

RECORD OF SOCIETY OF ACTUARIES 1991 VOL. 17 NO. 2

CURRENT FINANCIAL REPORTING TOPICS IN THE UNITED STATES

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Panelists: DONALD F. BEHAN
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Recorder: REED P. MILLER

The session will include discussion of the activities of the:

- National Association of Insurance Commissioners (NAIC)
- Financial Accounting Standards Board (FASB)
- Actuarial Standards Board
- American Academy of Actuaries
- American Institute of Certified Public Accountants (AICPA)

In addition, emerging issues in both statutory and GAAP financial reporting will be discussed.

MR. REED P. MILLER: Let me start off by identifying the two panelists. The first panelist is Dick Beuter, a general practice partner with Coopers & Lybrand in Indianapolis, with a principal concentration in the insurance industry. The second panelist is Don Behan, who is partner with Deloitte & Touche, in charge of its actuarial insurance practice.

MR. RICHARD W. BEUTER: I don't think you can talk about financial reporting in the United States in the last year without talking about Congressman John Dingell. Most of the activities that have been taking place in the AICPA, the FASB, and the SEC have in some way or another been influenced by Dingell's concerns with the industry. As you think back on the life insurance industry particularly, any insurance failures that we have had in the recent past are as a result of asset quality problems or reporting problems. I can't think of one that has been a result of a liability-type problem. Most actuaries are concerned with the liability side of the balance sheet, with the exception of some of the actuarially determined assets such as deferred acquisition costs or the present value of future profits as it relates to GAAP purchase accounting. The First Executive and First Capital issue is, in my analysis, primarily an asset quality problem. The other things related to those failures or some of the other insurance company failures in the recent past have to do with reinsurance. Again, I think that is as much an asset-quality-type or a credit-risk-type problem as anything. There may be some fraud involved in some of that, but I think you can break it down mostly to asset-quality-type issues.

Probably one of the largest things that happened in the last year from a reporting standpoint is the issuance of Practice Bulletin 8 by the AICPA. This Practice Bulletin provides guidance on narrow issues in the application and implementation of SFAS 97. We all know SFAS 97 focuses on universal-life-type contracts and investment-type contracts.

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PANEL DISCUSSION

The first issue in Practice Bulletin 8 is that of treating acquisition costs. And the question was, is there a difference in treating acquisition costs under SFAS 97 versus SFAS 60 for investment contracts and universal-life-type contracts? There really isn't any difference as far as what types of costs can be capitalized as deferred acquisition costs between the two types of contracts. The only difference being that if there is an acquisition-type cost that maintains a constant relationship with premiums, those would not be capitalized; they would be treated as a period cost and charged to expense in the period in which they are incurred versus being capitalized. Examples would be premium tax and things of that nature.

The next question relating to amortization or to deferred acquisition cost is, how should the amortization of deferred acquisition costs related to investment contracts be determined? For investment contracts, you should be trying to amortize the acquisition costs to maintain a constant yield over the life of the contract. An exception to that would be those investment-type contracts that have a significant surrender charge, generally at the end of the contract, and that should be taken into consideration in determining your estimated gross profit on the contract, or again, the yield on the contract. So essentially on an investment-type contract, you're looking at trying to maintain a constant yield over the life of the contract through the gross profit that you're going to make, including the amortization of the deferred acquisition costs.

On limited payment contracts, the amortization of the deferred profit should be based upon the expected future benefits, so that in determining the amount of deferred profit or in determining the amount of profit that you're going to defer, you would use the expected future benefit in determining the profit and deferring it. You should then again amortize that based upon the emergence of the expected future benefits.

The question related to limited payment contracts is, Should you be accruing interest on the balance of deferred acquisition costs and deferred profit? The answer there is that you should be accruing interest on those items.

How should you be treating internal replacements under SFAS 97? There was a lot of confusion right after SFAS 97 came out as to what to do with internal replacements, because in the industry about the time that SFAS 97 came out, there were a lot of conversions taking place from traditional-type contracts to universal-life-type contracts. Under SFAS 60, there were a lot of deferred acquisition costs that had been set up that had not been amortized yet when a traditional contract was being converted or replaced by a universal-life-type contract. Practice Bulletin 8 provides guidance that the internal replacement under SFAS 97 only applies to the replacement of traditional contracts with universal life.

Another issue under Practice Bulletin 8 is, How do you determine the estimated gross profit? What costs do you include when you do your calculation of estimated gross profits? You should include only policy related costs, even if they are not capitalizable-type costs. You still include those in your determination of the estimated gross profit. You would not include any overhead type of costs; only those related to the issuance and accounting or maintenance of the policy, but no overhead costs.

