RECORD OF SOCIETY OF ACTUARIES
1987 VOL. 13 NO. 4A

CURRENT TOPICS IN FINANCIAL REPORTING

Moderator:	ROBERT W. STEIN
Panelists:	CHARLES C. MCLEOD
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	BRIAN ZELL*
Recorder:	ROBERT W. STEIN

- o A brief Financial Reporting Section Meeting
- o Update on Financial Accounting Standards Board and National Association of Insurance Commissioners activities
- o Canadian issues
- o Update on the Valuation Actuary movement
  - -- Groups formed
  - -- Issues
  - -- Direction in which events are moving
  - -- New York requirements

MR. WILLIAM J. SCHREINER: Reviewing the 1987 annual statement changes in geographical order, the first changes under the heading of additions and modifications are:

1. New rules for overflow write-ins.
2. Revision of page 6, "Analysis of Increase in Reserves and Deposit Funds During the Year," and the addition of Part B showing the development of deposit funds (not involving life or disability contingencies) during the year.
3. New interrogatory prepared by the AAA following Exhibit 8: "Does the company at present issue or have in force policies that contain

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nonguaranteed elements?" If so, a statement must be attached which describes the determination procedures for the elements and an actuarial opinion relating to whether the nonguaranteed elements have been determined in accordance with generally accepted actuarial principles and practices. Several interrogatories also must be answered.

4. Exhibit 8A "Changes in Bases of Valuation During the Year" Expanded to provide for: A&H policies and Deposit Funds in addition to Life Policies.

5. Exhibit 10 has been expanded to encompass all contracts without life or disability contingencies and now provides for "Deposit Funds and Other Liabilities without Life or Disability Contingencies."

6. Schedule D, Part 3 (Long Term Bonds and Stocks Acquired during year) will again require detailed listings.

However, in Schedule DB, Section 2 of Parts A, B and C, summary amounts by group may be shown for Financial Options Acquired and Written, and Future Contracts Opened during the year.

1. Schedule S, Part 2 has had a column added to show Accident and Health reinsurance ceded premiums.

2. A new Note to Financial Statements regarding upstream investment transactions was added, and the note dealing with capital and surplus and shareholder's dividends was revised.

DELETIONS

1. All of the columns requesting variable life data that appeared in the 1986 statement have been deleted.

2. In Exhibit 2, Line 8, "Ratio of net investment income to mean assets" was deleted on the basis that, given various companies' different products and investment portfolios, it was no longer a useful basis of comparison among companies.

3. Five General Interrogatories were deleted. They were primarily of the "wife-beating" nature or outdated in view of current practices. Similarly, one interrogatory following Schedule S was deleted.

DISKETTE FILING REQUIREMENT

New effective dates for the refiling of 1986 data have been set. As you no doubt know, the states had little luck in uploading the original submissions and have been working with the various annual statement package vendors to work out the bugs. The 3 states involved have set the following schedule: NY - November 1, Texas - December 31, and NJ - as soon as possible on a best effort basis.

With respect to 1987 statement filings, the NAIC is seeking to expand the diskette requirement to cover 95% of the companies in the U.S. New states expressing an interest in joining the requirement are: California, Delaware, Florida, Illinois, Nevada, Pennsylvania, Virginia and Wisconsin.

It should be noted that the diskette specifications for 1987 data have been expanded from those of 1986 in certain areas in the Schedules. Therefore, 1986's package will not meet 1987 specifications.

PRINTING STANDARDS

While working on developing the diskette input format, the NAIC has also been paying attention to the paper format statement and has developed printing standards for computer produced annual statements. At the present time, the standards are guidelines, rather than requirements. They will be included in the annual statement instructions for 1987. The guidelines provide standards for the size of page margins, the maximum number of characters horizontally (18) and vertically (8), and contrast.

Turning now to accounting rather than reporting issues, there are two items worthy of note.

STUDY GROUP --
ACCOUNTING FOR INSURANCE COMPANY FUNDED PENSION PLAN

This study group recently completed its review of the utilization of GAAP pension plan accounting under FASB statement No. 87 in statutory accounting. The group concluded that GAAP pension accounting could be used in statutory reporting, but that certain intangible or prepaid assets would be considered nonadmitted, unless approved by the insurer's state of domicile.

