RECORD OF SOCIETY OF ACTUARIES
1988 VOL. 14 NO. 3

CURRENT TOPICS IN FINANCIAL REPORTING

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Recorder: ANTHONY J. TOKARZ

- Topics of current interest in the United States and Canada, including the activities of:
  - NAIC
  - American Institute of Certified Public Accountants
  - FASB
  - Securities Exchange Commission
  - American Academy of Actuaries
- Emerging issues in both statutory and GAAP financial reporting will be covered.

MS. CAROLYN GOODALE: I have been invited to present an update of what is going on within the National Association of Insurance Commissioners (NAIC) with regard to statutory reporting and accounting. I have given this same presentation many times over the past few years to various groups, including this one. Just once I would like to be able to say nothing has happened, but that is not true. Things have changed within the NAIC this past year.

The NAIC was organized in 1871. It is the association of insurance regulatory commissioners of the fifty states plus any United States territories. Since insurance is regulated on a state basis, the main purpose of the NAIC is to promote uniformity of regulation among the states. The NAIC achieves its goals by working through a committee structure. The NAIC meets several times during the year and they appoint the commissioners or someone from their staffs to serve on the various NAIC committees and to review various regulatory matters.

The subcommittee that is responsible for financial reporting issues is called the Financial Commissions Subcommittee. This subcommittee is one of the largest committees within the NAIC. It has about seven task forces and over 15 working groups reporting to it. The work of these groups has an affect on statutory accounting systems imposed upon insurance companies. Most of the changes though come about as a direct result of three NAIC task forces. These are the Blanks Task Force, the Accounting Practices and Procedures Task Force, and the Valuation of Securities Task Force.

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I will be covering the effects the 1988 decisions of these task forces have had upon statutory accounting for the life and health industry. I will discuss proposed changes to the 1988 annual statement blank, provide a status on the diskette filing project, and cover some other topics and projects going on within the NAIC.

The NAIC Blanks Task Force met this past spring just like it has for the past 107 years. This year they discussed changes to the 1988 annual statement blank and instructions. The agenda for that meeting contained about 102 proposals. This covered all nine financial annual statement blanks, and fortunately for the life insurance industry, only 43 of them covered the life blank. I am going to outline the changes that took place at this meeting, but please note that this was just the Blanks Task Force that adopted them. All these changes still have to be ratified by the parent committees of the NAIC. That is due to take place at the NAIC summer meeting in New York City. The list of changes to the annual statement is long, but worthwhile.

One important change that was heavily supported by the insurance industry but was adopted by a very narrow margin within the NAIC was the deletion of Exhibit 12. This is the reconciliation of ledger assets page. This proposal has been presented unsuccessfully to the Blanks Task Force many, many times, but this year it was finally adopted. The proposer this year was the Michigan Insurance Bureau. They believed that the cash flow schedule has replaced the reconciliation page in terms of its usefulness. The regulators, however, do believe that it is important that the insurance companies maintain the reconciliation information as a resource for an examination. They also believe it does not have to be printed in the blank anymore. Rumor has it, though, that this is one item that is going to be reconsidered. It is very likely that it will go back into the blanks. Therefore it has only been removed from the blank effectively for three months.

A second item that was adopted was a modification to schedule Y. The financial reporting group of the NAIC has determined the need for regulatory surveillance of the transactions between affiliates within their holding company system. The existing schedule Y is going to be modified and it is going to become two parts. The current schedule Y, the organizational chart, will become Part 1 and a summary of insured transactions with affiliates is going to be added. Another addition to schedule Y is the federal employer's identification number for every insurer listed in schedule Y.

The NAIC's movement towards automating the annual statement and the diskette filing processes has created a lot of changes to the NAIC annual statement blanks for this coming year. All of these are designed to facilitate the data capture project. In order to promote reporting consistency and to facilitate identification of negative numbers, insurers are now to report all negative numbers with the use of parentheses. Some companies put negative signs in front of or behind the numbers. This is just for standardization purposes. The parentheses will also be used in instances where the reported figure is contrary to what is expected, as in a decrease or a loss. Also for purposes of consistency and data capture, all ratios and percentages reported will be changed to percentages carried out to one decimal point.

A new numbering system has been designed so that all totals and subtotals in the annual statement and all details in schedule D will have a line number. Again, this is to facilitate identification for the whole data capture project.

To improve analysis of information, schedule S dates now have to be recorded as "month, day, year." In this way the computer can more easily sort this information and do comparison within reinsurance schedules.

To permit more accurate analysis of schedule D, summary information on acquisition and disposition of securities has to be summarized now in three categories: bonds, preferred stocks, and common stocks.

The last item which will facilitate this whole data entry project is the reformatting of schedule S general interrogatories.

A significant change adopted this year is that realized investment capital gains and losses will be reported as a separate line item in the summary of operations, rather than as a component of capital and surplus. Also, tax on capital gains will be reported. There is also going to be a line for unrealized capital gains and losses. This accounting proposal for capital gains and losses for life companies conforms with that which is already required for the fire and casualty blank and with GAAP accounting. This should more accurately reflect the company's true financial results.