CURRENT FINANCIAL REPORTING TOPICS IN THE UNITED STATES

The sticky issue is, what do you do in your estimated gross profit calculation with regard to investment gains or losses? Practice Bulletin 8 says that you should include in your estimated gross profit estimated gains or losses. What do you do then when and if actual realized gains or losses differ from your assumption when you do your estimated gross profit? Practice Bulletin 8 really indicates that you need to reconsider periodically your estimated gross profit based upon actual realized gains and losses. It doesn't give you any guidance as to what "periodically" means. I would suggest that you consider reevaluating realized gains and losses on a three-to-five-year basis. I think you will find that, probably in most cases, the variance of actual realized gains and losses versus assumed and your estimated gross profit calculation is not going to have a significant impact upon the amortization of the deferred acquisition costs related to those products.

In essence, realized gains and losses should be a timing issue, and I think you will find on the stream of amortization that it wouldn't have a significant impact.

The last issue I would like to discuss briefly in regard to Practice Bulletin 8 has to do with the recoverability and loss recognition issue related to investment contracts. You really need to separate them into two pieces: the recoverability issue and the loss recognition issue. Practice Bulletin 8 indicates that for investment contracts you should consider recoverability of the -- and I will change a little terminology here -- deferred issue costs rather than deferred acquisition costs. You need to do a calculation or make an estimate of the recoverability of that asset. But you would not be concerned with loss recognition. If you have negative spread, i.e., you're crediting on investment contracts a higher rate than your assets are earning, you would not accrue under investment type contracts for the future negative spread that you would estimate while the contract is in force. But again, the recoverability is an issue. The reason that I changed terminology is that I like to think about investment contracts and the deferral of costs not under SFAS 97, but under SFAS 91, because again I think those types of contracts are more like the issuance of mortgage loans or bonds. The costs that are capitalizable and amortizable are more like costs under SFAS 91 -- the issuance costs rather than acquisition costs.

The next topic that I would like to talk a little about is reinsurance, which again is a topic that has been receiving a lot of discussion lately. You've seen a lot of reinsurance problems contributing to the insurance company failures that we have seen over the recent past and that occur primarily in the property and casualty portion of the industry versus the life insurance industry. The AICPA Insurance Companies Committee met with the FASB in early April 1991 and has convinced FASB to add to its agenda reinsurance accounting. There are really two issues that are being discussed as far as accounting for reinsurance. One relates more to property and casualty than it does life insurance. The other one relates to both. However, there is only a discussion paper for property and casualty at the moment, but I think when something comes out for life insurance, it will follow fairly closely with what's being discussed currently for property and casualty. Those two issues are foreign reinsurance accounting -- and this applies more to property and casualty than it does life -- and the second is the transfer of risk problem. I will talk about transfer of risk separately in a moment. The items that are going to be on the agenda that the FASB is going to consider are (1) the netting issue, or what do you do with reinsurance recoverable on losses that haven't been paid yet, (2) should there be any recognition

PANEL DISCUSSION

of gain or loss in a reinsurance transaction, and (3) what should the disclosure be relative to reinsurance?

Currently under SFAS 60, which is the guidance that we have in the accounting literature for reinsurance, you're entitled to net reinsurance recoverable against the liability for unpaid losses, or in the life insurance industry you take reserve credits for the loss reserve. If the loss has been paid that you have not recovered reinsurance on yet, you would show that as an asset for reinsurance recoverable and paid losses.

This relates to property and casualty, but I think you can look at it in a similar vein in the life insurance industry. A lot of the failures had more to do with reinsurance than with anything. And Dingell has been very concerned about the fact that if the accounting and disclosure for reinsurance in those situations had not been on a netting basis, but would have been on a gross basis, the reader of the financial statements could have seen the extent of the problem much more quickly. So it appears as though we are heading towards a gross-up for accounting for reinsurance in the near future -- there won't be any netting in the loss reserves of reinsurance recoverable. We'll show it as an asset.

The other issue related to reinsurance has to do with the credit risk. I think here there is going to be a lot more disclosure, and I'll talk again a little bit more about SFAS 105 which was issued in 1990. Credit risk is a significant issue in the reinsurance arena. Again, I haven't seen as many of these problems in the life insurance industry. Maybe we'll see them with First Capital, but in the property and casualty industry, a lot of the problems with reinsurance have had to do with credit losses rather than anything else.

The second issue on the agenda is that of recognition of gain or loss in a reinsurance transaction. Here I think we are headed towards no gain being recognized because of the contingent liability nature regarding performance of the assuming company. So if there are any gains, and you'll notice that I'm talking about gains in a reinsurance transaction, they will not be recognized until the transaction essentially is closed or completed. If there is an anticipated loss in a reinsurance contract with accountants being as conservative as they are, I would expect that any losses related to reinsurance transactions would be recognized as you become aware of them, rather than waiting until they emerge through the completion of the transaction.

It is expected that a proposed statement on reinsurance will come out from the FASB sometime in mid-1992. July is the current estimate that we have. Transfer of risk relates to reinsurance. The question here is, what constitutes transfer of risk? Currently there is a draft paper out covering the property and casualty industry that discusses various criteria that you need to consider to determine if there is a transfer of risk, and how the reinsurance contract should be accounted for. There aren't any written papers or drafts of papers that cover this issue for the life and health insurance industry. However, I think the concepts that are in the property and casualty paper will apply to the life insurance industry with one exception, that being timing risk. I'll talk about that a little bit more later on.

