late 1987.

Having a framework in place in which the individual actuary can exercise reasonable judgment, it is then necessary to have some mechanism in place by which it can be demonstrated that the standards of practice are adhered to. Improved discipline procedures are required, and this will be the topic of a discussion at the November 1986 meeting of the Canadian Institute.

In the meantime, the Financial Reporting Committee is devoting its energies to the problem of providing more specific guidance in the area of Margins for Adverse Deviations under the proposed method of GAAP accounting. I am pleased to report that significant progress is being made in this difficult area.

A good deal of progress has been made due to the time and energy expended by many individuals both within and outside the profession, and we are, perhaps, now at the point where we can look to the future and see the general shape of a financial reporting structure in Canada. This structure would have an income statement which will properly reflect the operations of the specific period, while at the same time standards for solvency will be in place which will be sufficient to continue the tradition of stability which the industry can look to with justifiable pride.

MR. WILLIAM J. SCHREINER: I think Mr. Wallace's summary shows two things: the similarities of the problems that the Canadian industry and profession is attempting to grapple with and the very different solutions, particularly for GAAP, that Canadians seem to be reaching in comparison to the United States Financial Accounting Standards Board.

I will describe NAIC activities for the past 6 months. I think that, clearly, the reformatting of the 1986 life blank to facilitate data capture is the most significant NAIC financial reporting innovation of the year. Essentially all of the pages and exhibits in the statement have had their blank lines purged and, in their stead, aggregate write-in lines with detailed disclosure of the contents of those write-in lines in special exhibits on each page are being provided this year. As part of this effort, fixed positions for variable life insurance and other lines of business are now provided. And it is important to recognize that these are not new requirements -- these are only the fixing of positions of formerly indicated optional reporting. With respect to variable life insurance and other lines, the appearance of these requirements in the 1986 blank does not imply a new reporting requirement in comparison to 1985 and prior.

Tied to the appearance of the new format will be a requirement that will apply to virtually all companies that do business in either New York, New Jersey or Texas. These companies will be required to submit diskette versions of their annual statements, in addition to paper copies, to the NAIC office in Kansas City. Also, at least New York and Texas will require similar dual filings with the State Insurance Departments. New York has already mailed a notice of its requirements to its companies, and New Jersey and Texas are expected to do so in the near future.

Highlights of the key changes of the 1986 blank include a new requirement to classify deposit funds into one of three categories: guaranteed interest contracts, other contract deposits funds, and policyholder premiums. Also, withdrawals will be netted against premium or deposit income in very limited circumstances. Annuity surrenders or withdrawals will be reported as such. Also, if deposit income is reported, the gains from operations will now provide for reporting the change in the deposit liability. The objective of these changes is to provide more consistent reporting among companies and to highlight the extent of the insurer's annuity obligations. There also has been a modification to Interrogatory 21 to provide disclosure for the transfer of assets with put options. A new Schedule D, Part 1B was added to provide a summary display of bond investment quality. In addition, the jurat page was modified to require identification of the primary location of the company's records. Also there are standardized reporting requirements now for reporting activity with respect to uninsured accident and health plans. Not surprisingly, various changes to Schedule S were adopted -- including a new column for the effective date of reinsurance contracts and the separation of affiliate and non-affiliate transactions. In 1986, the actuarial statement for participating business in Schedule M will be applicable to stock as well as mutual companies. Also, a disclosure of interest rate swaps in the Notes was adopted.

Now that's a long list of things to add to the reporting requirements of the Annual Statement, but there were some things that were eliminated. First, Part 2, showing salaries, of Schedule G, was deleted. No longer will salaries be shown in the 1986 statement. As a quid pro quo, the schedule of examination fees and expenses of the insurance departments was deleted. Reporting requirements for Schedule D, Part 3, which identifies long-term bonds and stocks acquired during the past year, were modified to permit summary totals for unaffiliated entities. In addition, the credit life and accident and health insurance section of page 46 was deleted. Those are the major changes, plus and minus, in the 1986 Annual Statement.

In turning now from what has been accomplished to the work in progress at the NAIC, let me identify a few items that are currently being worked on. There is a financial reporting working group that is focusing on affiliate transaction reporting; the group is currently considering a proposal for a schedule of summary information with respect to affiliate transactions. The group is also considering a separation of affiliate assets and liabilities on pages 2 and 3. There is a life reinsurance study group that is considering a revision of page 5, analysis of operations by line of business, to separately show key items of direct, ceded and assumed business. There is also a deposit-type business study group. This group has two items on its plate. The first is the development of a guaranty fund assessment base data source -- perhaps in connection with the Annual Statement. It is also considering a revision to Exhibit 10 which would provide information on liabilities in connection with deposit-type business.

On the valuation of securities side, there are two key activities at the present time. The first is a study of Schedule BA assets. Questions have been raised about the valuation of the miscellaneous assets held in Schedule BA, so a study group has been formed to, first, identify the types of assets that are held in Schedule BA and, second, to appraise current statutory accounting for such assets and then, if necessary, to make recommendations for changes in the valuation of such assets. Also, a study group is being formed to assess the bond rating criteria used by the NAIC's Valuation of Securities Office with respect to non-public bonds. The current criteria were developed in 1950, and there is sentiment for taking a new look at them in the light of the current insurance company interest in high-yield securities. Of course, the major impact of any changes in bond rating would primarily be felt by life companies in their mandatory securities valuation reserve requirements.