Another key change adopted this year is the clarification of instructions as to the proper reporting of changes of reserves. Deficiency reserves are included in Exhibit 8; therefore, the changes for this deficiency reserve should go through the summary of operations and not go through as direct credits or charges to surplus as some companies have done.

There is going to be a new reinsurance schedule -- schedule S, Part 3(d). This is a five-year exhibit of reinsurance ceded. It is intended to summarize the reinsurance ceded business over five years for the purpose of identifying trends in the company's reinsurance program. The data are derived from sources throughout the annual statements so no new information is being required. Please be relieved that you are required to start reporting from 1988 on. Prior to 1988 the reporting is optional.

The new schedule D, Part 1(a) is going to replace the current schedule D, Parts 1(a) and 1(b). These schedules were the maturity of distribution of bonds and the quality ratings schedule. This new schedule combines these two parts and it provides more detail for definitive surveillance tests.

There are a number of notes to the financial statements that were adopted this year. A note has been added to allow for the disclosure of uncollectible reinsurance written off and commutation of reinsurance. A second note expands disclosure with regard to pension accounting. FASB 87 and 88 dealing with the accounting for pension plans gave rise to whether or not these rules apply to statutory accounting. As a result, the NAIC study group on investment company funded pension plans recommended a new note, which in essence, discloses the total benefit obligation and the fair value of the plan assets. The final note adopted is for disclosure of securities for borrowed money. The insurer must now include information regarding material loan provisions that must be satisfied or maintained on a continuing basis. You must also indicate if the company is in violation of any such loan provisions.

There is a new footnote to schedule E for bank deposits. This was changed such that short-term negotiable certificates of deposit are now reported in schedule D(a). This was adopted to facilitate the reporting of the short-term

nonnegotiable certificates of deposit as cash rather than categorizing them with bonds, commercial paper, and other securities. This represents a more accurate picture of the insurer's investment portfolio and should more clearly identify the securities which should be included in the Mandatory Securities Valuation Reserve (MSVR).

There is a new write-in line in schedule H (the accident and health exhibit). This is for deductions for certain underwriting items which were reported on page five, but were not reported in schedule H. Examples of this would be group conversions, transfers on account of group package policies and contracts.

The emerging issues working group proposal requires disclosure of strip securities in schedule D and DA. These will have to be represented by a footnote.

A line will be added to page three to show total liabilities, excluding separate account business. The reason for this proposal was to show the amount of general account liabilities covered in the general account on page two.

There is going to be a new line on schedule T to show other amounts not allocable by state. A couple of years ago when the whole annual statement was reformatted for data capture, write-in lines for this item were not allowed. Companies would include these under "other alien." This did not make sense, so now there is a write in for other items not allocable.

There is going to be an instruction change which requires additional submissions of the state pages (page 46). A state page must be submitted for each state where you do or are licensed to do business, to both to your domiciling state and the NAIC. In the past just one state page had to be submitted. Now 50 plus state pages will be required.

The filing date for the Credit Life and Accident Health Experience Exhibit was moved up 60 days. It used to be due on June 30 but is now going to be due on May 1. This is the first of what I think are going to be many changes in filing dates for all the supplements. The regulators believe that with all the automated software packages out there, the companies should be able to submit their supplements on the same date as the annual statement.

Another date that was moved up is the meeting date of the Blanks Task Force itself. In the past they had always met in the spring. This year, for the first time, they will meet in the fall. This change will provide more time for the regulators to prepare the blanks, prepare proper instructions, and provide the data capture specifications for the diskette project. Since the changes will be voted on, on a prospective basis, you will have about 15 months to accommodate them. The first meeting is going to be held in Nashville in October. They will be discussing changes to the 1989 annual statement.

The American Council of Life Insurance (ACLI) this past year submitted a proposal to the NAIC to combine the two separate account blanks (the separate account and the Variable Life Insurance separate account blank). This was not immediately adopted by the Blanks Task Force but was referred to the financial reporting group for further review. They have been reviewing this for the last three months and they have found that this combination is not an easy task due to guaranteed products reported in the separate account blank. A final draft will be distributed at the upcoming NAIC meeting. We assume that this

combined separate account Variable Life blank will be presented for 1989 year-end use.

In connection with other topics being reviewed, John Montgomery of the California Insurance Department submitted an extensive proposal for changing the life blank. I call it extensive because his proposal revised all the lines of business. This item, fortunately, was rejected by the NAIC in the spring, but they also recognized the need for some supplemental information concerning interest-sensitive products and long-term care benefits. John is now working with the group to design notes to the financial statements to cover interest-sensitive products and long-term care benefits.

John Montgomery also wants to revise financial reporting so as to provide a database of computer-generated reports and a surveillance system. The development phases of what John calls his "automated financial reporting" are currently being discussed. We had a meeting recently in Kansas City and set up a schedule. In the first couple of months we will define and outline the needs of financial reporting. The current annual statement blanks will be thoroughly reviewed to see if these needs are being met and subsequent discussions will center on how these unfilled needs can be satisfied. As you can tell, this is a long-range and very ambitious project.

I want to move on now to the diskette filing of the annual statement. For those of you who do not know, the NAIC has been requiring the filing of diskettes for three years now. In 1985 it was just a voluntary project. Diskettes were to be filed with the NAIC office. For 1986 year-end data, three states (New York, New Jersey and Texas) required diskette filing. That was a pilot project and a learning experience for all involved: the insurers, the regulators and the vendors. Not one company successfully completed that diskette filing, so a series of refiling took place.

