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INDEPENDENT AUDITS – AN ACCOUNTANT'S PERSPECTIVE

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A panel of Certified Public Accountants from major independent accounting firms will discuss a full range of issues concerning their firms' audits of life insurance company financial statements.

- Objectives of an independent audit
 - The Auditor's Report
 - Types of reports
- Generally Accepted Auditing Standards
- Roles of the American Institute of Certified Public Accountants (AICPA), Securities and Exchange Commission (SEC), Financial Accounting Standards Board (FASB) and other constituencies
- Independence issues and examples

MR. FRANK J. BUCK: Ken Koreyva will talk about the objectives of the independent audit, the auditor's report, generally accepted auditing standards and that sort of thing. Ruben Nava will speak second and talk about the role of the AICPA, and Don Caste will finish up with relationships with other bodies.

Ken is going to speak first. Ken is a Philadelphia-based general practice and life insurance services partner with Coopers & Lybrand. He recently returned to Philadelphia after serving in the National Accounting and SEC Technical Services Department in New York. Among his many responsibilities, he assisted the chairman in providing accounting and research support to the firm's insurance practice across the country, and he has served many of the firm's biggest clients. Ken is going to cover the areas of the objectives of the independent audit, the report, the types of reports, independence issues, generally accepting auditing standards, and the role of the auditor in special situations.

MR. KENNETH M. KOREYVA: I'm going to provide a little background or framework for those of you who haven't been involved in an audit situation and haven't had auditors pounding on your door. An audit means different things to different

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PANEL DISCUSSION

people, but I'm going to talk a little bit about an audit from the accountant's perspective.

An independent audit simply means that the audit's performed by people who are not employed by the company. They are from an independent audit firm. The objective of an independent audit is simply to express an opinion on whether the financial statements are fairly presented. The financial statements simply are the balance sheet or financial position, the statement of operations or profit and loss as it's commonly called, and cash flows. Cash flows are really broken down into three segments: operations, investments, and financing. An audit also provides a social purpose. In a sense it provides an enhancement to the credibility or the reliability of the numbers.

Let's talk a little bit about the limitations of an audit. It does not mean that there's no fraud necessarily or there's nothing wrong, because an audit is based on, in a lot of cases, estimates. An audit by itself uses a lot of sampling. If you reviewed every transaction, then you could say you had some high percentage of confidence that everything was completely accurate, but that would not be cost justifiable in today's world. So an audit in a sense does not mean everything is complete and accurate, necessarily.

From a public perception standpoint, that meaning is not necessarily the case. People who do not work in this environment who review an audit, sometimes say that an audit means everything is just the way it should be; every number is perfect, it's accurate, etc. Some people would say, when you have a clean or an unqualified type of opinion, it means there's no fraud in the company. Some people think that it means that the management team is competent. And some people would say, if you have a clean opinion from an accountant, the company must be a good investment. So that's the public perception sometimes. As a result what developed is what accountants call expectation gaps, that is, the outside users or readers of the financials had an expectation that was far beyond what an audit really does and does not deliver.

So, as a result, the AICPA, about two years ago, put out about 8 or 10 pronouncements to try to address some of these expectation gaps. Those were more reporting requirements in the areas of irregularities, or errors, or fraud, more responsibility to look at internal control and whether there was an adequate internal control structure. Adequate doesn't mean that the internal controls are always operating consistently. Was information from the basic policy, using an insurance environment, translated into reports from the very inception of a policy through its entire life with all the aspects of investing and expenses, etc.? At various departments is there adequate reporting? Is there adequate supervision? The AICPA also required the accountants to do more analytics, which basically look at financial relationships using your knowledge of a company's operations to understand whether the results of those analytics were either consistent or inconsistent with your expectations. This is no different than what you do probably day in and day out in many cases.

The AICPA also required us to change the language. Prior to some of these new reporting requirements an audit was very vague. The opinion itself was simply a couple of paragraphs. This was part of what led to expectation gaps, because the language never spelled out what an audit was. So there was another paragraph

INDEPENDENT AUDITS -- AN ACCOUNTANT'S PERSPECTIVE

introduced in the auditor's report that tries to describe in a brief summary what's involved in an audit and who takes responsibility for what. And for those of you who haven't read it, it simply says that the financial statements are the responsibility of management and that the audit involves reviewing management's estimate, employing techniques to try to reach a reasonable conclusion that the financial statements are fairly presented. And when you say fairly presented that assumes and presumes a degree of tolerance or what we would call materiality in the numbers. And materiality is not necessarily defined in a mathematical equation. The basis for materiality starts with some sort of mathematical percentage, but then there are a lot of other professional judgments or considerations that may go into it.

