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CURRENT TOPICS IN FINANCIAL REPORTING

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- Topics of current interest in the United States and Canada, including the activities of:
  - -- National Association of Insurance Commissioners
  - -- Canadian Institute of Actuaries
  - -- Canadian Institute of Chartered Accountants
  - -- American Institute of Certified Public Accountants
  - -- Financial Accounting Standards Board (FASB)

- One segment of the session will focus on the FASB proposal for a new accounting model for universal life insurance, with comments by a member of the FASB staff. Other segments will cover current and emerging issues in statutory and Generally Accepted Accounting Principles (GAAP) financial reporting in the United States and Canada.

MR. WILLIAM J. SCHREINER: I will begin with a review of the activities of the Blanks Task Force of the National Association of Insurance Commissioners and what they will mean for the 1987 annual statement. Perhaps the best way to start is to discuss the things that won't happen. These are useful because they identify current issues that are likely to be reconsidered by the NAIC Blanks Task Force in the next year or two.

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The first thing that won't happen in 1987 is that the size of the blank will not be reduced. The 19" x 12" sheet will remain in 1987. I expect that some day that will change. The next thing that won't happen is that the mandatory securities valuation reserve (MSVR) will not be moved from a liability to a component of required surplus. However, there is a growing realization on the part of some that the MSVR is an element of required surplus and there might be some advantage to identifying it as such. Also, realized investment capital gains and losses will not go through operations in 1987. Exhibit 12, "Reconciliation of Ledger Assets" and Exhibit 13, the "Schedule of Assets" will remain in the statement in 1987. Exhibit 2, "Net Investment Income" will be in the 1987 annual statement. However, Line 8, the "Ratio of Investment Income to Assets," will be taken out. It was concluded that the ratio is no longer a useful item that ought to be given the prominence that it has had in the past. Also, there will be no requirement in 1987 to identify balance sheet assets and liabilities attributable to affiliates. The issue of affiliates is something that has great interest to the regulators and one can anticipate that more activity will take place in that area in the future.

Now, here are the things that will happen in the 1987 statement. Several interrogatories will be removed. They are mostly of the "Are you an honest, God-fearing citizen?" type. The regulators agreed that no one ever answered "No," so they will be taken out. In Schedule D, Part 3, a detailed listing of bonds and stocks acquired during the year will again be required. It was not required in 1986. However, the detailed listing in Schedule DB, Section 2, Parts A, B, and C, which identify options acquired and written and futures opened during the year, may be eliminated in the 1987 annual statement. Schedule S, Part 2 in 1987 will require the reporting of accident and health (A&H) ceded premiums. Removed from the 1987 annual statement are all variable life columns that appeared last year.

In addition, action was taken on an item that I think is of particular interest to actuaries. An interrogatory has been added that will require reporting on nonguaranteed element products, if the company issues such products. Reporting will include an actuarial opinion as to the ability of the company to continue to meet the current levels of charges and credits. In addition, there will be new instructions for the 1987 annual statement; the format will include extra

write-in lines. And there will be new instructions for the cash flow statement, page 4A.

The third category is things that might happen in 1987. At its meeting in March, the Blanks Task Force chose to carry over several items to its next meeting in June. The first thing that might be adopted in June is an expanded page 6 which would provide an analysis of deposit funds. Also, there might be an expanded Exhibit 10 which would include deposit fund information. In addition, there may be instructions on type size and other printing specifications for computer-generated statements.

In a related area -- data capture -- I'm sure all of you are aware that three states -- New York, Texas, and New Jersey -- required diskette filings of 1986 annual statement data on a demonstration project basis. That has not turned out as well as the NAIC would have hoped. The reason for testing a computer friendly data collection device is to save a great deal of time, effort, and money, compared to the current paper statement input process. They have had a great deal of difficulty pulling the data off the diskettes and getting them into the file. They are still running, in parallel, the normal Insurance Regulatory Information System (IRIS) that will produce the early warning tests. They have been working with the various software vendors to fix up the problems that have cropped up in this first effort. It is their intention to require all companies to refile corrected 1986 diskettes at some later time this year.

Another study group at the NAIC has been active in the issue of insurance company employee pension plans. This group was formed to consider the appropriateness of the utilization of Financial Accounting Standards Board Statements Nos. 87 and 88 in the statutory statement for insurance company pension plans for their own employees. The study group has concluded that footnote disclosure of insurance company pension plans should be expanded and has prepared a position paper to that effect. With respect to the application of Statement No. 87 in the statutory statement, the group decided that it was permissible to do this, but that certain GAAP assets would not be considered as admissible. The group noted that since the application of Statement 87 is not required, any burdens caused by its use can be easily avoided by continuing current practices. The group has recognized that it has not yet considered the issue of the appropriateness of current practice for continued use in the statutory statement.

Another NAIC group has been working on the issue of market value disclosure of pledged securities. The thought behind this issue is that once an insurance company has pledged a security as collateral, it no longer controls that security and perhaps should no longer be permitted to carry it at amortized value in its annual statement. Perhaps, it should be required to carry the security at market value. The study group concluded that it was very difficult to develop cookbook rules for when pledged securities should be valued at market. Instead, it has developed a proposal which relies on increased disclosure in the notes to inform the regulator of the situation. This proposal will probably be on the 1988 Blanks agenda for implementation.