EMERGING ISSUES GROUP

The NAIC's Emerging Issues Group reached a similar conclusion in a recent meeting with respect to the subject of whether federal income taxes paid under the rules of the Tax Reform Act of 1986 could be considered as a prepaid asset. This issue is particularly important to P&C companies which will be carrying undiscounted statutory reserves, but paying taxes on the basis of discounted reserves. The regulators' reaction was that since a prepaid tax asset could not be used to pay claims, it would not be a statutory asset.

OTHER AREAS UNDER CONSIDERATION BY THE NAIC

Several issues currently being studied by the NAIC are likely to be considered for changes in the coming 12 months.

With respect to annual statements: it is likely that consideration will be given to:

1. Additional disclosure for insurance company pension plans.

2. A new schedule Y which would include an organization chart of affiliated companies and information on transactions among affiliates.

3. Reinsurance. A new reinsurance advisory group reporting to the NAIC's Actuarial Task Force has recently been appointed. Regulators remain very concerned about the potential, under current rules, for reinsurance to be used to undermine statutory reserving standards. This will remain an area of continuing activity and study.

4. A revision of the lines of business presented in the annual statement. John Montgomery of the California Insurance Department has developed a proposal that aims to modernize line-of-business reporting. For example, term and interest sensitive life insurance might be separated, while industrial life would be lumped with miscellaneous lines of business. Obviously, such a significant restructuring is likely to require a significant amount of time to implement.

5. John Montgomery is also working on a proposal to provide an array of investment data by quality/duration/type that would replace the current Schedule D, Parts 1A and 1B.

6. Consideration is also likely to be given to rescheduling the NAIC's Blanks Task Force activities. Because of the increasing complexity of data collection for the Statement and the likely increasing emphasis on diskette or similar data submission means, many believe that companies should be given more time to prepare for annual statement changes (the current system attempts to finalize changes in June of the year to be reported). Some believe that all changes should be set before the year to be reported on commences.

7. A group is studying the appropriateness of consolidating the separate accounts and variable life blanks.

VALUATION STANDARDS

A special industry task force was appointed this year by the NAIC Actuarial Task Force to develop a new valuation standard for life and annuity products. The formation of the group resulted from the concerns of regulators and actuaries that the present Standard Valuation Law was not up to the task of providing a base for defining solvency in a volatile environment of product design and investment opportunities. Many see this endeavor, too, as an opportunity to implement a stronger valuation actuary imprint on the issue of insurer solvency. However, the process is not without its problems.

At the October meeting of the NAIC Actuarial Task Force, the Advisory Committee reported that there were substantial issues on which no consensus had been reached, and therefore the original date for delivery of a conceptual framework of April 1988 was very much in doubt. Some of these remaining issues include:

1. The level of formula minimum reserves.

2. The extent to which reserves may be permitted to vary from formula minimums, based on actuarial judgment.

3. The range of methodologies and assumptions permitted for reserve adequacy testing.

4. When reserve adequacy testing should be required.

5. The relationship of formula minimum reserves to asset valuation standards.

6. The relationship of the mandatory securities valuation reserve to formula minimum reserves and reserve adequacy.

7. The implications of reinsurance.

It remains to be seen if the group can find a means to develop a consensus on these fundamental issues.

The work on new Health Insurance reserve standards is somewhat closer to fruition. New standards, including a somewhat controversial benefit ratio reserve calculation, which would base reserves on expected loss ratios less claims to date, has been presented to the NAIC Actuarial Task Force. However, there is another group that wishes the Task Force to consider a purely prospective reserve formula, and the Task Force is waiting for this proposal before going forward.

MR. CHARLES C. MCLEOD: I would like to describe some of the significant developments affecting financial reporting which are taking place in Canada. My remarks are 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 need to define a few terms and describe some features of the Canadian financial reporting framework.

First, Canadian life companies are only now about to have GAAP statements. I shall be talking more about this shortly, but up till now the statutory return and the shareholders' report have both shown earnings on the same basis.