This past year, eight states required and four states requested the submission of diskettes with 1987 data. About 2,800 companies submitted diskettes this past year and so far any errors found seem to be very minor. The NAIC has been able to take the diskettes and unload the data into their database. This been a real time-saver for them. As a result of this apparent success, the NAIC is now asking all states to require diskette filing for next year (1988 year-end).

The Accounting Practices and Procedures Task Force study group is working on defining proper accounting for transfers and sales of assets between or among affiliates. One of the major questions is should these transactions be on the basis of fair market value or book value? Hopefully, this study group will present a solution at their meeting.

The Valuation of Securities Task Force has not proposed any significant changes to the current valuation procedures. However, they are endorsing the use of Committee on Uniform Security Identifications Procedures (CUSIP) numbers as assigned by a special agreement with Standard & Poor's CUSIP Bureau. This is for both publicly traded and privately placed securities in the Securities Valuation Office (SVO) database. Footnote changes in schedule D have been proposed that require the use of these assigned private placement CUSIP numbers. So far, this has been deferred because the conversion is not finished. These numbers will probably be used in the 1989 annual statement.

In summary, I have tried to cover what has been going on with respect to statutory accounting within the NAIC. Not as much took place this year in the life insurance industry as did in the fire and casualty industries. Future meetings of the NAIC should prove to be quite interesting and I know we will see changes during the rest of 1988 and in the future.

MR. CHARLIE FLOOD: The FASB always is very appreciative of the opportunity to talk to any groups, especially non-accountants. In this way we get a little more realistic view of the world.

I would like to talk to you briefly about the FASB. The FASB is the accounting and reporting standard setting body that has been recognized by the SEC. It is the authoritative body for setting accounting and reporting standards.

There are seven Board members and, by design, those seven Board members have different backgrounds. Currently, the Board has three members who have public accounting experience (including the chairman), two people with industry background, one with an academic background and one from government. Two of the Board members have come to the FASB in the last year. One of these is a former chief accountant of the SEC. Board members are appointed for five-year terms. They are eligible to be reappointed for one additional five-year term, as long as their term at the FASB does not exceed ten years.

I will now talk about the due process and standard setting at the FASB. First of all, a topic or problem is identified and is presented to the Board. It is considered by them as being appropriate based on four criteria that they have established: (1) principally, that there is a problem that is pervasive in practice, (2) there are alternative solutions available, (3) there is a reasonable possibility that technically consistent and appropriate answers can be designed and (4) those resulting solutions would be accepted in practice. After a topic gets on the Board agenda, the staff prepares some background information. This can be in the form of a discussion memorandum that is distributed to the public and interested people in the Board constituency for comment. It will let the Board know if they have correctly defined the problem and if the scope of the issue is appropriate. Often, this will lead to some revision of the scope and the design of the proposed solution.

The next step is public hearings. These provide opportunities for interested groups to present their views.

Next, there is an exposure draft which is prepared by the staff, reviewed and approved with Board members. This is distributed to the public for their review and formal comment. At that point, there may be more public hearings, depending on the controversy created by the exposure draft. Hopefully, with further discussion, resolution and revision we might get down to a final standard.

The FASB has been very active during the past few years and particularly, last year. Since last October, we have issued five statements beginning with Statement 94. That statement basically requires consolidation of all majority-owned subsidiaries, unless the control is temporary or the control does not rest with the majority owner. It eliminates the exception for non-homogeneous subsidiaries that previously were not consolidated and may have been included as a one-line item in the financial statements (e.g., an equity investment). This statement is effective for years ending after December 15, 1988, which means it is effective for everyone in 1989. It does retain, at least temporarily, some of the

disclosures that would have been required for companies that previously did not consolidate such entities that are now required to be consolidated.

Statement 95 establishes standards for cash flow statements and requires that they be part of the basic set of financial statements. It supersedes previous requirements for a statement of changes in financial position. It is reflective of the Board's constituency in that one of the primary concerns with respect to uses of financial statements is the cash flow. This statement is designed (1) to standardize some of the cash flow reporting, (2) to get people to report cash flow, and (3) to improve comparability among companies within the same industry and to an extent among companies in different industries. It categorizes cash flow among three basic operations of a company: (1) operating activities, (2) investing activities, and (3) the financing activities. The statement is effective for all years ending after July 15, 1988. Therefore, it is in effect right now for companies other than those with years ending at June 30.

Statement 96 is probably one of the Board's best efforts. It was designed in response to criticisms of Accounting Principles Board (APB) 11, which are: (1) prior accounting for income taxes was difficult to apply, and (2) it was confusing and was not reflective of the economic circumstances. Going back to the minutes of one of the Board agenda meetings, it was disclosed that the primary objectives of revising accounting for income taxes was to simplify the guidance and to simplify the accounting. I do not think we have convinced anyone that we have done that, unfortunately.