The final group I would like to talk about is the NAIC Bond Rating Criteria Study Group. This group started work last year because of the great interest in high-yield securities -- junk bonds. This group's mission is to consider the current rules that the NAIC Securities Valuation Office uses to assign classifications to direct placement debt securities. The rules that are currently in existence were created in 1951 and it was felt that there had been sufficient changes since then, and that it would be appropriate to reconsider the existing standards. The study group appointed an advisory group which concluded that the rules were reasonably satisfactory -- they still accomplish their objectives -- although it might be appropriate to consider adding a cash-flow test to the existing tests and that it might be appropriate to consider the establishment of an additional MSVR category. This result, however, was not satisfactory to the study group. So a new charge to the advisory group was formulated -- the advisory group has been asked to produce a bond rating criteria proposal that would probably use 10 or 20 factors to produce a numerical scoring procedure. The objective will be to try to reproduce the kind of analytical work that Standard and Poor's and Moody's does in their evaluation of securities.

MR. CHARLES C. MCLEOD: I should like to describe some of the significant developments affecting financial reporting which are taking place in Canada. My remarks will be addressed mainly to U.S. residents. Even if your companies do not do business in Canada, I hope that you will find a description of Canadian developments, and the reasons for them, to be of interest -- they may also be relevant to some issues in the U.S.

To set the scene, I shall define a few terms and describe some features of the Canadian financial reporting framework.

- Canadian companies have only one published statement. The statutory return and the shareholders' report both show earnings on the same basis.

- Reserves must be certified by a valuation actuary, who is appointed by the company's board of directors. The valuation actuary will generally be an employee of the company, although a few smaller companies use consultants. He must be a Fellow of the Canadian Institute of Actuaries.

- Financial reporting is primarily a federal responsibility. The provincial insurance departments are not involved, except in the case of those companies that are not federally licensed.

- CIA means the Canadian Institute of Actuaries, and the CICA means the Canadian Institute of Chartered Accountants.

I should like to talk about three major developments in financial reporting in Canada: (1) more specific guidelines for the valuation actuary, (2) GAAP for Canadian life insurance companies, and (3) solvency testing.

MORE SPECIFIC GUIDELINES FOR THE VALUATION ACTUARY

Until 1978, Canadian reserves were developed in a similar manner to that in the U.S.A. There were prescribed mortality tables, there were limits on interest rate assumptions, mortality was the only decrement (i.e., there was no withdrawal assumption), and there were limits on the deferral of acquisition costs. Starting in 1978, the actuary was allowed considerable latitude in selecting valuation assumptions, although there continued to be limitations on the deferral of acquisition expenses. The actuary was required only to certify that the reserves were "adequate" and "appropriate." The CIA developed a set of guidelines for the valuation actuary, comprising "Recommendations," which are binding, and "Explanatory Notes" which are not. The actuary was and is required to follow the recommendations.

Unfortunately, the high expectations that went with the increased responsibility given to the actuary have not always been met, especially in the valuation of

ordinary life products. Surveys by the federal Department of Insurance, and by the CIA, have shown an unacceptably wide range of assumptions being used by different actuaries for similar plans. In addition, the methods being used by some actuaries to value certain types of products were considered unacceptable -- for example, in valuing renewable term policies, no, or insufficient, allowance was being made for the mortality deterioration which results from the healthy lives tending to selectively lapse their policies at the time of premium rate increases.

The group that looked at this problem considered a number of possible causes. Partly, the educational standards were lacking. For instance, there was no study note or textbook that gave an example of the current Canadian valuation method. Sometimes the valuation actuary was the only actuary in the company and did not have (or chose not to ask for) access to advice from other sources. Another reason was that the recommendations and explanatory notes had been written in an era of level and fixed premiums, and did not always provide sufficient guidance for the valuation of newer types of products such as lapse-supported products, or nonlevel or adjustable premium plans. In other cases the actuary may have been under pressure from management to reduce reserves so that earnings would be reasonable and/or new business growth would not be limited.

Whatever the reason, the result was unsatisfactory. To respond to the problem, a set of "Valuation Technique Papers" are being written. These are intended to provide more specific guidance than exists in the recommendations or explanatory notes. A technique paper may focus on a particular assumption, or the valuation of a particular type of policy. An actuary is not required to follow these papers, but if he chooses not to do so it must be for good reasons which he should be prepared to justify to the regulators, or, in an extreme case, to a disciplinary committee. On the other hand, the technique papers represent a "safe harbor." Compliance with the papers would normally represent sound actuarial practice.

The current status of valuation technique papers is as follows:

1. Two papers are in effect: (a) "The Valuation of Lapse Supported Products," the main topic of which is the maximum lapse rate permitted for valuation of these plans, and (b) "The Valuation of Individual Renewable

Term Insurance," which discusses the need to value benefits to the end of the benefit period, not to the next renewal date; the need to allow for mortality deterioration; and, in case of reentry products, the need to make an assumption about the percentage of policyholders who requalify for select rates -- the reentry proportion.

2. Two more papers are likely to be exposed to the membership shortly: (a) the maximum assumption that may be made about the interest rate at which future cash flow will be invested, and (b) techniques for valuation of reinsured benefits.

3. Four more papers are being written: (a) the mortality assumption for ordinary life products; (b) the valuation of adjustable premium products; (c) the valuation of new money products; and (d) the valuation of universal life.

Although the actuary is losing some of the freedom he obtained in 1978, I think that few actuaries resent this. The development of technique papers is resulting in sounder valuation practices, greater consistency between companies and a better set of defined standards. These become increasingly important with the likely move to the policy premium method of valuation where a change in an assumption is likely to have a bigger effect than under the current valuation method. The existence of standards has educational benefits, helps the regulators to do their job, and may assist the valuation actuary, who is under pressure from management to weaken reserve bases or to not spend money, to upgrade the valuation system. Perhaps the biggest difficulty with the technique papers is the difficulty in finding good authors with enough time to write the papers.