Now I would like to briefly note some things that have taken place on the valuation actuary scene. Perhaps the key result on the valuation actuary front in recent months was the action in September 1986 of the Board of Directors of the American Council of Life Insurance. It approved a task force report which called for the strengthening of the role of the valuation actuary by the profession and through regulatory requirements. In addition, the ACLI would support regulatory requirements that would require companies to appoint a valuation actuary and that would require a public statement of actuarial opinion as to the adequacy of the reserves of the life insurance company. However, there were several caveats attached to the Board approval. They include opposition to any regulatory requirement that the valuation actuary report on the adequacy of the company's surplus; that appropriate exceptions should be made for products where the volume of business or the nature of the risk indicates that testing is not warranted; and that the standards for determining the standards of practice should be controlled by the actuarial profession, rather than the regulatory community. The Board also sought relief, at the time any valuation actuary requirements were initiated, from any existing regulatory requirements for items that would be made obsolete by the existence of valuation actuary. It would appear to be fair to say that the Board's adoption was less than totally enthusiastic, as many believe that a convincing case of the value added by the valuation actuary versus its cost has yet to be made.

Other valuation actuary items include the continuing work of the Society of Actuaries Committee on Life Insurance Company Valuation Principles on its Exposure Draft of Life Insurance Company Valuation Principles. A second draft has been produced, and it appears likely that additional revisions will be made in that document.

The Academy of Actuaries has developed a draft of Recommendation 7, regarding actuarial opinions, that could be applicable on adoption of valuation actuary opinion requirements.

Also, an industry advisory group has been working with New York to develop proposed regulations that would implement the valuation actuary concept with respect to annuity business. The proposal includes a two-tier approach which would require a higher level of reserves if a satisfactory actuarial opinion is not obtained.

And finally, the NAIC adopted actuarial guideline 14 which advises regulators that they may wish to request an actuarial opinion during the course of their examination of a company.

MR. WAYNE KAUTH: Deferred Taxes are a very hot topic, as is the current tax bill. There is a lot of confusion now because there are two things in the drafting stage -- we almost have a new U.S. tax reform bill, and we have a FASB exposure draft that was released about a month ago on deferred tax accounting which is going to be a major change for everyone. It is the interaction of these two that causes some confusion and, I'm going to switch back and forth between them during my presentation.

Assuming these two situations both become effective, the tax reform act of 1986 and the FASB Exposure Draft are going to cause a lot of turmoil in the insurance world, as well as in all other commercial enterprises. They are going to cause some unique and special problems in the insurance industry and, particularly, in the life insurance industry.

The new tax law creates new tax rates that we are going to have to address over the next several years. We will have two different rates in place for 1987, if it is passed as it is now, and then a new rate will go into effect in 1988. Also, we have two different accounting methods that account for deferred taxes. The present one I'll refer to as the deferred method; the one that will probably come into play starting sometime late in 1987 or 1988, I will refer to as the liability method.

Under the deferred method, if there was a tax rate change that went from 46% or 36.8% to 34%, it did not affect deferred tax amounts, except as it affected the timing differences that originated that particular year and in the future years when the new rate was in effect. Under the liability method, those tax rates affect the balance sheet and the income statement immediately.

I think we are going to have mass confusion, but I think I can start off by tempering it a little bit. For those of you who don't have your third quarter 1986 statements out yet; you don't have to worry. You don't have to make any changes in your third quarter statement. They will be exactly as you have been reporting in the first two quarters. As a matter of fact, when you do your 1986 statements, irrespective of what happens to either of these pending situations, for all but a very small number of life insurance companies, there will be no impact at all. You don't have to do anything in your tax provision this year. There is a little bit of an impact if you have a significant amount of investment tax credits and, possibly, if you have some big leasing operations, but other than those types of tax reform situations, it will not affect you for 1986. So you say, why should we be discussing this now? The main reason for discussing it now is to start thinking of where you are going to be, and how you are going to approach it in the future. To the extent you can take advantage of certain planning strategies, you might want to start thinking about them.

We are all anticipating lower tax rates in 1987. And therefore should the President sign the Bill, there is a lot of thought that you could make the 1986 provision or, certainly, the fourth quarter of 1986 provision at a lower rate than the current rate and that is just not so. FASB has a proposed technical bulletin, in Exposure Draft right now, that would prohibit that. So when you do your 1986 tax provision, you will have to do it on the basis of the current tax rate, that being 36.8% for most companies.

Now, let's consider what the two methods do. The deferred method basically tries to do matching in the income statement. Any timing differences that originate or reverse in a period get tax-affected right then, at the rates in effect. Any prior deferred taxes just ride along. The income statement is the *primary financial statement -- the balance sheet just becomes a dumping ground* for what is left over, and it is impossible to analyze it at any given point to understand how it got there, unless you went back and reconstructed it. With the new liability approach, it becomes simpler. All you do at the end of each quarter or each fiscal year is to inventory the timing differences and multiply by the rate then in affect. You subtract whatever balance you get from that multiplication from the balance you had in the preceding balance sheet and that becomes your tax -- your deferred tax expense for the period. That is going to be much simpler, and obviously it's more balance sheet oriented; your income statement will become the repository of your balance sheet calculation.