And last, one of the areas the AICPA covered is the increased reporting requirements to boards or bodies of people who oversee the financial statement process. Typically, we call them audit committees or some committee of a board of trustees. It is some oversight body that basically oversees the process, and then we are required to tell that body at least our perspective in a number of areas. What in the financials are subject to significant management estimates? Did we have any unusual difficulties? Did management cooperate? Were there changes in accounting policies that may or may not have influenced the statement of operations or balance sheet, etc.? So there's effectively a number of required communications if there's anything to report or there's nothing to report. We are formerly now required to report to some oversight body. So a lot of those in summary were really put in place to try to address the expectation gap that exists between what an audit is and what people thought it was.

In our business we give opinions. We give opinions based on some set of rules. The common set of rules, at least in the insurance business, is the statutory accounting practices. Those practices are prescribed or permitted by the respective state insurance departments. So whatever state you're domiciled in really governs what you can or can't do with respect to accounting and reporting. To the extent you're licensed in other states -- for example, New York has a couple of nuances -- you have to kind of change those rules when you file a blank with another state.

But that's statutory accounting principles as we know it today. They're much different than GAAP because statutory is really liquidity and solvency based. It does not envelop what I would call the matching concept. Now that's subject to change and will discuss some of the things that are happening with respect to statutory accounting principles which are going to be conceptually consistent with the way we report on a GAAP basis. In short, the profession is trying to have one set of rules no matter what state you're in.

GAAP applies to stock life insurance companies, at least GAAP that is embodied in an audit guide or SFAS 60, or SFAS 97. One of the ironies here is, if you have a mutual life insurance company, the statutory accounting principles that it subscribes to in a particular state are no different than GAAP for that company, because the stock life accounting principles do not apply to mutual life insurance companies today. So when you look at a mutual life insurance company, what is generally accepted or comparable in a sense, is no different than statutory accounting principles. Stock life insurance companies generally have two sets of books, statutory and GAAP. And, beginning this year, for individual insurance companies that were part of a bigger

PANEL DISCUSSION

corporate holding structure, a lot of states permitted a GAAP-type opinion on generally accepted accounting principles not statutory accounting principles. Some of the differences between the GAAP set of principles and statutory involve deferred acquisition costs, benefit reserves, Mandatory Securities Valuation Reserve (MSVR), nonadmitted assets, and simply there are more realistic assumptions in a lot of cases than statutory.

Similar to the actuarial standards, the accountants also have a set of generally accepted audit standards. There are 10 standards that form the basis or conceptual framework for, to date now, 65 statements on auditing standards. So there were 65 specific applications, of the 10, what I call conceptual or framework, standards, and those standards are broken down into general, field work, and reporting.

General standards apply more on a personal basis. They apply to training, proficiency, independence, due care. Field work standards apply where you do planning and supervision of the work and internal control structures and whether you've got sufficient and competent evidential matter to support whatever you're attesting to. Reporting standards require the report be based on some comprehensive basis. In most cases, when you're providing an opinion on a full set of financial statements, there is some authoritative body of rules. The application of those rules have to be consistent, and if they're not consistent, there's provision to obviously explain that.

Disclosures have to be informative and, just as an aside, I gave a talk recently on this financial instrument. We have a new rule in GAAP called financial instruments that basically tries to get at all the off-balance-sheet deals that a lot of people have done over the years that are not necessarily disclosed anywhere on the set of financial statements nor in the footnotes. So in trying to describe some of the implications, it requires someone to really look at all the deals the company has struck and to put them in the footnotes. So if you pick up any set of financial statements, you'll find that the financial statements are now three or four pages and the footnotes may be 10 or 15 pages. So the story to tell with the numbers has a gotten a lot longer. It's gotten a lot more complicated as well.