Paragraph 40 of SFAS 60 is the only current authoritative literature that discusses accounting for reinsurance when there is or isn't a transfer of risk. The only problem

CURRENT FINANCIAL REPORTING TOPICS IN THE UNITED STATES

is SFAS 60 doesn't define or give you any guidance as to what constitutes transfer of risk. Under Paragraph 40 of SFAS 60, if you have a reinsurance contract that does not transfer risk, it should be accounted for as a financing arrangement, and any monies would be treated as deposits by the company receiving the money or a loan depending on which side of the transaction you're on. So if there is no transfer of risk in a reinsurance contract, it should be reflected in the financial statements as a financing arrangement.

What is transfer of risk? Under the property and casualty draft paper that is out, FASB indicates that in order for there to be a transfer of insurance risk you have to have both underwriting and timing risk. I think we all understand what underwriting risks are. Timing risk, to me, is an easier concept to apply in the property and casualty area because there the issue is: Are you going to have a loss, and if so, when will you have a loss? In the life insurance industry, it's harder for me to understand what timing risk is because we all know we're going to die – the question is when are we going to die? So I think in the life insurance area when the paper comes out, there will be more discussion as to whether or not we have to meet both timing and underwriting risk, and there will be more guidance as to what constitutes timing risk. So transfer of risk is an issue that needs to be dealt with, and right now there is not any good guidance.

Reporting of debt securities held as assets has been a hot topic for all of 1990, both in the profession and industry and the SEC. The issue was really raised in 1990 by the SEC, and again, I think it has to do with what the SEC saw coming down the pike relative to insurance company failures being mostly driven by asset quality problems. The SEC started a crusade of wanting to mark all investments in insurance companies for reporting purposes to market value. The problem with that is, if you're going to mark investments to market in our industry, you also have to mark the liabilities to market.

As a result of the controversy that has arisen primarily in the insurance industry, there hasn't been a consensus as to what to do with this issue. The result was that a draft came out in early 1991 on disclosure of debt securities held as assets. You'll see in a lot of the 1990 annual reports that there is increased disclosure with regard to debt securities held as assets.

What you'll be doing in that disclosure is showing the market value of all investments, particularly debt securities held as assets. The draft requires disclosure of the methods and assumptions that you've used in arriving at those market values. There are a lot of life insurance companies that have debt securities which are not readily tradable. Therefore, it is not easily determined what the market value is, so you have to have some type of a method to arrive at an estimated market value. This document will require your disclosure of what method and assumptions you use. What's novel about this is that it permits each entity in determining its own disclosure to apply some practicality in determining how that entity is going to arrive at this. So, you can use practicality in evaluating your methods and disclosures and the effort that you put into arriving at this market value disclosure. My prediction is that you've not heard the end of this particular issue, because I think somewhere in the near future we are going to have some type of market value reporting, be it either in the face of

PANEL DISCUSSION

the financial statement, or some type of footnote disclosure, and I believe in our industry, that it will include marking the liabilities to market.

Another issue of significance is SFAS 106, or other post employee benefits. There has been a lot of discussion in the press about this issue, and how it may bankrupt United States businesses. What effect does that have on the life insurance industry? I think it has two effects. First, those of you who are in product development are going to be able to use your imagination in developing new products that you'll be able to go out and market to other industries, helping them fund and fulfill their obligations under post employee benefits, which, up to this point they have been funding – as the accountants call it – on a pay-as-you-go basis. Additionally, it's going to have a significant impact on the financial statements of the insurance companies and their own plans.

In the new product area, you're going to see a lot of redesigning of existing plans, so that you, as product actuaries, will be able to come up with new products for this. You will also be able to come up with plans that will fund future cash flows. The financial impact that I mentioned is not going to really have an impact until 1993 unless you or your clients elect to early adopt. I haven't seen very much of that although some of the larger companies are doing it. There may be some advantage to early adopting, but you really need to sit down and do a calculation to see how that's going to effect you.

SFAS 106 is a very complex issue – the only SFAS that has come out that preceded 106 that I think has been as complex as this one was SFAS 87 on Pension Accounting. Unfortunately, I think the pension actuaries are the only ones who understand that. SFAS 106 is a major shift in accounting from what we, as accountants, have termed the pay-as-you-go method to accruing for these costs based upon the active service period of the employee. As I mentioned, you need significant individual analysis to determine what impact this might have on your company or your clients. As a result, SFAS 106 I think, is going to have a double impact on you as an insurance company. It's going to be expensive for yourself in the financial impact it has on your financial statements, and you're going to be requested to provide a significant amount of increased information for your policyholders so that they can adequately assess the impact and accrual that is needed under SFAS 106.