GAAP FOR CANADIAN LIFE COMPANIES

I mentioned earlier that Canadian life companies have only one published statement. The statutory return and the annual report both show the same earnings. Although the supervisory authorities will always be more concerned with solvency, and the accountants more concerned with the income statement, I think that almost all parties prefer the one-statement approach, even though the needs and interests of the users sometimes pull in opposite directions.

At present, Canadian life insurance accounting does not conform to GAAP -- there are no generally accepted accounting practices for life companies in Canada. The Accounting Recommendations in the CICA Handbook are specifically excluded from being applied to banks and insurance companies. In recent years the CICA has been trying to eliminate this deficiency. Fortunately there has been good cooperation between the CICA and the CIA. In January 1987, the CICA published an exposure draft on GAAP for Canadian life insurance companies. Most of this is noncontroversial and is in line with current statutory accounting practices. The major change is that liabilities would be calculated using the policy premium valuation method. This method, which was proposed by a Canadian actuary, Don Keith, in 1983, is a form of gross premium valuation. Unlike a true gross premium valuation, it does not result in expected profits being capitalized at issue, since all valuation assumptions must contain a margin for adverse deviations. The principle is that, by selling a product, the insurance company assumes certain risks for which it must hold certain margins. As these margins become unnecessary, they are released and flow into income. The policy premium method has been endorsed by the Council of the CIA, but at the same time the Council recommended that the policy premium method not be introduced until: (1) the CIA has produced appropriate standards for the level of the margins for adverse deviations; (2) the CIA has produced appropriate standards of practice for testing the adequacy of surplus; and (3) the CIA has a proper policing mechanism in force to ensure the first two requirements are met.

The Canadian Life and Health Insurance Association (CLHIA) has also endorsed the policy premium method, subject to the same conditions. The major party still to rule on the issue is the Federal Superintendent of Insurance, who is known to have some reservations about the method. In addition, a minority of actuaries have some misgivings. The major concerns expressed are: (1) The use of the policy premium method could result in a weakening of reserves -- which are too low already; (2) Reserves under the policy premium method are more sensitive to changes in assumptions -- and the range of assumptions being used is too wide; and (3) The policy premium method can result in an up-fronting of profits at issue. This is causing the most debate and is based on concerns that it is philosophically wrong to take credit for profits before income is received, that it will weaken reserves, and that it may motivate the tax authorities to review the way in which they define taxable income. Despite these concerns, I think that

almost all people favor the use of a gross premium method over a net premium valuation approach. It is much simpler to explain, it is easier to observe the sensitivity of reserves to changes in assumptions, and it is a much easier approach for products with nonlevel premiums.

Although most of the debate has centered around the possible up-fronting of profits, in practice this may be more of a theoretical issue than a real issue. The valuation assumptions must contain a margin for adverse deviations, and if the cumulative margins for adverse deviations exceed the pricing profit margin, then a loss will occur at issue. Only if the product is very profitable, and there are as few of these in Canada as there are in the U.S., will any up-fronting of profits take place. If, however, current management can sell a very profitable product, or negotiate a very favorable reinsurance treaty, why should the credit for their actions not be reflected in this year's income statement rather than in those of future years?

My best guess is that the policy premium method, including the potential for some up-fronting of profits, will be implemented, but not before the end of 1989 and possibly not until the end of 1990. There is too much still to be done. First, the Superintendent of Insurance must approve the method, and he will likely need to be satisfied through some numerical illustrations. Second, the issue is to be debated at the CIA annual meeting, which is in 10 days. I hope this will reduce the minority opinion. Third, the conditions set by the CIA in its endorsement of the policy premium method must be met. These are:

1. The existence of appropriate standards for the level of the provisions for adverse deviations. A working group of the CIA, under Yvon Charest, has done some sterling work of defining the margins for adverse deviations, but much more needs to be done.

2. The existence of appropriate standards of practice for testing the adequacy of surplus. I shall soon describe the work being done on solvency standards, but again the message is -- more has to be done.

3. The existence of a proper policing mechanism to ensure the first two requirements are met. Again, more work in this area is needed.

In summary I think the policy premium method will become a reality, with the question being when, rather than if. Until then, Canadian valuation actuaries need to keep informed on developments in this area, since the final result is likely to have a significant impact on companies' valuation departments and systems, and may also affect the level of reserves and the emergence of profits.

SOLVENCY STANDARDS

The third main development is in the area of solvency standards and testing. Traditionally, the level of surplus that a company should hold has been determined by fairly arbitrary rules of thumb, such as x% of reserves. A few years ago, a Canadian actuary, Allan Brender, who normally lectures in statistics and actuarial mathematics at the University of Waterloo, took a sabbatical leave and went to work for the Federal Department of Insurance. His assignment, which he performed admirably, was to develop a theoretical but practical formula for determining the level of surplus a company should hold.

The formula has since been modified by an industry task force, but the basic approach is unchanged. The key features are:

1. "Required" or "formula" surplus is calculated separately for the morbidity risk, the mortality risk and the C-1 and C-3 components.

2. Within each of these components, there are a number of elements. For example in computing the C-1 (asset default) risk, required surplus is calculated separately for each of the major asset classes. In the case of bonds, it is 0.25% of assets for AAA bonds, 0.5% of assets for AA bonds and so on, with the percentage doubling for each step down in grade.

3. Formula surplus cannot be calculated solely from data in a company's statutory return.

A company's ratio of actual surplus to formula surplus would not be published. This is because it could be misunderstood, possibly leading to a run on the "bank." The ratio would have to be submitted regularly to the Department of Insurance. It is likely that, if actual surplus fell below formula surplus, the company would have to submit a plan of action for increasing actual surplus to the formula level. If actual surplus fell below two-thirds of formula surplus, the

company would probably be required to stop writing new business. If surplus fell below half of formula surplus, steps would probably be taken to wind up the company.