There are some complications that come in with respect to life insurance companies that come from the small company approach and from situations involving net operating losses. One major change that is coming out of the FASB effort probably is not going to be received too favorably by stock life insurance companies. That is the necessity to provide a deferred tax on the policyholders' surplus account. If enacted in its present form, every company by no later than 1991 would have to set up deferred taxes on that amount. For some companies that could result in hundreds of millions of dollars in liability that will reduce stockholders' equity accordingly. Within the life insurance industry this is obviously a very controversial issue, but one which the FASB seems quite stuck on. If I were a betting man, I would expect that it's going to stay in there, unless there are strong well-reasoned objections.

Incidentally, and for actuaries I suppose this really goes against your grain, these deferred taxes once established are not going to be allowed to be discounted. That is a continuation of the present practice -- FASB has indicated that the discounting issue is going to be put off into a much bigger conceptual framework which the AICPA is working on. The likelihood of seeing deferred taxes on a discounted basis any time in the near future is quite remote.

There has been a lot of controversy over the past several years as to whether you can set up a deferred tax asset. Now when you see financial statements, you mostly see a deferred credit. Accountants, by and large, are told not to refer to that as a liability, but that is how it looks on the balance sheet to anybody reading it. There have been some situations in the past where you could set up an asset. But for all practical purposes, except in very limited circumstances, that asset possibility will be washed away if the new FASB Exposure Draft is approved. I think you can say that you should not see deferred tax assets on anyone's balance sheet in the future.

Under the proposed tax reform, the property/casualty companies are going to have what is referred to as a fresh-start adjustment. In 1984, you remember that the life insurance industry got one of these. In that case, it reduced tax expense and obviously increased net income. Now the provision in the tax bill which refers to a fresh-start for property/casualty companies has led a lot of accountants and others to think they're going to get the same type of treatment -- a onetime boost to their income statement. But unfortunately, the answer is that it is not going to happen. Basically the reason it will not have that effect is that there never were any deferred taxes set up on those reserves. The tax reserves and the book reserves were identical for almost all companies. Therefore, no timing differences existed and no deferred taxes were in place. You cannot take down something that was never established, and therefore, you will not get any relief in that area. I know there is some confusion on this point, and there is nothing in any published literature that would support what I just said. However, the AICPA Insurance Companies Committee met two weeks ago and took a vote on the issue. It was almost unanimous that the large accounting firms and the other firms represented on the AICPA Committee have concluded that a fresh-start adjustment would not produce any increase in the net income for property/casualty companies.

The other thing that will cause some problems under the new tax act, as well as under the FASB proposal, is the alternative minimum tax. If you are a company that ends up paying the alternative minimum tax, it will be treated as a timing difference and carried forward.

A brief word on transition issues relative to the tax act. As indicated previously, there is no effect in 1986. If the tax bill is passed in the fourth quarter of 1986, you will start providing taxes at the new rate in 1987 in your first quarter. If, as anticipated, the FASB Exposure Draft is adopted sometime in mid-1987, it will be mandatory for calendar year companies to adopt it in 1988. Earlier adoption, of course, will be encouraged and permitted.

The Explosure Draft will be adopted in one of two ways. You can go back and restate prior years and put that tax liability on your balance sheet -- for most life insurance companies, we are talking about creating a larger tax liability on the balance sheet. I suspect very few companies right now have what amounts to a 34% tax liability up on their inventory of timing differences, and therefore, a lot of companies may decide to go back and restate it, throw that charge into retained earnings two or three years ago, or at the earliest reporting period. However, if you don't want to go back and restate, you will also be permitted to throw it into the current year's income statement as of January 1, 1988, or whichever year you adopt the liability method.

I would like to cover a few other topics. The first is Accounting for Health Maintenance Organizations. A paper is going to be issued for exposure, and the real issue boils down to: do HMOs have to accrue for situations where the incident has already occurred? For example, if the insured is in the hospital, do you have to provide a liability after December 31 to take care of that entire claim, or do you only have to provide a liability through December 31 of the current year? And the answer in the paper is that you only have to provide it through the current year. That's a tentative conclusion. Obviously, this is in direct conflict with the way insurance companies account for claims for situations where the incident has already occurred. I mention this for your attention because this conclusion would result in two industries that look alike, but would be following different accounting rules. From an informal poll, I think most HMOs currently do follow that practice, although some accrue liabilities much like an insurance company.

Just recently the SEC has issued Staff Accounting Bulletin No. 62. It deals with discounting. It's probably the first time the SEC has tried to clarify what its governing opinion has been for some time. For those of you who have seen registrations go in and bounce, discounting has always been a hot potato. But basically what the the SEC has done is to put in writing what has been its informal policy for years. It mostly affects property/casualty companies, but it could affect companies in the health business to a lesser extent. The Bulletin says that if you are going to discount in the property/casualty field, you can discount it in an SEC filing if you discount only those lines of business which you discount in your statutory convention statements, and if you discount at the same rates that are permitted by those state regulatory authorities. Obviously, a question has arisen for those who have Bermuda captives because in Bermuda you can discount every line of business, at practically any rate. The SEC has not yet taken a position on that, but it is probably not going to permit it. The other items that you can discount would be obviously settled claims, structured settlements and the like.