I mentioned earlier the disclosure in financial statements of concentrations of credit risk. This is SFAS 105, for those of you who like to talk about numbers. SFAS 105 requires disclosure of concentrations of credit risk and off balance sheet risk. The question here is, What constitutes concentration of credit risk? Again there isn't any clear guidance in SFAS 105, so you need to use your own evaluation. But most people are looking back on an old accounting pronouncement on segment reporting and using the criteria outlined in that to determine what constitutes a segment to also apply to what constitutes a significant concentration of credit risk. Netting of transactions, or offsetting, is discouraged in this statement in determining what you should be disclosing for concentrations of credit risk. Again, I think this is a reaction to a certain extent to what has developed in the last year or so relative to failures and attempting to provide more disclosure to the reader of the financial statements as to what are the credit risks in the financial statements so that they can appropriately assess those.

CURRENT FINANCIAL REPORTING TOPICS IN THE UNITED STATES

As far as disclosure of off balance sheet risk, here you are required to disclose cash requirements to meet these off balance sheet risks, such as options, futures, or things of that nature. One of the issues under SFAS 105 that affects our industry is trying to determine whether or not it applies to an insurance entity. SFAS 105 does not apply to insurance contracts. I have heard some people take the position that that means it does not apply to an insurance company because almost everything in an insurance company is the result of an insurance contract. I have also heard people say that is not true, it really means that it just doesn't apply to insurance contracts, but other portions of the insurance companies financial statements that aren't insurance contracts, SFAS 105 would apply to. So you have investment considerations, options, hedges and things of that nature. There is still a controversy as to the application of SFAS 105 to the insurance industry.

The audit guide that exists in the profession applies to stock life insurance companies versus the property and casualty audit guide, which applies to all both mutual and stock companies. So in the accounting profession, statutory accounting practices are considered to be generally accepted accounting practices for mutual life companies. There are a couple of issues that have arisen in the last year that are of concern in this area. We all know that most states do not allow consolidation for statutory accounting practices -- you're to carry investments in subsidiaries and affiliates on the equity method. Some companies in reporting to policyholders, want to report on a consolidated basis. There currently is no professional guidance in this area. Some firms have endorsed the consolidation of subsidiaries or affiliates with mutual life parents as GAAP. Others suggest that disclosure of this difference should be made in the financial statements. Currently Coopers & Lybrand's position is, if a mutual life company wants to consolidate, it will require disclosure that this is a difference from statutory accounting practices.

The second item I want to talk about in this area is the disclosure of debt securities held as assets. The question is, does this statement of position apply to mutual life insurance companies? I think here you need to take a close look at what's required by the state of domicile. There are a few states that require disclosure in mutual life insurance company financial statements using GAAP. If your company is in one of those states, then I think the statement of position on debt securities held as assets would apply. If the state of domicile does not require disclosures in accordance with GAAP, then you could argue that the statement of position does not apply, and you would not be required to make those disclosures.

SFAS 96 has been around for several years but has never become applicable because the FASB continues to defer it. It has again been deferred one more year. The FASB is attempting to scrap what exists and start over and come up with a statement that will have more practicality and application. In theory, I think FASB still wants to have a liability-type approach to the determination of deferred income taxes. But, the scheduling and so forth that was required under the existing printed literature was quite onerous, and the business industry -- not just the life insurance industry -- has convinced the FASB that it is not very practical to apply that approach. I'm only aware of two life insurance companies that have adopted SFAS 96, and one of them is Conseco and the other is First Capital in Los Angeles.

PANEL DISCUSSION

Another issue is fronting arrangements. There will be something that comes out – probably from the AICPA Insurance Companies Committee on fronting. I believe that it is going to resurrect an old draft on fronting, and I also believe that the conclusion you will see there is that you will be required to report fronting arrangements as if they were reinsurance arrangements.

The only thing I'll say regarding the NAIC is that it currently has a project to come up with a common set of accounting practices that would be prescribed and permitted so that they would be universal throughout the 50 states, and that you wouldn't have to worry about what every state requires. From my professional standpoint, that would make our reporting easier, because then we would be able to say prescribed or permitted in accordance with NAIC versus what we now have to say, prescribed or permitted in accordance with the state of domicile or state of New York, Indiana, or whatever.

The investment valuation issue is going to continue to be a hot topic with the SEC, and in 1990 annual reports, you're going to see that there has been an increased emphasis by the SEC on management discussion analysis and focusing on investment disclosures. Because of the SEC's thrust on focusing on investment issues, Con-seco's annual shareholders report management discussion and analysis turned out to be fourteen 8.5 x 11 typeset pages, and more than half of that involves investment discussion.