A company's reserves must be certified by its Valuation Actuary, who is appointed by the company's Board of Directors. The Valuation Actuary is generally an employee of the company, although a few smaller companies use consultants. The Valuation Actuary must be a Fellow of the Canadian Institute of Actuaries (CIA).

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

Today I should like to talk about three major developments in financial reporting in Canada:

1. GAAP for Canadian life insurance companies.
2. More specific guidelines for the Valuation Actuary.
3. Solvency testing.

GAAP FOR CANADIAN LIFE COMPANIES

Until now, Canadian life companies have had 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.

Until September of this year there were no generally accepted accounting practices for life insurance companies in Canada. The Accounting Recommendations in the Canadian Institute of Chartered Accountants (CICA) Handbook were 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, and this was approved in September 1987. The new accounting practices are to be used starting in 1989, but companies are encouraged to start using them sooner. Most of the new Accounting Recommendations are non-controversial and are in line with current statutory accounting practices. The major change is that liabilities are to be calculated using the policy premium valuation method.

Before I describe the policy premium valuation method, I should point out that most companies will, for the time being, continue to calculate and show reserves on the current Canadian statutory method in their shareholders' reports. The reason is that Section 82.1(4) of the Canadian and British Insurance Companies Act prohibits a life insurance company from publishing any statements in which reserves are calculated on a different basis than the statutory basis. This prohibition does not apply to non-insurance companies. If a life company is owned by a corporation which is not a life company, the owner's consolidated return could be prepared on the basis of policy premium method reserves. For the time being, however, most companies will not be allowed to or will not need to calculate reserves on the policy premium method.

The policy premium valuation method, which was first 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 CIA 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.

3. The CIA has a proper policing mechanism in force to ensure that the first two requirements are met.

The Canadian Life and Health Insurance Association (CLHIA) also endorsed the policy premium method, subject to the same conditions. The most important party, however, 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.

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 most actuaries 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 non-level premiums.

Although most of the debate has centered on the potential for 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 products in Canada as there are in the U.S. -- will any up-fronting of profits actually take place. If, however, current management can sell a very profitable product, or negotiate a very favorable reinsurance treaty, why should the credit for its 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 (but with some safeguards to prevent abuse), will be permitted for statutory reporting, but not before the end of 1989, and probably not until the end of 1990. There is too much still to be done. First, the Superintendent of Insurance must approve the method. Second, the issue is to be debated at a CIA meeting next month. 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 on 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 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 that 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; the question is when, not if. Until then, Canadian valuation actuaries need to keep informed of 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.

MORE SPECIFIC GUIDELINES FOR THE VALUATION ACTUARY

Until 1978, Canadian reserves were developed in a manner similar to that followed in the U.S. 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 healthy persons tending to *selectively* allow their policies to lapse at the time of premium rate increases.

The group that looked at this problem in 1985 identified 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 premium policies, and did not always provide sufficient guidance for the valuation of newer types of products such as lapse supported products, or non-level 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 on 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.
   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;
      -- in the case of re-entry products, the need to make an assumption about the percentage of policyholders who requalify for select rates -- the "re-entry proportion."

2. A third paper exposed to the CIA membership addresses the maximum assumption that may be made about the interest rate at which future cash flow will be invested.

3. A fourth technique paper on the valuation of reinsured benefits is likely to be exposed before the end of 1987.

4. Four more papers are being written:
   a. Mortality Assumption for Ordinary Life Products
   b. Valuation of Adjustable Premium Products
   c. Valuation of Universal Life
   d. Valuation of New Money Products.

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 do their job, and may assist the valuation actuary who is under pressure from management to weaken reserve bases or not to spend money by upgrading the valuation system. Perhaps the biggest difficulty with the technique papers is finding good authors with enough time to write the papers.

SOLVENCY STANDARDS

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 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 defined separately for the morbidity risk, the mortality risk, and the C-1, C-2, 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 Federal Department of Insurance, probably starting in 1988. 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 for 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 unfavorable. A CIA committee under Dave Johnston is working to define these scenarios. Solvency testing could become mandatory as early as 1989, based on 1988 year-end data.