Also, the SEC is reviewing certain situations in which it will require more disclosure starting next year involving reinsurance commutations. Loss reserve development data will be switched from a calendar-year basis to an accident year basis.

Finally, one last item, which I think you will find interesting, is the Income Statement for life insurance companies. You currently have what is referred to as a two-step income statement. The two-step income statement means you have all your operations on top. You have premiums, investment income, and then following it, you have your benefits and expenses. Then you have your income taxes, and you come down to a line called operating income or gain from operations for the GAAP statement. Next, you have your net realized capital gains and then net income. That is referred to as a two-step income statement because the realized gains, which are a type of income, are down all by themselves. Almost all other industries, including banks that used to have a two-step statement until a couple of years ago, had to move their capital gains up on top of their income statement. The SEC is exploring whether it ought to require insurance companies to start following the one-step income statement.

MR. WAYNE S. UPTON JR.: I am the FASB Project Manager assigned to the Insurance Issues project. Before I begin, let me start out with two disclaimers.

First, my comments reflect my views -- not the official positions of the FASB. The FASB encourages the expressions of views by Board members and staff. Official positions of the FASB are reached only after extensive due process and are published in Exposure Drafts and Statements.

Second, the Board's tentative conclusions that I will be describing are just that -- tentative. The views of the Board members can, and often do change during the development of an Exposure Draft and between the publication of an Exposure Draft and a final Board Statement.

The FASB Project on Insurance Issues came to the Board in late 1984 with the AICPA issues paper on universal life insurance and related issues. The issues paper addressed questions that were identified in 1982 when the existing accounting guidance was extracted into FASB Statement No. 60, "Accounting and Reporting by Insurance Enterprises."

The FASB added a project to address those issues in its agenda in February 1985. The staff began by forming a broadly based advisory group from industry, the actuarial profession, and public accounting. Our advisory group members were chosen, to an extent, with malice aforethought. We intentionally chose individuals who held widely differing views -- unanimity was not our goal. The staff met with the advisory group in May 1985, and we have relied on individual members of the group for advice and information ever since. Now that the Board has reached and covered all the key elements of this project, we will be meeting with the group again.

The Board and staff have discussed this project at sixteen public Board meetings during 1986. I know of no other project that has occupied as many meetings this year. The staff has met with people from outside the Board on fourteen occasions. Given the intensity with which the Board and staff have approached this project, I must admit that I am a bit surprised by the lack of response from FASB constituents. We have received only fourteen letters about this project; all of which have been circulated to the Board members. We have received two responses to frequent requests for asset share information on existing policies.

I would like to review with you the key tentative decisions and a bit of the rationale behind them. I would also like to discuss some of more problematic objections to those conclusions.

The AICPA and AAA both recommended that universal life and similar products be accounted for using the Composite method. This method is essentially an extension of the accounting called for in Statement 60. The method would suggest that the provisions for adverse deviation that would otherwise be made should be increased. Net income would then emerge in relation to management's estimation of risks under the contract, with some income continuing to emerge as a residual percentage of premiums received. Most commentators have acknowledged that the composite method is a compromise between the premium or natural reserve method and the prospective deposit or full release from risk method. This is a compromise that began in the 1970s with development of the AICPA Audit Guide on Stock Life Companies.

After an extensive review of the insurance accounting model, the Board rejected the composite method and settled, tentatively, on the retrospective deposit method. Why the Board took this step can be found in an analysis of 1) the universal life contract, and 2) the elements of the composite model.

The traditional long-duration insurance contracts that were contemplated by Statement 60 and the Audit Guide that preceded it were fixed and guaranteed contracts; the seller possessed any discretion or significant flexibility in the execution of the contract. Universal life insurance and similar products embody substantially different relationships between buyer or seller.

The scope of this project reflects the view that there is a basic economic difference between 1) a contract that provides fixed and guaranteed benefits and terms of performance, and 2) a contract that describes the method of operation and rights of the parties but allows for flexibility and discretion in the amounts charged, credited, and paid. A method of accounting that might be considered acceptable when applied to the former contract might be found unacceptable when applied to the latter. This is in keeping with the closing sentence of the FASB Mission Statement, which states, "The Board believes that this broad public interest is best served by developing neutral standards that result in accounting for similar transactions and circumstances similarly and for different transactions and circumstances differently."

The premium component of the composite model, or for that matter of the traditional model, is similar to a cash-flow or installment sale methodology. Installment methods are sometimes accepted in accounting when evidence suggests that service performed does not vary significantly over time and when the terms of the contract are both fixed and measurable. The premium approach seems to provide a workable bookkeeping device when:

- Required premiums and benefit payments are both fixed and guaranteed by the contract.
- Cash flows from premium receipts are fixed and occur over about the same period that benefits are provided.
- No better, more objectively measurable device exists for the measure of the contract liability.

The design of universal life and similar contracts violates those three conditions.

The release from risk component of the composite method embodies ideas that are unique to life insurance accounting. I know of no other industry that can record something similar to a reserve for adverse deviation and still be in conformity with GAAP.