MR. DONALD F. BEHAN: My presentation will cover recent and proposed activities of the Actuarial Standards Board related to life insurance financial reporting. In addition, I will discuss some recent communications between Congress and the FASB. At present, we have a mixture of old and new standards that apply to actuaries in the area of life insurance financial reporting. While the Actuarial Standards Board has issued six standards that are directly related to life insurance financial reporting, most of the previous standards of the American Academy of Actuaries have not yet been superseded. The American Academy Committee on Life Insurance Financial Reporting has reformatted five of the Academy standards for issuance by the Actuarial Standards Board. While the reformatted standards include some revisions, these were intended as clarifications or to drop portions that were no longer relevant, and they were not intended to introduce substantive change in the standards.

The five reformatted standards, with their descriptive titles, are the following: (1) Interpretation 1-I, which is Methods and Assumptions with respect to accounting under statement of SFAS 60, for nonparticipating guaranteed renewable insurance policies; (2) Recommendation 5, which is recognition of premiums and financial statements of stock life insurance companies, under SFAS 60; (3) Recommendation 7, which is statement of actuarial opinion for statutory statements; (4) Recommendation 9, which is materiality and financial reporting; (5) Recommendation 11, statement of actuarial opinion for interest indexed universal life insurance contracts.

The reformatting was largely the work of Bill Schreiner and Alan Kennedy of the Academy staff. I think you will find that they have greatly improved the clarity and the precision of the drafting of the standards. The reformatted standards were reviewed by the Life Committee of the Actuarial Standards Board in March 1991, and

CURRENT FINANCIAL REPORTING TOPICS IN THE UNITED STATES

they were formatted with comments to the Actuarial Standards Board. It is my impression that the Actuarial Standards Board is very cognizant of the need to expose any substantive change in the standards before they are adopted. There has been some discussion between the Actuarial Standards Board and the Life Committee on some specific issues, and I believe it is still possible that some of the standards will be exposed before they are issued. However, most of the reformatted standards will probably be adopted by the Actuarial Standards Board without any exposure. In addition to the standards that I just mentioned, the American Academy of Actuaries Recommendation 2 deals with the actuaries' relations with the auditor in a life insurance company context. It was felt that that standard could be broadened to include casualty insurance as well. The process of rewriting that standard is currently underway. There has been some recent activity in that regard by both the AICPA and some consulting firms to clarify the relations between actuaries and auditors. There are two levels of issues. At one level, the issue is how the actuary and the auditor communicate with each other to be confident that they understand the scope of each other's work, and the conclusions to be drawn from each other's work. The second issue is how the respective roles and responsibilities and the conclusions of actuaries and auditors should be communicated to the users of their work, in the form of statements of opinion. I think that at the present time the situation leaves the respective responsibilities somewhat unclear and that actuaries and auditors, as well as the users of their work, could benefit from some clarification and resolution of these issues. Since data quality is such a pervasive issue, I would think that this draft would be of broad interest.

Just as an aside, I don't know whether you might be aware, but the number of comments that come in on almost any of the proposed standards, ranges in the 20s, that's a typical number of comments. Twenty-five comments would be a relatively high number. So, to the degree that you can measure participation in the standard setting process by the number of comments, the participation up to this point has been pretty limited. I think that the Actuarial Standards Board welcomes any comments, and there have been a lot of thoughtful comments among the 20 or so, on each of the statements. But I think it's appropriate to encourage more participation and to ask you to look at standards that will relate to the particular type of work that you do, and to get involved at that point. Once the standard is issued, then it's going to be a very slow process to resolve or improve on any aspect of the standard that you might feel is inappropriate. I think that the Actuarial Standards Board and the committees have been very responsive to comments that have been sent in. As you read the final versions that are released, you'll see a very thoughtful commentary on the various comments that were received, and how these were taken into consideration in the final standard. I'm not saying that every comment is simply incorporated into the final standard, but at least each is given thoughtful attention and consideration.

The final item that I'm going to discuss is a recent communication between the Congress and the FASB. In February 1991, Congressman John Dingell, on behalf of the Subcommittee on Oversight & Investigations, wrote to the FASB with a series of 15 questions. The subcommittee referred to its February 1990 report, Failed Promises, the report that its members wrote on the insurance industry. And they expressed their concern that the accounting standards may not encourage companies to establish adequate reserves. The flavor of Congressman Dingell's inquiry is captured

PANEL DISCUSSION

by two of the 15 questions that he asked, "Does GAAP currently allow the establishment of reserves based on statistically predictable future events, if all or a portion of the premiums being collected from the policyholders, perhaps over numerous policy periods, are for the funding of those probable events?" There's a lot there and as you think about that question, it raises many, many other questions. The second question that I think captures the spirit of the inquiry is this: "Does the FASB believe that investors and policyholders are better served by allowing statistically predictable events, to be recognized only after they occur, rather than accumulating reserves while the policyholder premiums are being collected?"

Now the letter was written in the context of catastrophic reserves for casualty insurance. But I believe it's relevant to life insurance, as well. In fact, the letter specifically refers to life insurance and the differences between life insurance accounting and casualty insurance accounting. Areas that could be related to the subject of the letter include security valuation reserves and AIDS reserves, as well as other areas.