Statement 96 revises the approach from the deferral method. This results in going from accounting for taxes on a transaction basis to a balance sheet approach that deals with the liability and asset. Current tax law is used to determine amounts payable or refundable in the future as opposed to using the tax law in effect when the transaction occurred. The recognition of an asset as recoverable is allowable only to the extent that recovery could be received from a carry-back of prior taxes paid. This was a subject of significant controversy within the Board, right up until the time the statement was issued. The Board was firm in a majority opinion that this was the consistent and appropriate approach to follow.

There have been significant problems generated by the guidance provided in Statement 96. The Board recognized early that they were going to have these problems so they organized a task force of representatives who participated in the previous public hearings. The representatives were composed of people from the larger public accounting firms, people with some specific tax experience, as well as people from industry. I believe the task force is comprised of about 20 people, plus five representatives from the FASB staff. They have had two task force meetings to discuss approximately 80 specific questions which deal with the implementation of Statement 96. There are approximately 15 to 20 additional comments that are being looked at by the FASB staff. It is not known whether there would be another task force meeting to discuss those. The FASB staff is in the process of writing a report that would include the particular questions raised, the discussions, and the FASB opinion.

One of the problems with this is that there are certain people (certainly the representatives and maybe their clients) who that know what the preliminary discussions and answers are. Therefore, there has not been a wide distribution of those discussions. Several comments have indicated there is some favoritism because this information has not been widely distributed. The staff is alert to

this and is proceeding as quickly as possible. Unfortunately, our due process requirements will require us to spend some time in review to make sure what we put out is actually what the FASB consensus is. We expect by early in the fourth quarter that there will be a report out that deals with specific implementation questions.

FASB 97 deals with reporting for certain insurance enterprise products. That statement was directed at products that had been developed since the extraction in Statement 60 of the insurance accounting practices. It was directed, particularly, at contracts that did not rely on morbidity and mortality and were a combination of investment and or insurance products. The accounting method established a liability for policy benefits which is the account or contract balance. FASB 97 also requires that long-duration contracts issued by insurance enterprises that do not subject that enterprise to risks arising from policyholder's mortality or morbidity are to be accounted for in a manner consistent with those for interest-bearing or other similar financial instruments. The statement also addresses limited pay contracts that subject an insurance enterprise to mortality and morbidity risk over a period that extends beyond the period in which premiums are collected. Revenue and income from limited pay contracts are recognized over the period that the benefits are provided rather than on the basis of the collection of premiums. FASB 97 is effective for years beginning after December 15, 1988.

Statement 98, which was just issued on May 31, has to do with leases and sales of real estate. It deals primarily with an inconsistency in the accounting for sales of real estate and leasebacks. In order for a sale leaseback or real estate to qualify for sale leaseback accounting, it must also meet the accounting for sale requirements for real estate. It also has some other implications principally related to leasing.

Well, that is what the Board has issued so far. What do they still have going?

Currently, there are four major projects, the first being financial instruments. Financial instruments has been broken up into two phases: (1) disclosure of financial instruments and (2) measurement of financial instruments. The project is intended to resolve the rash of accounting issues regarding new instruments that have evolved in the past several years. Those instruments include repurchase agreements, interest rates swaps, collateralized mortgage obligations, nonrecourse liabilities, call options, preferred stock, and financial guarantees. The initial phase of that project was an exposure draft that was issued last November. The exposure and comment period was extended through April 30, and the staff is still in the process of evaluating those responses. We have received approximately 452 comments on the exposure draft, some favorable and some not so favorable. In general, the information is being challenged on the basis of the cost benefit, who will use the information, and what relevance information such as market value has on an ongoing basis. Another significant item that has been discussed is how often these types of analyses need to be done (i.e., annually or quarterly or what?). The proposed statement has been very controversial because of the quantity of information. It could significantly affect the operations of most life insurance companies because of the type of instruments in which they are normally involved. The staff is now in the process of evaluating responses to test cases. Although this one has not been included, Traveler's Insurance is one of the test applicants. The staff is scheduled to meet with them within the next week or two to discuss what they believe the strengths and weaknesses are in a proposed financial instruments statement.

The next phase has to do with recognition and measurement. It will reflect the results of what has been discussed and what the Board learns from the disclosure document. I cannot predict, and would not attempt to predict, when there may be significant activity on that. I think that the initial exposure draft on disclosures of financial instruments proposed a December 15, 1988 effective date. I would be very surprised if that is met. I would think that anything that comes out would be effective later and any final statement on disclosure would come out late in the year.

Another major project that the Board is currently involved in is other post-employment benefits. This is really a spinoff of the pension project. During that project, the Board identified the fact that there were significant obligations related to nonpension type benefits that were not being properly recorded. A tentative step was made in Statement 81 which required companies to disclose their accounting method in the notes to their financial statements. The Board is now considering how to properly account for those benefits and has decided that the benefits actually represent a form of deferred compensation. Therefore, recognition should relate to the benefit and service provided. Some of the significant assumptions that are included would be claim costs, the health care cost trend, Medicare reimbursement, the discount rate, turnover, retirement age, dependency and life expectancy. It is a very complicated problem. The staff plans to have an exposure draft out by the end of the year and public hearings are scheduled for early 1989. A final statement is planned for the later part of 1989. I cannot overemphasize the significance of this because there are billions of dollars involved in these benefits.