In a sense, the provision for risk of adverse deviation is similar to the catastrophe reserve or provision for general and unspecified risks that were proscribed by FASB Statement No. 5, "Accounting for Contingencies." (Statement 5, however, does not amend the accounting practices of life insurers.) In another sense, adverse deviation is similar to the implicit assumptions incorporated in actuarial estimates of pension liabilities. FASB Statement No 87, "Employers' Accounting for Pensions," proscribed the practice of using implicit estimates and required that pension liabilities "reflect the best estimate solely with respect to that individual assumption."

Nor can the application of adverse deviation contemplated by the composite method be characterized as an extension of accounting conservatism. Concepts Statement No. 2, "Qualitative Characteristics of Accounting Information," indicates that conservatism is "a prudent reaction to uncertainty." The Concepts Statement goes on to point out that, while conservatism may suggest that the more conservative of two equally likely alternatives should be used in an accounting measure; the idea of conservatism does not suggest that a less likely outcome be used simply because it is less favorable to the entity.

In rejecting the composite method, Board members did not suggest that adverse deviation, as it is presently incorporated in the accounting for traditional insurance policies, should be reconsidered. The Board did, however, reject accounting approaches that would incorporate additional provisions for adverse deviation beyond those that would otherwise be contemplated by Statement 60.

One of the objectives of the Board's project on insurance issues is to identify whether, for the new generation of insurance products, a measure of liability exists for certain insurance products that is more consistent with the definition of a liability found in Concepts Statement No. 6, "Elements of Financial Statements."

In the view taken toward this project, the minimum amount of an insurer's obligation to a policyholder of a universal life or similar policy is the amount which, without further action by policyholder, will fund operation of the contract until exhausted. This amount, the contract value exclusive of surrender charges, is unique to universal life and related policies. This contract or account value provides the measure against which the other attributes of the contract -- mortality charge, administration, and interest -- are measured. As such, the account balance shares many of the features that are normally found in other financial deposits.

The use of an account value does represent a departure from traditional notions of life insurance accounting. Many of those notions are based on a view of insurance in the aggregate, rather than on the basis of individual contract relationships. As discussed in earlier sections, the nature of the contract relationships suggests that this aggregate view of the advance funding attribute of universal life and similar policies is no longer appropriate.

The Board next considered the amortization of deferred policy acquisition costs (DPACs) -- perhaps the most difficult issue in this project. Illustrations of DPAC amortization typically base amortization on the expected revenue margins over the life of the book of business. The Board tentatively accepted this approach, but with two exceptions.

The Board tentatively concluded that interest should not accrue to the unamortized balance of DPAC. The Board and staff recognize that interest does accrue to the balance of DPAC in the traditional model. That is consistent with the notion of a liability valuation in a cash-flow accounting model. We also recognize, I believe, that most actuaries view the liability for future policy benefits in the traditional model as a net balance. Again, that is consistent with other similar models.

The retrospective deposit method, however, is not a cash-flow accounting model. DPAC can no longer be described as a valuation account or a yield adjustment. Instead, it takes on more of the appearance of the classic accounting deferred charge. Interest does not accrue to deferred charges for other nonmonetary balances in GAAP as we know it today.

The Board also tentatively concluded that charges designed to recover front-end costs, whether assessed universally as initiation fees or selectively as surrender charges, should be accounted for as cost recoveries.

The last major tentative decision that I will touch on addresses the internal replacement of a traditional life policy with a universal life policy. The AICPA proposed that the balance implicit in the old policy, usually a loss, should be deferred and amortized with DPAC on the new policy. The Board has tentatively rejected that view and concluded that any gain or loss should be recognized in the period of replacement.

In reaching this tentative conclusion, the Board recognized, I believe, that many believe that the new policy is a continuation of the old. Such arguments are not new to accounting. Similar arguments are voiced for debt refinancing, for example. Arguments for deferral, however, usually go with amounts that would otherwise result in a loss. Very few contend that credits, amounts that result in net income, should be deferred.

The accounting profession addressed the question of debt extinguishment, including refinancing of existing debt, in 1972 with Accounting Principles Board (APB) Opinion No. 26, "Early Extinguishment of Debt." The replacement of a traditional policy with universal life is very similar to a debt extinguishment. The APB contended that, "all extinguishments of debts are fundamentally alike." The Board agreed with that proposition in analyzing internal replacements and tentatively concluded, as the APB did fourteen years earlier, that gain or loss should be recognized.

I mentioned earlier that several objections to the Board's tentative conclusions have been raised. Several of those objections have been particularly thought-provoking and helpful. Others have been less so, and I would like to conclude with a discussion of some of the latter group.

Some have contended that the FASB is motivated by a desire to "bail out the auditors." Nothing could be further from the truth. The FASB does not consider issues with the benefit, or detriment, of any constituent group in mind. Indeed, if the accounting profession held sway over the FASB, then the Board would have accepted the advisory conclusions of the AICPA issues paper -- rather than rejecting them.

There is also a school of thought that maintains that the FASB is returning to statutory accounting. Again, this is far from the mark. Statutory accounting, in the insurance or any other industry, is driven by a specific regulatory objective. Such methods are seldom based on any conceptual or technical basis. The Board's tentative conclusions are based on an analysis of the underlying transactions and contracts -- viewed through the glass of the Board's conceptual framework. Statutory accounting will remain where it belongs, within the realm of those who regulate the insurance industry.