In terms of a life insurance company, the major audit areas are investment valuation, deferred acquisition costs (DACs), and benefit reserves. They're really the three primary areas where you spend a great deal of your time trying to get comfort that the amounts reported on the balance sheet are reasonable and fairly presented. What's interesting is the actuary has had a lot of input in deferred acquisition costs -- whether they're recoverable based upon a set of assumptions that everyone tries to agree upon and the benefit reserves. Are they calculated correctly? Are they based on reasonable assumptions? Have they been locked in? Have they been changed? What was interesting in the last few years is that I think the actuarial house and the actuarial involvement has substantially increased in the investment arena. I now call some of my actuary friends real estate actuaries, because the actuarial profession is going to play a key role as we develop more rules on how to carry assets, at least on a GAAP basis, because the statutory world tends to be more formulaic. But in terms of asset valuations with respect to insurance companies that hold a tremendous amount of real estate, some of the key things are the liquidity, duration, and ability and intent to hold. These are some of the basic premises in asset valuations that go back many years. In today's market they're even become more important, because if

INDEPENDENT AUDITS -- AN ACCOUNTANT'S PERSPECTIVE

you're holding a piece of real estate and it's somewhat depressed and you don't have liquidity and you can't hold it, that valuation may be significantly different under two different sets of circumstances. Other audit areas are asset and liability matching studies, reinsurance, and mergers and acquisitions.

Let's spend a minute just on some special situations. What does an auditor do in mergers and acquisitions or demutualization? How does that impact the actuarial profession in the merger and acquisition situation on the buy side, sell side, or whatever? Auditors are usually asked to go in and do some sort of financial due diligence to help the potential purchaser get smart and decide whether and how much to pay for a potential new company. And the due diligence is usually broken down into the financial, which sort of comes part and parcel with our job or it can be in areas of operations -- how do the underwriting departments function, claims, etc? More often due diligence involves how many people are in there, can we manage one-half the amount, etc.? It also involves outside marketing, distribution, etc. That's typically what your due diligence is, and obviously, in any insurance acquisition you can't really do a comprehensive due diligence unless you use the actuary to come in and look at the blocks of business and, obviously, look at the projections and what are the assumptions and how soft are they? What happens if you change them? In terms of demutualization, which is just changing from one set of clothes to another in a lot of cases, the actuaries play a key role in deciding how to take today's worth and parcel it up.

In short, if I look ahead, anything that the audit profession or accounting profession is involved with in terms of life insurers, the actuarial profession will have to be involved with also side by side.

MR. BUCK: The next speaker is Ruben Nava. Ruben is a partner with Deloitte & Touche, and he's the national director of the Insurance Industry Services. He's been involved in services with insurance companies for approximately 20 years. He's a CPA, CLU, Chartered Property and Casualty Underwriter (CPCU), and Fellow of the Life Management Institute (FLMI). He has served on numerous insurance committees including the AICPA Insurance Companies Committee, the AICPA Relations with Actuaries Committee, the AICPA Loss Reserve Task Force, and the AICPA SFAS 97 Task Force. During his career he has served many of Deloitte's largest insurance clients, has participated in mergers and acquisitions and demutualizations, and has been an expert witness on insurance matters in insurance department hearings and other forums. Ruben is going to talk about the roles of the AICPA and the Insurance Companies Committee and the future agendas for the Insurance Companies Committee.

MR. RUBEN D. NAVA: As Frank stated, I'm going to be speaking about AICPA activities in the insurance industry, and Don Caste will follow with some of the FASB and other regulatory body relationships. They are all interrelated to some extent, which we'll try to cover for you.

The first lead committee of the AICPA is the Insurance Companies Committee. It's made up of approximately 14 members which are typically representatives from the big six firms, several smaller firms, industry, and currently, there is one representative from the General Accounting Office (GAO) on the committee. They meet

PANEL DISCUSSION

approximately 8 to 10 times a year. We'll also meet with the other regulatory bodies, FASB, SEC, etc.

The second lead committee is the Relations with Actuaries Committee and some of my accounting brethren have asked me how do you have a relationship with an actuary, but I'm sure you could ask the same thing about accountants. The American Academy does have a related committee called Committee on Relations with Accountants, so you can use the same joke about the accountants.

Those two committees do meet jointly. They meet typically three times a year to discuss issues that are of relevance to the two professions. Those two committees were established about 10 or 15 years ago because of some degree of strife between the two professions, particularly back when some of the pension pronouncements were coming out. But they are designed to promote a free flow of information between the two professions.

Many of the task forces of the Insurance Companies Committee relate to property/casualty businesses and reinsurance, but I'll mention them quickly because some will have some overlapping affect on life insurance.