It has been estimated to be anywhere from 50 to 60 times the liability the companies currently have for pension plans. Many companies do not have the information available to accurately assess their liabilities in this area. One of the problems here is how to account for new forms of stock ownership. Does it represent an equity investment in the company or is it a company's means of borrowing money to finance their current operations? How to measure the expense in these plans is a problem, because of the different conversion rights.

The Board is also involved in developing a concept relating to the reporting entity, the equity method and consolidation. They hope to apply that concept to accounting that is now in place and to develop, in addition to a concept statement, a standard for consolidation that is consistent with current reporting.

In addition to those major projects, the FASB staff is involved in the emerging issues task force. Carolyn mentioned earlier some of the things that the emerging issues task force is involved in. I would like to talk about that now.

The task force was formed in 1984 and its primary purposes are (1) to promptly identify and define emerging issues, (2) to develop responses and alternatives that could be applied in practice and (3) to avoid the need for formal guidances. As I noted before the due process of the Board often can take several years on some of these major and even minor projects. There was and is a perceived need to deal with some of these problems more quickly.

Why is the Emerging Issues Task Force (EITF) important? The SEC chief accountant has stated that he will challenge any registrant's accounting that differs from a consensus position at EITF. This is pretty strong and easy to enforce. The EITF consists of eight representatives from the largest public accounting firms. Normally, these are the senior partners in the technical area

of those practices that are involved in the issues as they develop. There are three representatives from small and medium size public accounting firms involved in activity from that perspective.

There are also four industry representatives which are selected by various organizations, the Financial Executives Institute (FEI), the National Association of Accountants (NAA), the Committee on Corporate Reporting (CCR).

The FASB director of research and technical activities serves as the chairman. He is really more of a referee than anything else and is a nonvoting member. The SEC chief accountant and the Accounting Standards Executive Committee (ASEC) chairman are also participating observers and they are also nonvoting members. They present the opinion of their particular organizations and add any insight or experience that they may have with respect to the particular problems being discussed. Also outside groups are often involved to the extent that they can present their industry's, business', or personal opinion.

The task force meets approximately every six weeks, usually in New York City. The meetings are open to public observation and many times people come because they are interested in one or two particular issues.

Issue summaries and minutes are also available on a individual or subscription basis. Through these subscriptions you can monitor the progress that the EITF is making on a particular project and review the agendas.

To date the task force has addressed more than 175 issues dealing with a wide range of topics (see Exhibit 1). Over 40% of these issues have to do with financial instruments or financial institutions.

EXHIBIT 1
EITF ISSUES GROUPED BY TYPE

Financial instruments	26%
Financial institutions	15
Income taxes	13
Business combinations	11
Pensions/employee benefits	8
Off-balance-sheet financing	7
Inventory/fixed assets/leases	6
Real estate	4
Other	10
TOTAL	100%

Income taxes generate a lot of questions. Business combinations generate a lot of questions due to the activity in leverage buyouts and takeovers. There are a lot of practice problems with respect to accounting the allocation of purchase price, goodwill, etc. There have only been a couple insurance-related problems discussed at EITF. However, a lot of the financial instrument problems certainly relate to the operations in insurance companies.

Nearly two thirds of the topics have been resolved by a consensus (see Exhibit 2). A consensus exists when at least 13 of the 15 people agree to an answer. Eleven issues have been resolved by the FASB, either in subsequent statements or technical bulletins. There are currently two EITF topics which are dealt with by technical bulletins. Statement 98 originated in the EITF and

evolved into a statement because of the pervasiveness of the problem and the inability of the authority of an EITF decision or a technical bulletin to resolve the difference.

EXHIBIT 2
DISPOSITION OF EITF ISSUES

Consensus reached	61%
Resolved by the FASB	11
Resolved by SEC	2
FASB staff work in progress	2
Resolved by the AICPA	1
ACIPA committee work in progress	1
Issue to be addressed within an existing FASB major project	5
No resolution	11
Further discussion by the Task Force is pending	6
TOTAL	100%

The AICPA is working on a problem related to real estate syndicators. Approximately 11 out of 175 of the questions raised have not been resolved by a consensus. This indicates that there is a wide range of practice in certain situations. The Board has looked at all of those issues and is either working on them or has determined that those particular situations do not warrant further clarification. One of the controversies about the EITF is the retrievability of results. Since 1984, the retrievability has not been widely known. As a result of that, in October of this year, the Board published its first book of EITF abstracts, which is a summary of proceedings. That includes summaries of the minutes, the issues being discussed and some of the significant discussions that took place. There is also a loose-leaf service which is updated for each. The hard-bound book is scheduled to be updated each year.

Industry representation has been another criticism of the EITF. Only four of the representatives are industry representatives. The EITF has been criticized for showing too much favoritism toward accounting firms, particularly large accounting firms. One of the responses to that is the Big 8 accounting firms bring the majority of the issues to the EITF. That is misleading, however, because in most instances they are not creating those issues to bring to the EITF. The issues are raised by their clients. I think that the better perspective to take is that industry is being represented through the Big 8 accounting firms. The FASB staff and industry representatives have also brought some issues. The FASB has looked at the industry representation controversy, discussed it with the appropriate people and determined that currently there is appropriate representation.