Calculation of required surplus, although not a two-line calculation, should become a fairly routine practice once companies become familiar with it. What will represent a much greater demand on the valuation actuary will be the need to test that his company has sufficient surplus not only at present but also in the next five years. This solvency testing must recognize the sale of new business, and will probably need to be made under a number of different scenarios, some favorable, some unfavorable. A CIA Committee under Dave Johnson is working to define these scenarios.

The motivation for the interest in solvency testing, both currently and prospectively, is twofold. The first reason is that the Canadian life insurance industry has no compensation fund or insurance protection against default. Although the financial stability of the Canadian life insurance industry has been excellent, the lack of a compensation fund has been a disadvantage when competing against other financial institutions. A compensation fund is likely to be in existence soon, but to avoid the stronger or more responsible companies being forced to pay for the recklessness of others, minimum solvency standards, together with an early warning system, were considered necessary. Second, as I mentioned earlier, the CIA and CLHIA endorsement of the policy premium method was partly conditional upon the existence of appropriate standards of practice for testing the adequacy of surplus.

CONCLUSION

As you can see, there is a lot taking place in Canada. If I have any reservations, it is that we as a profession may be trying to do too much at one time. Within the next few years the following are required: (1) additional valuation technique papers; (2) continuation of the work on setting margins for adverse deviations; (3) further work on solvency testing; and (4) keeping members advised about developments, running seminars to explain the new methods, and updating our educational standards.

The pressure on companies' valuation departments will be severe, since they will have to cope with the policy premium method -- requiring a change in valuation

systems and approaches, new assumptions, and the choice of the appropriate margins for adverse deviations. Companies will also need to have at least a simple financial modeling capability to permit prospective solvency testing.

If the profession and companies can get through the transitional period, the end result should be excellent. We will continue to have one financial statement, there should be greater consistency between companies' statements and we will be using a better valuation method. The solvency of the industry should be strengthened, and the incidence of income in companies' statements should be more appropriate than at present. Solvency testing should, as a by-product, help companies in the development of business plans. As I said in my opening remarks, some significant developments are taking place in Canada. If you do business in Canada, or are thinking of doing so, make sure you keep up to date!

MR. BRIAN ZELL: The powers in the world of GAAP have been very active in deliberating about changes in accounting that may affect the insurance industry. The one major project that directly affects the industry, FASB's universal life project, will be covered by Wayne Upton. I will try to touch on the other various developments at the FASB, AICPA, and SEC. Let's start at the top with the FASB.

INCOME TAXES

A project that has occupied much of the FASB's attention for the past several years concerns GAAP accounting for income taxes. The FASB issued an exposure draft last September that would change the method of accounting for income taxes from a deferred method to a liability method. Very briefly, the big difference is that the deferred method measures tax expense based on book and tax differences in the income statement using the tax rates at which the differences originate. The liability method focuses on balance sheet differences between book and tax amounts and measures those differences at the tax rates at which they will reverse. This change might have appeared more esoteric were it not for the 1986 Tax Act that lowered tax rates and changed or eliminated a lot of timing differences. Under the deferred method, those changes might affect deferred taxes over future years as timing differences reverse, but under the liability method, changes in tax rates or tax laws are recognized immediately. The combination of the new tax law and the new accounting method will result in

major adjustments of deferred tax balances. The proposed change to the liability method was not too controversial by itself. However, the exposure draft included some other proposals that received considerable criticism.

The exposure draft would be more restrictive on a company's ability to recognize the tax benefits associated with net operating loss carryforwards and deferred tax debits. Property/casualty companies in particular may be adversely affected by this part of the proposal since many of them have unused net operating losses. Also, the discounting of loss reserves will accelerate their tax payments and put them in a deferred tax debit position. The limits on the ability to record future tax benefits will cause some companies to report income tax expense at rates higher than the statutory maximum tax rate. Although the Board has made some changes to make it easier for companies to offset deferred debits against deferred credits, those changes are unlikely to provide much relief for property/casualty companies.

On a more hopeful note, the Board has voted to reverse its proposal that would have required stock life insurance companies to provide deferred taxes on the policyholders' surplus account (PSA). Under existing standards in APB Opinion No. 23, certain timing differences, including those with respect to the PSA, were exempt from deferred taxes because their reversal is indefinite and substantially subject to the taxpayers' control. The FASB will require more extensive disclosure regarding these items for which no taxes are provided, but those disclosures will be fairly straightforward for the policyholders' surplus account. Finally, the Board has reaffirmed its decision not to address the discounting of deferred taxes at this time.

The new alternative minimum tax (AMT) under the 1986 Act has created enormous confusion for everyone. The FASB's Emerging Issues Task Force recently took a stab at the accounting for the AMT under current standards. The task force's basic decision was that the AMT should be accounted for as a separate system of taxation. This means that companies will have to calculate their tax expense by applying the regular tax rules to financial statement income and then apply the AMT rules to financial statement income. The reported tax expense will be the higher of the two calculations. The result could be that a company might find itself paying taxes at the regular rate, but recording tax expense at a hypothetical AMT rate. The alternative view, rejected by the task force, sees

the AMT essentially as a prepayment of taxes that will be recouped through the carryforward of AMT credits.

With regard to AMT credit carryforwards, the task force essentially decided that they should be treated similar to net operating loss (NOL) carryforwards. The AMT credits would be used to offset existing deferred taxes, subject to certain limits. Otherwise, the credits ordinarily would be recognized when realized and reported as extraordinary items.