The FASB sent a very thoughtful, 42-page response, to Congressman Dingell's letter in March, covering background issues, as well as specific responses to the 15 questions that the Congressman had raised. It's easy to focus on Dingell's letter as being based on the lack of familiarity with actuarial and accounting concepts. What is the definition of statistically predictable? How do premiums collected during the term of one policy fund the claims that will be incurred during a different policy period?

I think to focus on this aspect, however, misses the most important point of this correspondence. The Congressman is voicing a public concern with the solvency of the insurance industry. In great measure, this concern may arise from failures in the savings and loan industry, that are only remotely related to the risks that are assumed by the insurance industry. But whether the public's basis for the concerns is rational or not is to some degree irrelevant. The concerns exist and we need to be prepared to respond to them.

The FASB acknowledged one area that's subject to some disagreement, and that is, the area of financial statement disclosure. The SFAS 5 for financial statement disclosure states that future contingencies should be disclosed in the financial statements, if they are "reasonably possible." That is a quote, "reasonably possible." In case it's not clear to you what reasonably possible means, the statement goes on to clarify it by saying, "reasonably possible means more than remote, but less than likely." The FASB acknowledges the existence of different interpretations of the phrase, reasonably possible. I think that an important way that we, as actuaries, can make a contribution, is to refine our understanding of the probability and the magnitude of future catastrophic events, and to provide a basis for deciding which ones are material and which ones are reasonably possible.

An area of confusion that the FASB tried to clarify, is the distinction between liabilities and equity or surplus. The concerns of Congress might be able to be addressed by making more clear the risks to which a company is exposed, and the potential cost of such risks in relation to the company's ability to provide for these costs. We know from our study of probability, that there's no way to build up and release a fund that

CURRENT FINANCIAL REPORTING TOPICS IN THE UNITED STATES

will smooth out the financial effects of independent events. When a catastrophe occurs, that does not reduce the probability of an additional catastrophe. The law of large numbers does say that when probabilities are known, the relative cost of risks in relation to exposure will tend to stabilize toward the expected level. A careful statement of the law of large numbers, however, will reveal that, while the relative costs will stabilize toward the expected value, the absolute cost will continue to diverge from the expected amount. Therefore, the resolution of this issue would not appear to be in establishing a better funding mechanism, but rather in providing better disclosure of the contingencies.

That concludes my remarks, but I would like to raise a couple of questions related to Dick Beuter's presentation. One of them relates to the comment on SFAS 97, about the need to periodically review the amortization of acquisition costs and what periodically means? I'd like to express an opinion on it and I would be interested in Dick's response. I think that whenever a review of the amortization of deferred acquisition costs would reveal that there has been a material change, or there would be a material difference between the amortization based on current and anticipated experience and the amount of amortization that has actually been taken, that the standard would require that the amortization pattern be reopened and recalculated.

So I think that, if we are interpreting periodically to mean that there is a three-to-five-year cycle, wherein we would review the amortization, then we have to, in the interim, have some basis for saying that there is not a material effect. I think that that process probably is going to come reasonably close to actually going through the review, in order to determine that there's not a material effect of using current and currently anticipated assumptions to redo the amortization pattern.

Dick raised the point about netting of reinsurance and that we're moving away from netting of reinsurance toward a process where the disclosure would show the gross liabilities and the reinsurance recoverable as an asset. For 1991 statutory financial statements of casualty insurance companies under the NAIC regulations, the actuary who is expressing an opinion on the reserves will have to express an opinion on both the gross reserves before taking credit for reinsurance, and the net reserves. So we're already there on the casualty side, in terms of being required, at least for statutory purposes, to show the reinsurance separately, and to express an actuarial opinion on the gross reserves, as well as on the net reserves.

MR. BEUTER: I might respond to Don's comments on the reevaluation of the estimated gross profit. I agree with what he was saying, that the SFAS 97 requires that you reevaluate the estimated gross profit, I think, annually. When I was talking about a periodic reevaluation of the assumptions, more closely, I was trying to narrow it down to the portion that related to the estimated gains, investment gains or losses. And the concept that I was trying to get across is, I don't think that just because you may recognize \$25 million of gains in one year and you didn't expect it, you ought to automatically reopen your estimated gross profit for that, just because you had an unusual aberration in one year. So I agree with your clarification, Don.

MR. RICHARD L. GIBBS: I have two questions for Dick. Both of these are with regard to year-end statutory reporting for 1991. One of the modifications to the instructions apparently will require the submission to the states of audited financial

PANEL DISCUSSION

statements with footnote disclosures that are based on GAAP. I would want to ask your view as to whether that would imply full GAAP-type footnote disclosures for mutuals? And the second question relates to what the prognosis is, with regard to a potential mortgage and real estate valuation reserve, currently being deliberated by the NAIC for year-end 1991?