The third major controversy is the concern about due process. The FASB gets together every week in New York and because the SEC chairman is there, new accounting guidance is being set.

The FASB has been criticized for their due process. Looking at the different levels of GAAP accounting guidance, the EITF consensus positions are fourth in order of priority. Certainly, they become widely recognized practice and I think that it would be inappropriate to require formal guidance on every different type of accounting problem that comes up in practice. I think you would have much more criticism if too many standards and too many statements were out.

As I mentioned, the director of research and technical activities is the chairman of the task force meetings and participates as a "referee." He keeps the discussion and progress on-line. The FASB board members review all EITF consensuses and act accordingly if they have a different opinion. Some of the EITF consensuses have been challenged and a couple have been overturned via technical bulletins.

Interested parties certainly have the right to appeal to the EITF or to the Board directly. The Board does receive and evaluate those comments. Has the EITF been successful? Questionnaires have been sent out with respect to the EITF's success and its ability to deal with problems. The three major controversies have come from responses to those questionnaires and the Board believes that they have addressed those concerns adequately. They believe it has provided guidance to practice and at the same time has kept the Board focused on some major long-term projects. A recent poll indicated that the EITF is needed.

MR. PAUL F. KOLKMAN: As Bud indicated, my role is to talk about the recent accounting changes and to give the point of view of someone working at a company trying to implement these changes. Despite Carolyn's long list, there really are not any major statutory accounting changes that we are implementing this year. So I am just going to be covering the GAAP topics. I caution you, this is from the point of view of one company, one person, so the remarks cannot be considered general. Hopefully, our experiences will be helpful.

I want to talk about three recent accounting standards that we are in the process of implementing. Those are FASB 95, 96 and 97. My comments on both 95 and 96 will be rather brief with most of the time spent on 97.

I have not heard a lot of discussion about 95 which deals with the reporting of cash flows. The only open issue that I am aware of that affects life insurance companies is the classification of cash flows from the investment contract defined in 97. Ninety-five deals with three classes of cash flows: (1) financing activities, (2) investment activities and (3) operating activities. It classifies debt transactions in investment contract type transactions as financing activities.

According to FASB 95, all of the cash receipts and disbursements from deferred annuities should be listed as financing activities, while all of the cash receipts and disbursements from life insurance should be classified as operating activities. Although this is the literal interpretation of 95 it does not seem quite logical to list your annuity cash flows as one type of activity and your insurance cash flows as another. While it is not a critical issue, companies and their auditors are going to have to decide on some position for this year-end. There are a lot of issues revolving around 96, but surprisingly few that impact large mature life insurance companies. Ninety-six introduces some volatility in reported earnings by the use of a liability method. That is one problem that we are going to have to learn to live with. The only other significant issue is the situation of a large life insurance company which is part of a consolidated group where some members have potential tax assets. Ninety-five is restrictive with respect to the holding of tax assets. Since most mature life insurance companies wind up with the net tax liability, the projected year-by-year turnaround of the items that give rise to that liability become significant in the consolidated tax determination. In the interest of keeping down their volatility of reported earnings, they project the year-by-year turnaround of those items that give rise to the life insurance companies' tax liabilities (such as Deferred Acquisition Cost [DAC] and reserve differences). We book tax differences in those areas,

project those out on a model basis, and use the projected pattern throughout the year. We do not plan to update more than once a year and we believe that will keep down fluctuations within a year. We would change it only if compelling evidence develops.

I am now going to talk about how we are implementing FASB 97 in our company. I will be talking about our general approach, the issues that have surfaced, what we have accomplished so far, and what we have learned.

Ninety-seven is easily the biggest accounting project of its type since the original conversion to GAAP in the early 1970s. Depending on the situation some companies may find it an even bigger project. My staff and I had been quite involved in the evolving accounting rules for the contracts covered by 97 and thus believed we had a pretty good base from which to work. We were caught a little bit off guard by the inclusion of all deferred annuities under the category of investment contracts at the end. It wound up being broader than we thought. We almost panicked early this year when our ultimate parent, American Express, indicated a strong desire to adopt 97 as of year-end 1987. We convinced them that there was no way to do that and have any assurance that our statements would be materially correct. They finally decided to give us time to take a more orderly approach to adopting 97.

Our current timetable calls for us to continue to report 1988 results on the old basis. That will keep down variances between planned and actual results. We plan on reporting 1989 results on the FASB 97 basis in January. Again, this will keep down variances between plan and actual.

Of the steps we have taken so far, the first was an educational and increased awareness effort. There were a number of people in our accounting area, systems area, and the corporate financial staff of our parent company who really were not aware of 97 and its implications. We started this education process by routing them copies of 97, pointing out where it would affect them and asking them what they plan to do about it. Given a suitable time for education and increased readiness, we did what most large companies do with a project of this size. We set up a task force. However, this task force was not really charged with the implementation of 97. It was charged with the communication and the coordination between different areas that are necessary to get 97 adopted.

Our task force meets weekly and a report is distributed every other week. The task force will be responsible for the final report and documentation on the project, but each of the areas affected is responsible for its own component. One of the early accomplishments of the task force was a combined timetable. This is very important in a project like this, because so many areas have to interface and coordinate their activities.