The FASB also has discussed how the AMT should be treated under the liability method. As under the deferred method, the AMT would be treated as a parallel tax system, so tax expense would be the higher of the amount using regular tax rules or using AMT rules. However, the liability method measures deferred taxes at the rate at which timing differences reverse. Because of certain required assumptions under the liability method, companies may be less likely to look ahead to an AMT situation. So there is a hope that the AMT may be less troublesome under the liability method. The final FASB statement will include some guidance and examples on AMT.

The FASB's timetable is to issue a final statement in the third quarter of this year. There is some indication that their schedule may have slipped a bit, but we should have a final statement this year. Companies would be able to apply the new rules for 1987, and would be required to apply them in 1988.

CONSOLIDATIONS

Another FASB project that is scheduled to be finalized this year concerns the consolidation of subsidiaries. The title of this statement pretty much sums up the requirements: "Consolidation of all majority-owned subsidiaries." Presently, some subsidiaries are not consolidated (that is, their assets and liabilities are not grossed up on the balance sheet), but reported on a one-line basis as an investment in subsidiaries. This one-line method, or equity method, has been followed, for example, for some insurance subsidiaries of commercial companies or for finance and leasing subsidiaries because some feel that the differences between the operations of the parent and the subsidiaries would make consolidation difficult. Sometimes foreign subsidiaries and majority-owned subsidiaries with significant minority interest also are one-lined in the balance sheet.

The new standard would require all majority-owned subsidiaries to be consolidated. The use of the equity method for majority-owned subsidiaries would be prohibited. The FASB recently held hearings on the proposal, and most commentators supported retaining the current rules. Some suggested that the consolidation requirement should extend only to captive subsidiaries that deal only with the parent company, but it appears that the Board will stick with its general requirement for all majority-owned subsidiaries.

Consolidation will change some debt-to-equity ratios, and the change in accounting will require some companies to renegotiate debt covenants. The FASB may consider extending the effective date to 1988 to allow those companies a chance to make the necessary arrangements with their creditors.

OFF-BALANCE SHEET FINANCING

Another FASB project, which is in its early stages but deserves watching, concerns the broad area of financial instruments and off-balancesheet financing arrangements. Many of the accounting issues that the FASB has been facing concern novel financial transactions, such as repurchase agreements, interest rate swaps, collateralized mortgage obligations, nonrecourse debt, put and call options, unusual preferred stock, financial guarantees, and many more.

Among the issues raised by these types of transactions are:

1. Whether assets should be considered sold if the seller has continuing involvement with them, whether liabilities should be considered settled when assets are dedicated to settle them, and when related financial assets and liabilities can be offset.

2. How to account for financial instruments and transactions that seek to transfer market and credit risks -- for example, futures contracts, interest rate swaps, options, forward commitments, nonrecourse arrangements, and financial guarantees -- and for the underlying assets or liabilities to the risk-transferring items.

3. How issuers should account for securities with both debt and equity characteristics.

The first step in this project will be to propose some additional disclosures regarding factors such as credit risk, market values, maturities, and interest rate sensitivity of assets and liabilities. An exposure draft on the proposed disclosures should be issued soon. The broader projects on income recognition and measurement will follow.

POSTEMPLOYMENT BENEFITS

A spin-off of the FASB's project on accounting for pension costs concerns the accounting for postemployment benefits other than pensions. Often, companies have accounted for these benefits on a pay-as-you-go basis.

The first effort in this area was a 1984 requirement for companies to disclose information about postemployment benefits. As a next step, the FASB issued a technical bulletin in April 1987, which permits companies to begin accruing for postemployment benefits prospectively, without the need to report a cumulative effect of the accounting change.

The next phase of the project concerns whether or when companies should be required to accrue for postemployment benefits and how to measure those liabilities. This study has begun, and an exposure draft is scheduled for issuance in 1988.

AICPA DEVELOPMENTS

While the FASB has been busy proposing new rules right and left, the AICPA has been fairly quiet on the accounting front lately. This probably is due in a large part to some uncertainty on their part as to exactly what their role is in the standards-setting process.

When the FASB took over from the AICPA the responsibility for setting "Big GAAP" about fifteen years ago, the AICPA carved out for itself accounting for specialized industries, accounting issues related to specialized transactions, and an advisory role to the FASB. The FASB's Emerging Issues Task Force has, in the past few years, taken over responsibility for addressing oddball transactions, and the FASB has been increasingly willing to take on special industry accounting issues. That leaves the AICPA the role of advisor. Since the FASB has not shown much willingness to accept the AICPA's recommendations on accounting issues lately, that role also is in question.

The AICPA currently has several projects in various stages that are suffering from an uncertainty as to exactly what these projects are intended to accomplish. One project concerns the accounting for continuing care retirement arrangements. The AICPA has drafted a paper that attempts to address issues such as revenue recognition and the accrual of costs for future services. The project has gotten bogged down somewhat over the treatment of the time value of money in the accounting process.

The AICPA's project on prepaid health care plans also is stalled somewhat. This project concerns the accounting by HMOs and similar entities. The principal issue concerns whether these plans should accrue for future services. An exposure draft concluded that they should not accrue for future services, but there is a group that continues to question whether a liability for services is incurred before services are provided.

The AICPA also has prepared an issues paper on the Board issue of discounting. It discusses issues such as determining the discount period when there is uncertainty as to the timing of future cash flows and the selection of the discount rate. This paper is being held up pending a decision on whether AICPA issues papers should or should not include recommendations to the FASB.