MR. BEUTER: Okay, the instructions to the blank that you referred to, which requires an audit certification starting with years ending December 1991, have a provision that will require footnote disclosure on a GAAP basis. I think that provision will require full GAAP footnotes. I also think that's probably some of the impetus behind the NAIC trying to come up with one body of what's prescribed or permitted, rather than having every state have something different. I see that over the past few years, the trend of the NAIC is to try to move towards the GAAP positions, particularly, as they relate to liabilities. The next California Insurance Commissioner is already starting to apply some of the GAAP concepts as they relate to reinsurance, when he takes a position that California won't allow so-called financing reinsurance or surplus relief treaties. Something like 50% of First Capitol's surplus was from surplus relief, and something like 25% of First Executive's was surplus relief. So I think you're going to see a movement along the lines that you've suggested.

The second question you had concerned general reserves for mortgages and real estate. Again, I think that's another area where the NAIC is going to be moving more towards a GAAP concept in having you put up so-called general reserves, rather than specific reserves. So I just think it's a trend that you're going to see the NAIC moving towards GAAP in certain areas, and I don't think it will ever get away from a nonadmitted asset area, because of its approach toward solvency, but I think the NAIC's move towards GAAP is going continue in the future.

MR. ANTHONY J. ZEPPELLA: Could one of you comment on the possibility of whether SFAS 106 would apply to statutory accounting for a mutual company?

MR. BEUTER: I don't have anything specific in mind other than the comment I just made about the NAIC moving towards GAAP concepts, so I would expect that SFAS 106 probably will become applicable to statutory financial reporting. It's a guess on my part.

MR. BEHAN: I don't really have anything to add other than in the absence of standards, we've generally taken the position that GAAP would apply for statutory purposes. This issue was such a large one, that presumably there would be some specific guidance coming on it.

MR. RICHARD S. ROBERTSON: I don't have a question, but may I take about five minutes and talk about market-value accounting?

One of the interesting adventures that I've had for the last few years is that I am in the fourth year of a four-year term as a member of the Financial Accounting Standards Advisory Committee. This is a group that is put together by the Financial Accounting Foundation to advise the FASB on a broad range of issues. And I'm there because it wanted to get an actuary's point of view. In fact, I replaced John Fibiger, who was the designated actuary before I was there.

CURRENT FINANCIAL REPORTING TOPICS IN THE UNITED STATES

The advisory committee has spent most of the last six months talking about this problem of asset value accounting for financial institutions, and I would say the discussion has been 75% in the bank framework, with some thought given to insurance companies, but not nearly enough. But the good news is that the FASB has accepted the premise that there need to be consistent accounting on both sides of the balance sheet. That is, FASB understands the necessity that, if market values are to be used for some or all of the investments, then there must be something comparable to that for the liabilities. The FASB doesn't have any idea how to do it. And I'm afraid neither do we, which is part of the problem. I think that if FASB had its preference, it would simply do some disclosures of what it knows how to disclose, and not make any changes in the values that are recorded in the financial statements. And I think that's the most likely thing that will happen.

The problem is that FASB is under intense pressure from the SEC, and the SEC is not encumbered by the necessity to take into consideration all the facts. It is operating substantially from a political perspective. And in particular, the SEC is under intense pressure from its constituency, which is Congress, where we have even less interest in the facts. But I think the FASB is well down the road of the disclosure route, and I think the SEC has, to some extent, lessened its pressure a little to see what is likely to happen. But that may change.

At the last meeting of the Council, the members talked about three basic approaches: (1) disclosing the market values of those assets for which market values could be determined, (2) putting those market values directly on the balance sheet, and (3) trying in some way to identify some classes of liabilities that can be associated with assets and putting some kind of a current value on that. This last one is a rather vague concept, but I think from an actuarial or really a financial perspective, one that makes a lot of sense. Fortunately, the second one, a one-sided restatement of the balance sheet, did not have a lot of support.

What I'm coming to is, I want to urge those of us involved in this issue from the perspective of either the insurance business or the broader financial business and the actuarial profession, to be supportive of efforts to disclose these current values, even though they might be misused by someone who might then conclude that the disclosure represents a change in the real value of the company. I think disclosure is an alternative to actually restating the financial statements, and I do believe that most people who use that number, will not misuse it, particularly if we can help them to understand how it should and should not be used.

The second thing I would urge upon you is to work very hard to come up with some kind of a conceptual framework that will allow us to value liabilities in a manner that is consistent with using market values for our assets. I'm afraid that, at some point, we are going to have to do something with respect to current values of assets. Unless we are prepared to show people how to be consistent on the other side of the balance sheet, we will lose the basic battle of consistency.

MR. DONALD R. SONDERGELD: I've thought a lot about this market-value accounting over the years and served on the board of a U.K. company some years ago. I would like to think that a lesson could be learned from the accounting practices in the U.K. where assets are valued at market, and the liabilities are valued on a consistent

PANEL DISCUSSION

basis. The major problem, of course, in the transition, is that we have book value guaranteed cash value policies here in the United States, and the transition from what we have to what they have in the U.K. is not an easy one. Perhaps, a solution could be a transition that starting at some point in time in the future, you wall off your assets, either new products or new premiums or something be done on a market basis, and liabilities done on a consistent basis. I know that might sound like a mess, but in trying to get there from here to tomorrow, is a rather sudden jump that could really cause some dislocations in the surplus positions of a lot of life companies.