Our second accomplishment was a classification of all of our products by accounting type. This was actually easier than most of us expected. When the process was finished we had only three types of contracts: (1) universal life type contracts, (2) investment type contracts, and (3) the contracts covered by FASB 60.

There were no limited pay contracts. We have eliminated those by convincing ourselves that the affected blocks of business are either immaterial in size (such as our life paid up at 65 block) or that the results using FASB 97 limited pay rules are not materially different from the FASB 60 results (for example, life

paid up at 95). This makes the whole process significantly easier for us, but it is not something that every company can do.

The only remaining classification issue we have involves the single pay immediate and payout annuities. 97 really puts those types of contracts into three different categories: (1) universal life type, (2) limited pay, or (3) an investment contract. A fixed single pay immediate is a FASB 60 contract if it has life contingencies. An immediate or a settlement of a deferred annuity without life contingencies is an investment contract. A variable single pay immediate is a universal life type. This is an illogical result that FASB 97 did not intend. We will split the contracts by whether or not they have mortality risk and treat them either as FASB 60 or investment type contracts.

Another unresolved issue is how to handle investment contracts. There is no real guidance or unanimity between the knowledgeable commentators. We have settled on a method which we are referring to as the interest method or the yield method. This method is described best in paragraphs 18 through 20 of FASB 91.

In the interest method or the yield method the expense and associated loans or fees are netted together and any surplus or deficit is put into the carrying value of the contract. It is reflected as an incremental yield over the life of the contract. This is a very big issue for us. About 75% of our business is investment contracts. Therefore, our parent and our external auditor are going to have to fully understand what we plan to do here and be comfortable with it.

Another unresolved issue is the definition of deferrable expense. There is some opinion that FASB 97 might have changed the definition of deferrable expense for different types of contracts. It is my belief that was never the intent of 97. Though we probably will not adopt these different definitions, we are currently looking into this problem.

We are not approaching 97 as a burden or something that we have to comply with. We are taking it as an opportunity to review our valuation and reporting and to make improvements where possible. Our two guiding principles in the design of our system are flexibility and simplicity. We are burdened with a FASB 60 system that is exceedingly complex. Everything is done by quinquennial age groups, and there are very fine product code distinctions. We will not have any factors in our new valuation system. We will approach valuation from first principles at each month. While this may sound a little complex this will actually eliminate a lot of complexity by dramatically reducing the number of valuation cells. We will use only plan and year of issue as a valuation cell, which will keep computer run time down.

Building our system this way gives us the potential to build in financial projection and source of earnings analysis capabilities. This is something that is very difficult right now with our FASB 60 system. The only structural issue remaining with respect to valuation deals with the information that we would really like to have on the valuation date to do the job right. This would include such things as commissions, general expenses, and certain investment pieces. We would like to include these in the current month's valuation but we may wind up estimating these.

This system, being simple and having a relatively small number of cells, would also allow us to unlock easily whenever we feel that we need to do so.

Things we have learned so far include the following: (1) Do not underestimate the level of resources and time required to adopt 97. There is a surprising amount of work required especially in the accounting area where a lot of new accounts need to be set up. The effort in general is not cheap. We are estimating that we are going to spend about 1/2 million dollars in our corporate actuarial area this year in allocated time and programming resources. Although we have not done a similar estimate for the controller's area, it may be as much or higher. (2) I caution you against inflexible systems. You want to be able to unlock because your competitors are going to be able to unlock. You do not want to have a situation in which you do not unlock for two or three years because it is difficult. When you finally bring yourself to do it, you have got quite a "catch-up" to report. You want to be able to unlock and "true up" your results as experience emerges. You also want a system that you can adapt to any clarification of some of the open issues in the next two to four years. If you go with an inflexible system you are going to be incurring an expensive conversion. (3) Another area of concern is restatement. It is easy to get the information needed to report on a 97 basis on a going forward basis. It is a lot more difficult to get information going back in time. You are going to have to use some estimates. Start the process early. If you wait until the end you may be faced with making significant estimates on your statement. (4) Finally, I caution you against an overly literal reading of 97. Some of the people in our controller's area have become paralyzed by this. We believe that we should be following the spirit of 97, as opposed to the word of 97. Probably, the single best example is the reinsurance piece. It says that "reinsurance will continue to be handled under FASB 60." They cannot mean that. If this were true, I could engage in a reinsurance transaction with a similar company, take all my 97 business, reinsure it with them, take all their 97 business, reinsure with me and just continue to account for all this on a FASB 60 basis. We are interpreting this to mean the use of FASB 60, in the sense of not reporting too much or too little income. We plan to look right through the reinsurance agreement. If it is a block of business that we would account for directly as investment contracts, we will handle the reinsurance that way.

These concerns aside, I think we have a good handle on 97 at my company. We set up a structure to handle it. We actually performed a small reorganization in both the corporate actuarial area and our systems area to do the work. We are identifying the issues, and getting the procedures in place to resolve them in a timely manner. We have great expectations with respect to simplicity and integration of valuation projections and income analysis. As to whether or not all of these come to fruition, we really will not know until about next year this time.