SECURITIES AND EXCHANGE COMMISSION

In the past few years, the SEC has taken something of a fatherly interest in the accounting practices of the insurance industry. In April, this solicitude took the form of a letter to life insurance registrants. In the letter, the SEC noted that the company seems to write policies that would be affected by the FASB's exposure draft on universal life. The letter asks whether this assumption is correct and, if so, whether the effects would be material. It also asks whether the company had given any thought to disclosing this possible effect in its 1986 annual report.

Ordinarily, there has not been a requirement to disclose potential effects of exposure drafts. The lack of an explicit disclosure requirement and the complexity of the restatement process most likely caused companies to omit disclosures regarding the FASB proposal. Apparently, some at the SEC think such disclosures should have been considered.

The SEC is studying several other issues that may be of interest to the insurance industry. First, the FASB has proposed that insurance companies report realized gains and losses before, not after, operating income in the income statement. Such a change would require the SEC to amend its reporting requirements under Regulation S-X, which now require insurance companies to use a two-step income statement. The SEC has previously expressed support for the proposed one-step income statement, and there have been indications that the SEC might adopt a one-step requirement even if the FASB does not.

The SEC has also recently adopted some temporary rules that clarify exemptions from provisions of the Investment Advisors Act for separate accounts that are used to fund flexible-premium variable life insurance. The new rules, which are very long, specific, and complex, were amended based on comments principally from the ACLI.

The SEC also has requested comments on the use of financial guarantees and their impact on the regulation of the securities market. Currently, certain debt issues that are guaranteed by banks are exempt from registration with the SEC. The increased use of insurance to guarantee debt securities -- either financial guarantee insurance or, in some cases, guaranteed investment contracts (GICs) -- has raised questions about competition between banks and insurance companies and the exemption rule.

A 1986 law passed by Congress mandated that the SEC study the financial guarantee issue. That study is to focus on the impact of the guarantee exemption under the Securities Act on investor protection; the impact of the guarantee exemption on competition between banks and insurance companies and between domestic and foreign guarantors; and whether, and under what circumstances, debt securities guaranteed by insurance policies should be exempt from registration under the Securities Act.

Finally, the SEC has requested comments on the current rules regarding management's discussion and analysis section of the annual report. Currently, annual reports are required to include a discussion of factors and trends affecting liquidity, financial condition, and results of operations.

Several accounting firms have recommended that Management Discussion and Analysis (MD&A) include expanded discussion of risks to which the company is subject, and that there be a higher level of auditor involvement with MD&A. Apparently, the commissioners are not convinced that such changes are warranted, so there may be no changes. However, the SEC is willing to listen to further comments.

MR. WAYNE S. UPTON, JR.: This is my third time speaking at a Society meeting about the FASB project on insurance accounting issues. That means that there is an actuarial probability that a number of you have heard me open with a disclaimer and a wisecrack. I only have one wisecrack, so I'll spare you a second or third repetition. I can't spare you the disclaimer. The FASB encourages the expression of views by members of the Board and its staff. The comments you will hear, though, are my own.

By now, most of you are aware of the FASB project on life insurance accounting issues. I won't be spending a lot of time on the details of the exposure draft today, other than in summary. Mr. Schreiner has asked instead that I comment on the responses to the document and on the direction of the project from here.

On December 23, 1986 the FASB issued an exposure draft with the five-dollar title, "Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Insurance Contracts and for Realized Gains and Losses from the Sale of Investments." In summary, the draft addresses the accounting for universal life-type contracts, for limited-payment contracts, and for realized gains and losses.

Universal life-type contracts would be accounted for using a retrospective deposit method, with the policyholder account balance representing the minimum measure of a company's liability. In adopting the retrospective deposit method, the Board considered but ultimately rejected proposals from the American Academy of Actuaries, the American Institute of CPAs, and the American Council of Life Insurance. I ask you to recognize that such a step was not taken lightly, as we will soon see.

The Board's implementation of retrospective deposit accounting differs, however, from current practice in four respects.

1. Capitalized acquisition costs are amortized without interest.

2. Surrender charges are treated in a manner identical to estimated salvage of other assets.

3. Costs associated with a replaced policy are charged to operations when the replacement occurs. The AICPA issues paper had suggested that such costs should be deferred and amortized over the life of the replacement policy.

4. Premiums are not reported as revenue, nor are payments that represent revenue or a return of policyholder deposits reported as expenses.

Limited payment contracts include those contracts that have terms that are fixed and guaranteed, subject the insurer to a risk from mortality or morbidity, and for which premiums are paid over a period shorter than the benefit period. Any income that would otherwise have been recognized as a residual percentage of premiums would be deferred and recognized over the period that benefits are provided.

The limited payment provisions also identify those contracts that do not incorporate a risk of mortality or morbidity; for example, the lottery annuity. In the Board's view, such contracts are not insurance as that term is contemplated in the accounting literature. Such contracts would be accounted for in the same manner as other interest-bearing obligations.

Finally, the document does away with the practice of reporting the results of operations in a two-step format. The income statement would instead show the gain from the sale of investments in the same fashion as other commercial companies.

The Board has received 99 comment letters in response to the exposure draft. That's about an average level of response to a specialized issue like this one. The commentators include: two insurance trade associations, six of the Big-8 public accounting firms, two professional organizations, the AAA and the AICPA, the American Accounting Association -- an academic accounting organization, twelve investment analysts, all of whom commented principally on the reporting

of realized gains and losses, and the remaining letters were mainly those of life insurance companies. It is interesting to observe here that none of the major actuarial consulting firms provided comments to the FASB on this exposure draft.

Before beginning a discussion of the comment letters, I'd like to paraphrase Mark Twain. "The rumors of our death are definitely exaggerated." I have had a number of phone calls from people hoping to confirm someone's prognosis of the future of this project. They range from a prospect of enactment in exactly the same form as the exposure draft to a total abandonment of the project.