MR. FRANK J. ALPERT: I have a related question to market value accounting for liabilities. Would any of the speakers care to comment on the discussion draft circulating in the accounting profession on discounting future liabilities?

MR. BEUTER: This is a personal opinion, not a Coopers & Lybrand opinion. And again, I'm probably maybe sticking my foot in my mouth, speaking to a bunch of actuaries, but basically, I think life insurance liability accounting is essentially a present value accounting, so I think the issue really relates to property-and-casualty-type accounting or those insurance products in the life insurance industry that aren't discounted, such as health reserves or something like that. Personally, I happen to be a proponent of present-value-type accounting and feel that, if you have a reserve or a liability that has some predictability through statistical approaches where you can predict a payment pattern, then you ought to be entitled to discount. You're probably quickly getting the impression that I may have some medical malpractice clients or riders as clients, so I'm a proponent of present-value accounting. The profession being as conservative as it has been, I think is why we haven't had it in the past. I think we'll ultimately have some form of present-value-type accounting. But I don't know when or what form it'll take.

MR. MILLER: I'll just make a couple comments, just from my own observations, not necessarily related to the discussion draft that Frank referenced, but the whole idea of market value of the liabilities, I think, is a much broader issue than just accounting. I think it's an issue that provides a lot of good management information if it can be done well, to better understand reserve margins and changes in economic value of the organization. We've struggled with trying to develop some internal measures along these lines, and are a long way from having anything that we feel is totally usable yet, but we see a lot of value beyond just the accounting issue. And just to expand a little bit on what Dick says, yes, on the life insurance side, we are usually dealing with present values already, but the present values driven by statutory and GAAP are a long way from economic present values, both in terms of interest discount rates, reflection of lapses, reflection of expenses, reflection of realistic mortality and any of the other discount-type factors, or contingencies that we have to recognize. Not only that, but also so much of what we do now is done in a static environment, where you're just looking at one set of assumptions. You don't look at the sensitivity associated with the fact that your assumptions aren't going to be right. And something approaching valuing the options of our contracts, is something a little bit closer to the real economic environment that we're in. I think regardless of what the accounting rules dictate, there is a tremendous value to management of the company. Whether it's a gross premium valuation or asset/liability cash-flow testing, all those types of things are headed in the direction of economic valuation or market

CURRENT FINANCIAL REPORTING TOPICS IN THE UNITED STATES

valuation of your liabilities. I think there's a lot of value in pursuing it regardless of the dictated accounting treatment.

MS. AMY J. ABRAHAMS: We've been focusing on the valuation of fixed income assets. And I was wondering if there's been any discussion at all, about the valuation of equity real estate, either on the balance sheet or as part of this disclosure?

MR. BEHAN: When you say equity real estate, you're talking about ownership of real estate or mortgages or what?

MS. ABRAHAMS: No, actual equity real estate, at least within the mutual company industry, there's what we call our hidden surplus, the unrealized appreciation on real estate, which we don't get to report on the balance sheet, but we do talk about it. I'm wondering if there's been any discussion about either disclosing that or doing something with that information?

MR. BEUTER: I don't think it's been a real top priority from the discussion point, because generally in most companies, real estate isn't that major of an asset. I realize that some mutual companies have large ownership in real estate, but I think it's probably not been discussed because for most insurance companies real estate is not a major asset, other than mortgage loans. And I think they would be market or estimated value.

MR. DAVID J. MERKEL: I think we're about 10 years away from where we will have a practical way of doing market valuations of our liabilities. One of the major hurdles has been overcome in the last five years, the ability either in a continuous framework or in a discreet time framework, to be able to discount certain obligations. A good example of this is mortgage-backed securities and such things, and the major investment banks are using this already. And the thing that we still lack, which has been overcome with mortgage-backed securities, is that we have an idea of what the prepayment function is. Granted, it's still imperfect, but we have a far better idea with that, than we do with respect to what is the sensitivity of our liability cash flows, with respect to certain economic variables like interest rates and other non-economic type variables. I'm speaking primarily to encourage everyone to consider working on developing reasonably good functions to determine how our lapse rates change with respect to interest rates and in cases where you have flexible premium policies, how do our premium continuance and discontinuance change? Once we have that, that is the major remaining hurdle. The discounting and option valuation technology exists, we just don't know how our liabilities change with respect to interest rates.

MR. BEUTER: I generally agree. The comment was already made that in the U.K., actuaries are routinely doing gross premium valuations, but the issue is that the cash values there are not at a level that we have, and so that obviously creates a stumbling block, but presumably, we could learn from U.K. actuaries how they're going through that process on a routine basis, and adapt many of the things that they do.