Others have maintained that the Board has abandoned the matching principle. If that were true, then the Board might move to the immediate expensing of all policy acquisition costs. Matching does not, however, imply the smoothing of operating results in the face of factors that suggest that there is a more representationally faithful accounting measure. We can see the problems of matching and an income statement orientation in the current accounting for deferred taxes. APB Opinion No. 11, "Accounting for Income Taxes," is a totally income-statement and matching-driven document. The resulting balance sheet amounts, though, have been widely criticized as having little meaning beyond the computational techniques on which they are based.

Finally, there are those who argue that the Board's approach is either overly conservative or not demonstrably conservative enough. I do not believe that the setting of accounting standards is or should be motivated by an attachment to conservatism in the sense this contention implies. As I mentioned earlier, conservatism is an appropriate prudence in measurement. It is not the deferral of income that should otherwise be recognized. Nor does accounting conservatism call for the establishment of liabilities that exceed management's best estimate of a probable future sacrifice.

The Board's technical agenda calls for an Exposure Draft of an accounting standard in 1986. That is a tight schedule, but one we hope to meet. The exposure draft will be followed by a public hearing in mid-1987.

The Board and staff welcome comments throughout the course of every project. We have received some very thoughtful comments already, and they have contributed to the work we have done thus far. We would welcome additional comment now and during the exposure draft.

MR. SCHREINER: You've not only done a fine job of articulating where the Board is, but have given us the benefit of the reasons why it has gotten there, and I think that's extremely helpful.

Wayne, it will not come as a surprise to you if I say that the present path being followed by the FASB is not favored by the great majority of the life insurance industry or the actuarial profession. Those who disagree with the retrospective deposit approach believe that its virtues are overstated and that its choice would be potentially damaging to the interest of insurers and the users of their financial statements. I think further that the industry and profession believe that different accounting models should not be used for products that are economically indistinguishable. Their view is that the FASB has erred in concentrating on the characteristics of individual policies. This micro perspective appears to have led the Board to say, yes, indeed, universal life and traditional ordinary life are different. Well, of course, they are different if you look at them with the eyes of the customer. For that matter, if you look at universal life policies with the eyes of the customer, the universal life policies of Company A are different from the universal life policies of Company B. What makes life insurance unique is its fundamental characteristic of pooling individual risks. The perspective of the critics of the FASB current path is one of focusing on the aggregate cash flows of blocks of business. From that perspective, universal life and traditional whole life present the same economic picture, and therefore, different accounting models for the two products would be inappropriate and potentially harmful. They would say that an accounting model should be driven by the economic perspective of the insurer, not by the economic perspective of a purchaser of its products.

Wayne, how do you think the Board would justify its individual contract perspective as a basis for accounting for the financial results of an insurance company which is founded on the pooled aggregate perspective of FASB's critics?

MR. UPTON: The point Mr. Schreiner raises, although I'm sure he views it as unique to the life insurance industry, is perhaps one of the two or three most difficult problems in accounting in general. A former Board member describes this as the portfolio problem. At what point do we establish the accounting unit for something? It's clearly a bothersome problem, and it's clearly one, though, that is in no way unique to the life insurance industry. Modern American industry cannot function in most situations doing one of anything. And so the notion that life insurance somehow should be aggregated where others are not, in my personal view, is inappropriate. Beyond that, though, I think we have to recognize that when things are aggregated, it's because we believe they're all alike or they are substantially alike. And I don't believe that we have that situation between the traditional policies and universal life. Beyond that though, and this is a distinction that also came up in the pensions project, I think it is important to recognize that, at least from this accountant's viewpoint, if I'm charged with measuring a liability, I have to recognize that the company has no liability to a group. It has a number of discreet liabilities to individual members of a group. We also recognize the mortality and the pooling of risks notion, and that is unique to life insurance. This concept suggests then that to the extent that life insurance performs a mortality function, then aggregation should occur, and there's nothing in the Board's tentative conclusions that would lead otherwise. But when life insurance performs an advance funding function that is captured in the universal life policy in the account value, we believe that aggregation would be inappropriate.

MR. SCHREINER: Wayne, one of the points I was making, quite apart from other organizations, is that it is a fundamental basis of insurance that you must deal in aggregates. It is the entire basis. Furthermore, when you talk about your obligations as liabilities to individuals, that may be correct, but the only way you can measure them in the life insurance business is in the aggregate.

MR. UPTON: I think Mr. Schreiner and I have agreed to disagree on this one. I agree with you, life insurance is a pooling of mortality risks from my viewpoint, but to the extent we have a financial advance funding arrangement, there is nothing pooled there any different than would be pooled in the certificates of deposits of the savings and loan or of a bank or any other similar financial transactions.

MR. JOHN O. MONTGOMERY: There are a couple items that you didn't cover in your report on the NAIC activities. One of them that could be significant is that the new proposed Exhibit 10 is in three parts. The last part is eventually to go into a revised page 6. The first part is the various reserve liabilities that are associated with deposits, then there is the dividend accumulations and so forth that are scattered. This is a proposed Exhibit 10, and it will all be by line of business. The second part is the amount of reserve credit for reinsurance ceded at the beginning and the end of the year. You remember that the amounts that are shown as a liability are net of reinsurance, so this will give you an idea of how much reserve credit was taken in determining those liabilities in the first part. The third part, as I said, is something like a page 6 build-through, but in that is the interest credited on deposits, and that is a very significant item for some of our regulatory tasks.