The Board has not deliberated this project since December. Predictions that presuppose the outcome of the Board's due process, particularly before we have even held the public hearing, are simply out of line. Stated differently, there is, arguably, no one who knows more about the prognosis than I do. I admit to having no prediction, nor should I until the Board resumes deliberations.

I'll not give you a nosecount of the comment letters. I haven't tallied the comments nor do I expect to except as a summary for the Board. The comment period is not a plebiscite on the Board's proposal. I don't believe that there is any part of the exposure draft that is unanimously supported or opposed. There are strong opinions on many of the issues, as one might expect given the diversity in practice.

Nor will I mention specific comment letters by name. It is more important, I believe, to focus on the substance of the comments and not the personalities of the respondents. This project has had its share of form letters, bombast, assertions, and downright silliness. Board member Art Wyatt has described this as the point at which the emotional and the irrational enter the arena along with the conceptual, the neutral, and the evenhanded. Unfortunately, many confuse tactics that work well with vote counting bodies -- form letters and hyperboles -- with those that are likely to influence a deliberative body like the FASB.

Fortunately, many comment letters are, on balance, constructive and challenging. This is as true of letters that generally oppose the Board's conclusions as it is of those that are generally supportive. One of each comes to mind. One letter stands out as disagreeing, I believe, with every position taken in the exposure

draft -- except the color of the paper. The letter was well reasoned, drafted with care, and uncluttered with tangential comment. Another letter was generally supportive, but pointed out a number of conceptual and practical problems and -- more important -- proposed solutions.

With all that in mind, lets turn to some of the principal areas of comment on the exposure draft. A number of commentators suggest that the Board should reconsider life insurance accounting generally. Beyond that suggestion, though, there is no clear message. Some believe that the retrospective deposit method should be applied to all contracts. Others are most concerned by incompatible methods of accounting for what they consider to be similar contracts.

The Board has resisted a general reconsideration of Statement 60. Many Board members are unsatisfied with insurance accounting generally. A reconsideration of accounting for an entire industry, however, is not lightly approached. Any reconsideration of insurance accounting would have to consider the accounting for mutual insurance companies; the long-duration accounting model; the role of provisions for adverse deviation; the lock-in principle; reinsurance and the transfer of risk; discounting of property/casualty loss reserves; the components of capitalized acquisition costs; and the carrying basis of assets and liabilities.

Another frequently voiced opinion is the view that traditional life insurance and universal life share more similarities than differences. Commentators observe that both contracts provide for advance funding and mortality coverage, are marketed to similar groups, and under similar assumptions, may project similar profitability. Many of those views could be stipulated without changing the essential point of the exposure draft.

I believe that the Board members considered similarities between universal life and traditional life insurance carefully before reaching their decision. As I mentioned earlier, the rejection of learned recommendations is not easily undertaken. The introduction of universal life-type contracts brings additional degrees of freedom or vectors of risk to the relationship between buyer and seller of insurance. Few have argued that the flexibility in interest crediting, premium payment, and mortality charges does not change the range of possible outcomes from a book of policies.

It is important also to recognize that the long-duration insurance accounting model in Statement 60 incorporates accounting devices that are proscribed in other industries -- installment recognition, lock-in, and the provision for adverse deviation. The Board was willing to leave this convention in place for those contracts for which it was designed. Board members were unwilling to perpetuate or extend the method by applying it to contracts without fixed and guaranteed terms.

One subset of the comments on similarity bears special mention. Some commentators have suggested that the Board was unduly influenced by the marketing of universal life contracts. I don't believe that this is true, but the comments have another, more cynical dimension that I find disturbing. The implication seems to be that we should presumptively ignore the way a contract is represented to buyers or shareholders because everybody knows that advertising and marketing are misleading.

Opinion on the retrospective deposit measure of liability is surprisingly divided. Many companies and three of the Big-8 firms support the method, as does the AICPA. Their support is conditional, though, on one or more modifications to the exposure draft.

Those modifications are the closest thing to a unanimous view among the commentators. Most believe that the alternative view expressed by three Board members should be incorporated in a final standard; that is, that the amortization of deferred policy acquisition cost (DPAC) should incorporate discounting and interest and that surrender charges should be considered an element of revenue rather than a cost recovery. It's worth noting that these are also the only points on which a significant number of Board members dissented from the several provisions of the exposure draft.

The proponents of discounting in this case, though, face a difficult problem. Capitalized acquisition costs are clearly a nonmonetary item and are not conceptually different than a drill press or a building. They are more closely associated with a specific source of cash flows than are some assets, but no more so than others in which discounting is not employed.

I look forward to the discussions of this point at the public hearings. Some of the comment letters build strong cases for the use of discounting, but seem to fail to deal with the essential problem of accruing interest to a balance that is not itself monetary in nature. Many of the participants also address what they believe to be conceptual or administrative difficulties with the amortization, particularly the requirement for a catch-up adjustment. Again, I look forward to their comments at the public hearing.

The last area that I would like to touch on today is the question of limited payment-type contracts. While some commentators would prefer no change in this area, most seem to support some notion of deferral that prevents the front-ending of profit on limited payment contracts. The problem seems to be that limited payment is a concept a bit like pornography. Most people seem to think they know it when they see it, but it is notoriously hard to define. The Board has received suggestions that the line be drawn at one, five, ten, and twenty annual premiums. None of those suggestions, though, seems to carry any theoretical basis for the division. One actuary recently suggested that a limited pay contract has one annual premium fewer than the product his company sells. I fear that his candid observation is at the heart of many other comments on this issue.