MR. FRIEDSTAT: I think it is appropriate at this session to acknowledge three papers that have been submitted and approved for publication in the financial area. These are *Amortizing Acquisition Expenses in Proportion to Premium and Revenues* by Mark Evans and *The Relationship between Statutory and Generally Accepted Accounting Principles* by Lou Lombardi. There is also a paper jointly authored by Bob Stein and Joe Tan, which discusses the source of earnings under the prior accounting models for Universal Life.

MR. RICHARD M. WENNER: I have a question on 97 dealing with the capital gains and losses and their treatment, specifically the prohibition against reserving for them in any fashion. Consider the situation of a bond swap in which there is no economic gain. Let us say for the sake of argument that there is no profitability in the business that the swap pertains to. How is the actuary

going to avoid reserving for that and still have adequate reserves? It seems like there is an inherent conflict here with the FASB 97 in what an actuary normally would do and what I think he has to do. As I understand it, a strict reading of 97 says that you have to, in effect, hold inadequate reserves, given the assets that you now have after the bond swap.

MR. KOLKMAN: I do not know how the issue of inadequate reserves gets into it, because the reserves are specified as accumulation values. What is going to happen is, in practice, people will sell a bond and realize a gain or a loss. When you reinvest the proceeds you are going to have higher or lower investment margins in the future. When you unlock that will cause your DAC to go up or down. It would not be an offset, but it is right when you make a transaction that 97 says you have to report a certain way. Once that transaction is over and you reproject your future investment margins, then your DAC amortization is going to be affected on a "catch-up" basis.

MR. WENNER: I was thinking particularly of GIC business in which there is typically no DAC. If you hold only the account balances, the assets equal to that balance will have yields lower than what you are guaranteeing on the GICs and you will not have adequate reserves.

MR. FRIEDSTAT: I think there is a partial offset on the DAC. I have heard some people say that indirectly you can accomplish what you want to. Theoretically, if you have a well-defined investment strategy (i.e., approved by management), you are going to be paying out some of these gains to policyholders in the future. Some people say that they should be holding an additional reserve because they know it is very clearly set down in their company procedures. You may not call it deferring the gain, but they would accomplish essentially the same thing by holding an additional reserve.

I think you have to have a very clearly set-out statement of your company's philosophy to adopt that approach. There is a good deal of logic in what you suggest and I am not sure this issue has been settled at many of the companies that we are talking with.

MR. SCOTT H. DELONG, III: I have a comment on Mr. Wenner's question. It seems like your comments are addressed in paragraph 77. The way I see it, those words would indicate, under the conditions you described, that you could set up that liability. On the other hand, this same sentence prohibits indirect spreading of capital gains.

My question is really addressed to Mr. Flood and it is relative to accounting for deferred annuities under 97. The statement itself refers to accounting for those products in accordance with other interest-bearing instruments. I am not sure what that means. For deferred annuities being priced similarly and sold by similar distribution systems, we have concluded that deferred annuities with explicit account values might be accounted for under the retrospective deposit methods specified for Universal Life.

I have attended two seminars this year, one by the Society in Dallas and another one by one of the Big 8 accounting firms, where it was stated that this position was validated through private discussions with FASB staff. I would like to hear Mr. Flood confirm that position.

MR. FLOOD: I cannot confirm or deny that informal discussion. I could follow up with the staff involved in that statement. Not being directly involved with Statement 97 I cannot tell you if they gave that answer or what the controversy is. There is some controversy over the statement. There are things that were not dealt with, such as specific guidance on how to account for particular investment contracts. This is because of the diversity of things that are or may have evolved in practice and problems that can be caused by analogies to those answers. I think it would be inappropriate for me to respond to what somebody else gave as a private discussion.

MR. FRIEDSTAT: At some of the seminars that our firm has given, we said that might be one way of looking at it. We break up the annuity contract into two categories: (1) those that have fixed and determinable features, in terms of the future payout (such as a structured settlement annuity which does not have any life contingencies or an annuity) and (2) supplementary contracts not involving life contingencies.

For certain annuity type contracts which closely resemble universal life, a retrospective deposit approach, similar to that in the Universal Life category type contracts, would be appropriate. I think we are able to give some arguments to help support that. I think at the seminar a person gave a slightly different criterion for when to use the retrospective deposit approach or prospective type approach.

I think that the criterion is consistent with the spirit of FASB. I view it as accounting for similar type instruments or insurance contracts in a similar manner. Thus, the retrospective deposit approach should be used for the deferred annuities where the company does have discretion in terms of crediting future interest rates. The prospective approach should be used where the terms are fixed and determinable.

This is very similar to the accounting for some of the financial instruments outside of the insurance area.

I had one brief question for Charlie. There has been a lot of controversy in the financial instruments area. Some people believe there will be a very dramatic effect on disclosure requirements for insurance companies. Could you briefly describe that issue and where it is headed?

MR. FLOOD: There has been widespread concern about the disclosure requirements, particularly for financial companies, banks, and insurance companies. That statement and the financial instrument statement certainly affect every company. As I mentioned, there have been 452 comment letters. There has been a great diversity of opinion concerning the cost benefit of this information. I think it is premature at this point to say what is going to happen. The Board is going to give a lot of consideration to the responses and I anticipate that there probably will be additional public hearings on the topic. I think we are a long way from resolutions. This is because of the problems in disclosure, accumulating this information, and the implications for recognition and measurement down the road.