MR. SCHREINER: John, there's been an extraordinary amount of interest at the NAIC level in reinsurance reporting of one sort or another. Would you describe the regulators' concern in this area.

MR. MONTGOMERY: Well, the concern is that a lot of companies have no concept. All the page 5 that we are proposing does is lift out all of the reinsurance related items which are readily determinable from other parts of the Blank and put them together in one area, so it'll give you some idea of the sources of gains and losses from the various reinsurance activities. The problem we have had with reinsurance, as far as financial reinsurance, reserve credits, and so forth, is that many companies don't realize what reinsurance means to their activities.

Another thing that could be coming out of this is that, in the next 5 years or so, we may suddenly start to get a lot of extra mortality and morbidity through AIDS, and this could come out in that report very well through the various ratios that could be developed, such as claims to premiums, to give you an idea of whether or not there's a trend. We are very concerned that there will be an increase and a lot of this business is currently on the books -- it's not a matter of underwriting new business, which is another problem, but a lot of these people who may get AIDS are already on your books, and this would really bring it out.

SPEAKER FROM THE FLOOR: Mr. Kauth, I would like clarification on a point you mentioned on the alternative minimum tax. You said something about it being treated as a timing difference, and I'm not clear how paying an additional tax is a timing difference.

MR. KAUTH: What I intended to say is that, to the extent you pay this alternative minimum tax, you can treat that in the future as an offset against taxes that will become payable when your regular tax rate becomes a normal corporate tax rate. It's not a timing difference that you would add with DPAC, but it's a dangling debit that you will be able to use in the future to reduce your taxes.

MR. CHARLES D. FRIEDSTAT: With respect to your description of the approach that FASB is leaning towards, I have an observation and a question. The observation is that in your tentative approach, it appears that there is a distinct shifting away from emphasis on the income statement and a significantly greater emphasis on the balance sheet than has normally been the case in GAAP accounting for life insurance companies previously. It appears that the pattern of earnings under the different accounting models may not be looked at and may not be quite as important in your judgment in coming up with the guideline as may have been previously the case. My question is, in applying your proposed approach as I understand it, we have seen some tentative illustrations of patterns of earnings which produce a loss in the first year and profits in later years and that to me is inconsistent with FASB 60 and with general accounting principles. Has the Board addressed this, and if it adopts a tentative accounting model that would produce a loss in, say, the first year followed by gains in later years, assuming all experience is actually realized, how is it going to resolve this apparent conflict?

MR. UPTON: Regarding the apparent switch from emphasis on the Income Statement to an emphasis on the Balance Sheet, that is not focused on the life insurance industry particularly. I think that's an evolution in accounting in general that, over the past 10 or 15 years, we have seen accounting move away from what I described as an APB 11 -- everything is the Income-Statement approach -- to an approach that tends to view income as the residual difference between two balance sheets. So I don't think it is specifically a move away just on life insurance accounting -- I think it's part of a broader move. Beyond that, I think we do recognize that in some circumstances a policy would create a loss under this accounting in the current year. That's problematic to an extent, I guess. I've heard some, in your own profession argue that it's appropriate because there are no earnings or because earnings in the earlier year are not sufficient to offset costs. So in and of itself, no -- the fact that this approach might produce a loss I don't think is problematical per se.

OPEN FORUM

MR. SCHREINER: Wayne, I think you indicated that you received comments from analysts who expressed concern about whether the FASB was going back towards statutory. I think it is not a reflection of those analysts' interest in statutory or their fear of statutory, but a reflection of their concern that this might depress early earnings and force them out into the future. I think it is that same kind of concern that you're hearing expressed by the analysts.

MR. UPTON: I recognize that, and I recognize that there has been a significant amount of attention paid in the industry to pattern of earnings and incidence of earnings. I guess I would play back to you the comment made by one of your fellow actuaries from one of the larger insurance companies when he said the problem with existing GAAP for insurance companies is you figure out what you want income to be or how you want income to emerge and then you force the balance sheet to meet the difference. To a certain extent, I think that's an accurate presentation of where we are right now and certainly where the composite method would put us, and that frankly, is bothersome to the Board. More bothersome than the chance that we may have a loss in the first year or two of the policy.

MR. SCHREINER: Wayne, from my observations it seems to me that what you describe is one of the most troubling aspects of the current accounting model for life insurance companies from the standpoint of the Board. Would you agree with that?

MR. UPTON: I think so.

MR. EDWARD S. SILINS: Companies have been providing for their universal life policies under a variety of accounting methods, and I was wondering if FASB has reached any tentative conclusions on whether restatements would be made and if so, how?

MR. UPTON: Transition is always the last thing we talk about and we frankly have not. At the staff level we have brainstormed it, but we haven't even begun to develop recommendations to the Board, and how they'll react, I don't know.

MR. SILINS: Do you know when you will begin to consider that issue?