Public hearings on the exposure draft will be held in Stamford on June 22 and 23. Twenty-two companies and organizations will testify, with the Academy batting in the lead-off position. A public hearing is not, or should not be, an adversarial proceeding. The Board's objective is to gain additional insight through a direct interchange with interested parties.

The Board will then commence deliberations on a final statement, probably at one of the August Board meetings. The comment letters will provide a major part of those deliberations. In addition to the conceptual issues raised, many commentators have called our attention to implementation problems and possible improvements. Our schedule remains to issue a final standard by the end of this year.

MR. RICHARD S. ROBERTSON: I'm not going to comment at this point on the content of the exposure draft. This is not the forum to debate that -- we'll get into that next month. But I'd like to ask Mr. Upton to comment on or refute the widely held concern that, while the Board has been very willing to meet with

people and allow them to express concerns that they have, there is very little evidence that the Board has paid any attention to the views the people have expressed. I think it would be appropriate for you to present the Board's side of that issue.

MR. UPTON: I think I can understand the frustrations that you feel and that many feel when dealing with the FASB. Without minimizing your comment, it is one that we hear on every single project. There are, in fact, a couple of standardized responses that I suspect we hear, one being: "I told you what I thought and you didn't agree with me; therefore, you must not have listened." It is inherent in the standard setting process that we're going to disagree with somebody. Beyond that there is also the comment, "You don't understand my industry," which I can assure you we have heard about every industry in the United States. But, other than to say that it is a comment that is frequently raised, there isn't much refutation beyond that that can be made.

MR. DANIEL J. KUNESH: I have two questions for Mr. McLeod, but, first, one comment for Mr. Upton. Maybe I can relieve your disappointment with respect to actuarial consulting firms. The firm I represent is probably the largest employer of actuaries and I think the people that are close to the accounting field believe that the position taken by the American Academy fairly represents that of our firm, or at least members of the firm who are close to the subject. We decided to encourage our company clients to write to FASB, rather than for us to collectively come up with a position, which has been difficult for a firm as large as ours. I share the concern of the previous comment. One of the big disappointments I have is a belief that the Board has already made up its mind that it is going through a formal procedure. In fact, there's a belief that the whole process of an exposure draft is too formal and it just doesn't work.

Now, Mr. McLeod, with respect to universal life in Canada and a new Canadian GAAP model, is the premium method a prospective approach? And second, on deferred acquisition cost, will that be an asset on the balance sheet or will it be netted against the reserve as in the past?

MR. MCLEOD: I will answer the second question first. The deferred acquisition expenses will not be an asset on the balance sheet. It will, in effect, be reflected in the liabilities.

In dealing with the first question, universal life is not the same issue in Canada as it is in the States for a variety of reasons -- the product is not being sold nearly as widely as it is here. There's a lot of discussion going on as to how it should be be valued. It will probably result in something like the cash value of the policy. But doing some testing on a prospective method under different scenarios will make sure the cash value is a good approximation. But to do a complete seriatim valuation for universal life under a number of different scenarios is an enormous job. I think there probably would be some modeling suggested to see what level of reserves results and, hopefully, one can take the cash value or some simple approximation to that and hold that as a reserve.

MR. NATHAN F. JONES: My question is for Mr. Schreiner on the subject of the blanks. Has there been any action in recent years to try to make Exhibit 5, the expense exhibit, more useful? I think it could have more value than it does now; our department does not find any real use for it.

MR. SCHREINER: That's a very easy question to answer. No.

MR. JONES: And no prospects I guess?

MR. SCHREINER: If your department believes that there are problems and more information is required, I would note that one of the common submitters of proposals for Blanks Task Force consideration, of course, are the insurance departments.

MR. JONES: And I guess the New York Department is chairman, right?

MR. JOHN O. MONTGOMERY: In my view, eventually the work of the valuation actuary is going to cause extensive revisions of financial reporting, including splitting a blank up by risk group, rather than lines of business, and revisions in many other areas. All of this is part of the general overhaul which probably will come in the late 1980s or the early 1990s.

MR. SCHREINER: Mr. Montgomery, if I can express a personal opinion -- I think we're in a transition period between the traditional regulators' view of regulation of checking all of the arithmetic in the annual statement and a broader

perspective that asks questions along the lines of "Is this company going to be able to meet its obligations?"

MR. MONTGOMERY: That's right. Also, the arithmetic formerly had to be presented out in the open; with the age of computers and their continuing advances, I don't think that's necessary anymore. That can all be done by audits in computer operations. But the blank itself has to be clarified. I hate to say simplified because it isn't going to be simplified, but it will be different.

MR. SCHREINER: Would you agree that you see some evidence of movement in that direction?

MR. MONTGOMERY: Yes. Look what we're doing this year with our proposals on Exhibit 10 and in the beginning of the revision of page 6, which is going to be an evolutionary process.

MR. JAMES G. COCHRAN: Mr. Upton, can you give us any hope for a delayed implementation date of the FASB proposal?

MR. UPTON: Having said that no one should predict what will happen, I'd be hard put to give you a prediction. It's an issue that a number of people have raised in the comment letters and it will certainly be one that the Board will consider.

MR. CALVERT A. JARED, II: Is there anything in the accounting literature of other industries where deferred acquisition costs or other depreciation-type items are retrospectively adjusted as opposed to prospectively adjusted?

MR. UPTON: Yes, Statement 91 on the Accounting for Loans Fees, which was issued almost simultaneously with this exposure draft, may also give you a hint as to why it's in the exposure draft. Very comparable cost is adjusted retrospectively for a change in estimate. Many commentators have observed though that most depreciation-type adjustments are made prospectively. Certainly, this is something the Board will be considering.