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 had 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 protect the stronger or more responsible companies from 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.

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.

Apart from the normal cost control pressures on most life insurance companies, many valuation actuaries are spending large amounts of time on tax reform. Some fairly significant changes to the taxation of life companies were announced in June, and the industry is putting considerable effort into attempting to persuade the government to modify its proposals. Unfortunately, this is limiting the ability of some very good actuaries to contribute fully to the debates on valuation methods and 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 among different 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 consequence, help companies in the development of business plans.

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:

FASB REACHES TENTATIVE DECISIONS ON LIFE INSURANCE ACCOUNTING PROPOSALS

The Financial Accounting Standards Board has been meeting regularly since mid-September to reconsider its proposals on GAAP accounting for life insurance and annuity products. The FASB has reaffirmed the basic approach proposed in its December 1986 exposure draft to require a retrospective deposit method for "universal life-type" life insurance and annuity products. However, the Board tentatively has agreed on several significant changes, including:

- Interest should be used in the amortization of deferred acquisition costs.
- Surrender charges and front-end fees should be treated as revenues rather than as recoveries of deferred acquisition costs.

- The classification of universal life-type policies should include traditional participating whole life policies and indeterminate-premium life policies.

The FASB has further issues to address, including the question of whether premiums should be reported as revenues and the effective date and transition provisions. And while the specific details of the final standard have yet to be worked out, the general outline of the Board's revised proposal has taken shape. The following is a summary of the FASB's current positions based on tentative decisions at its public meetings.

UNIVERSAL LIFE-TYPE POLICIES

Universal life-type policies include life insurance or annuities that feature an account balance, policy charges or credits that are not fixed, or flexible premiums. This would include participating whole life policies and indeterminate-premium life policies.

The liability for universal life-type policies will be equal to the gross account balance or, if the policy does not have an account balance, the cash surrender value. Policy charges are presumed to be earned in the period they are realized, except policy charges that are not assessed over the policy period (e.g., front-end fees) are deferred as unearned revenues.

Policy acquisition costs are deferred and amortized in a constant relationship to the present value of estimated future gross profits, and interest is accrued to the unamortized balance of deferred acquisition costs. Recurring acquisition costs are expensed when incurred. The interest margin portion of gross profits is based on the interest spread times the gross account balance. Expected surrender charges are included in estimated gross profits, and surrender charges are recognized in income when they are realized. When estimates of future gross profits change, the amortization of deferred acquisition costs recorded to date is adjusted, and the adjustment is recognized in current income. Deferred front-end fees and any other deferred revenues are recognized in income on the same basis as the amortization of deferred acquisition costs.

LIMITED-PAYMENT POLICIES

Limited-payment policies are those policies that require the payment of premiums over a period substantially shorter than the period that benefits are available.

Thus, policies with relatively long payment periods, such as 20-pay policies, may be effectively excluded from the classification. The FASB has yet to discuss the accounting for limited-payment policies.

NON-MORTALITY RISK POLICIES

Policies under which the insurer bears no substantial mortality risk would be accounted for as interest-bearing deposits. Policies that have a separate accumulation phase with no mortality risk followed by a payout phase, such as certain deferred annuities, would be accounted for as a deposit during the accumulation phase and as an insurance product during the payout phase.

OTHER ISSUES

Balance sheet amounts related to traditional policies that have been replaced by universal life-type policies would be written off to income or expense in the period of the replacement.

Realized investment gains and losses would be reported in the income statement on a pre-tax basis in arriving at operating income before tax.

TIMETABLE

The FASB is attempting to complete its deliberations in time to issue a statement before the end of 1987. The Board has not decided whether a final statement should be issued or whether the changes it has made are sufficient to require reexposure for additional comments.

Certain of the Board's changes, such as interest in amortizing acquisition costs and the treatment of surrender charges as revenue, have brought the proposed standards closer to current practices of some companies. However, other changes, such as the inclusion of participating whole life, raise significant new issues. The specific wording of any final statement likely will reveal many additional issues and implementation questions.