MR. UPTON: Shortly after our meeting with our advisory group on October 31, 1986. Probably the first meeting or two in November 1986 will address the issue.

MR. G. SCOTT BUCHER: I want to focus on the item with regard to surrender charges being treated as cost recoveries. We currently have a product under development that has very high surrender charges in the first 5 years, and we've been experimenting with the proposed method in applying it to this product. As it turns out, if surrender occurs in the first 5 years, the surrender charge, which would be written off as additional deferred policy acquisition costs, is more than the actual deferred policy acquisition cost that is associated with that policy. I wondered if that was a logical result?

MR. UPTON: That was a problem that we wrestled with. The notion that most companies which treat surrenders as a margin do so without associating any cost to begin with. And above and beyond that, surrender charges do kind of serve a double purpose. Frankly, the problem was that we had -- we experimented with approaches that would write off some of DPAC -- some amount that could be associated with the individual policy -- and we found that DPAC in practice, as we understand it, has kind of grown from what many perhaps thought it should be initially. Certainly, it is no problem from an accounting standpoint -- writing off the commission on surrender or mortality or something like that and allowing DPAC to ratchet down in step, if you will. The problem is that we've got all these indirect costs like mass marketing, agency development, and things like that that wind up in that debit that don't associate with individual policies. What the Board did allow in the tentative conclusion was that, to the extent that surrender charges ultimately exceeded DPAC in total, they then would be a revenue, but only after all costs were recovered.

MR. DANIEL J. KUNESH: First a comment, then a question. Your comment about companies designing an accounting method that would yield earnings is an unfair indictment of the composite method. The composite method is designed not to come up with any specific pattern of earnings, but to recognize the need for adequate liability. I think most actuaries would agree that an adequate liability and fair presentation of the financial condition of the insurance company is more important than the pattern of earnings, although earnings can and will be designed and will be manipulated, if that's your implication, under the retrospective deposit method. My question relates to your comment earlier about the discrete nature of insurance policies and why the account value is appropriate as the measure of liability. I think you were relating back to the concept or theory that there's prefunding in life insurance on universal life and that prefunding generates a fund which is in the favor of the policyholder and that fund is used for multiple purposes, one of which is funding, in part, death benefits. That funding rests on probabilities that relate to aggregate theory. How can FASB really reconcile itself in good conscience to the concept that FASB 60 can continue to be used for any cash value type life insurance of the traditional nature?

MR. UPTON: I would like to recognize Dan Kunesh as one of the authors of one of the most thoughtful letters that we've received. The question really is how do you justify opening for reconsideration the accounting for one type of a long duration insurance policy, without reconsidering it for all of them? Is that fair? That's a problem. How about it? The Board has reached the tentative conclusion that it's appropriate because the policies are different. The basis for the differentiation is the difference in contractual relationships. That doesn't mean that there is a single Board Member who is tickled to death with Statement 60, or that he would not at some future date consider it appropriate to reconsider life insurance accounting, if it met the criteria for addition of a Board project. I suggest to you that a general reconsideration of Statement 60 falls well down on the list of priorities because of other more pressing things that the Board needs to address. In good conscience, the Board reconciles this issue because it thinks it's dealing with something different than Statement 60 was designed to address. Does that mean that the Board endorses Statement 60 wholeheartedly? Not at all. You should recognize that Statement 60 was what we call an extraction project. It was one of a series of pieces of industry specific accounting guidance that the Board agreed in the late 1970s or early 1980s, I believe, to extract and incorporate under Board control and to take responsibility for it. The Board's responsibility in performing an extraction was only to insure that it was faithful, and the Board reserved the right in every one of the extractions to do a general reconsideration after it had finished the conceptual framework. We are at that point now.

MR. JOSEPH H. TAN: Given the uncertain nature of universal life policies, in premiums and interest credits, how does FASB deal with the lock-in principle, particularly with respect to DPAC amortization?

MR. UPTON: The Board has discussed the problem -- dual problems of lock-in and DPAC amortization. There are some who would believe that like any other amortization, DPAC amortization on universal life ought to be treated as a change in estimate and the amortization should change, just as any other depreciation or amortization computation does. We have not formalized that, even in a tentative decision of the Board. It's a point well taken.

MR. ROBERT W. STEIN: The logical extension of the proposal would be to eliminate premium from the income statement and eliminate reserve changes since both are deposits, in effect. I would like to ask where you stand on that? Will, in fact, interest margins and mortality spreads become revenues and will we not have all this other clutter in the Income Statement? Do you believe that going to that sort of presentation would enhance the value of the information provided to the user of the data?

MR. UPTON: The Board has tentatively decided that premiums on a Universal Life policy are not revenues and should not be so presented in the Income Statement. Having done so, we're not entirely sure what the implications of that are to an industry that is very much driven by gross cash inflow, and an industry in which the users of financial statements view total revenue, for better or worse, as an important number. The Board directed the staff to do some more work on that point, and we will be returning to the Board with some staff views and staff analysis on the issue. The problem, of course, is what do you do with the integrated company? I mean the company that's been around a long time and has a lot of traditional business on the books for which premiums are still revenue and a lot of new business on the books in which premiums would, perhaps, not be revenue. You lose some communication value there, and that's a point very well taken and one that we're working on.