The first is the Reinsurance Task Force. A task force by definition is supposed to have limited life. This one has been living for over 10 years, however. It has generated a number of papers which I'll talk about. Second is an Agents and Brokers Task Force which is also about to issue a paper on accounting by agents and brokers. There's a task force called Auditing Loss Reserves which, again, is property/casualty. I chair that task force. We are trying to issue guidance on the audits or what considerations the auditor must go through in auditing property/casualty loss reserves. But obviously audits of health insurance reserves, for instance, encompass very similar issues. And the last task force is Life Insurance Audit Guide Task Force, which I'll cover in a little bit more detail.

The current Life Insurance Audit Guide was written 19 years ago in 1972. Obviously, it is seriously out of date regarding new insurance products, new types of investments and, as Ken mentioned, the 8 or 10 new auditing standards that were issued by the AICPA just recently. This task force had its first meeting in April 1991. Its target for issuance of a guide is 1993, which I can tell you is very aggressive. These guides go through enormous numbers of reviews. They run through the AICPA editorial process, through the FASB, the Government Accounting Standards Board (GASB), the SEC and, ultimately, public exposure. It is intended to be an audit guide only, not to have any new insurance accounting guidance. At this point, they do expect to cover both statutory and GAAP audits because, as many of you know, the many new regulations regarding state insurance audits require statutory audits. Canada has new audit requirements for Canadian branches and the like, so the Audit Guide probably will cover a little more in terms of statutory issues than the older guide.

The AICPA recently issued what is called Practice Bulletin No. 8. Quite frankly, these practice bulletins don't get terribly wide circulation as a FASB statement would. I hope you're all aware of the general provisions of it, but I'll run through some of those provisions quickly. This was issued in November 1990 by the AICPA. It is an

INDEPENDENT AUDITS -- AN ACCOUNTANT'S PERSPECTIVE

interpretation of the guidelines set forth in SFAS 97 regarding accounting and reporting for universal life type products. For those of you who have worked on those types of products, there were a lot of questions circulating when SFAS 97 was first issued on interpretations. The AICPA decided at that point to try to interpret what SFAS 97 meant, and we ran into significant opposition from the FASB about issuing this pronouncement. FASB felt and, as a matter of fact, it stated in public meetings, that it thought SFAS 97 was perfectly clear and FASB could police and interpret its own statements. We responded, well, if you really believe that, you ought to go out and start reading some insurance company financial statements because there is some divergence of practice in interpreting SFAS 97.

By the way, you can get Practice Bulletin No. 8 from the AICPA if anybody would like a copy. It covers a number of issues such as deferred acquisition costs. Are they the same definition in SFAS 60 versus SFAS 97? There are some slight differences that are discussed there. Deferred acquisition costs for investment contracts is also covered since we are now classifying certain GICs and certain annuities as investment contracts. There was a lot of question as to whether there is such a thing as deferred acquisition costs for those contracts and there is. There are some slight differences on how you amortize DAC for investment contracts and that's also discussed. The question on amortization of deferred profits on limited pay products was whether to amortize with interest, and the answer was, yes, it should be done with interest. Regarding internal replacements of universal life products, SFAS 97 has a provision that deferred acquisition costs on traditional life products should be written off when those products convert to universal products, but the statement was silent as to whether, if you have a universal product that converts to another universal product, you follow that same method of writing off the old DAC. Interestingly, the answer is no to that question. The provisions of SFAS 97 only apply to an ordinary universal conversion and please don't ask me to explain all of the rationale for that answer. There was a question on application of SFAS 97 to universal health-type products. If they are essentially the same as universal life, should we account for them the same? The answer is substantially, yes. Questions on computation of estimated gross profits for amortization of DAC were covered; questions like should capital gains be included in those estimates? Again, the answer is, yes, and I know that has created some difficulties for at least one or two companies. As far as loss recognition on investment contracts, the question is whether SFAS 60 and SFAS 97 provisions of premium deficiency apply to GICs and other investment contracts, and the answer there is no.

I mentioned the task forces that have generated some of the other papers that are in progress. There's an "Accounting and Auditing Guide for Agents and Brokers." That guide has been in draft form for several years. It has now been approved by AICPA and FASB and is going through a final editorial process and should be issued in summer 1991. And that, by the way, is accounting and auditing, not only auditing, and there are some accounting issues for agents and brokers which will have to get dealt with or because of that guide's issuance.

"Accounting for Foreign Property and Liability Reinsurance" also has been around for a few years. It was put on the shelf by the FASB for a while but has now been cleared for exposure in summer 1991.

PANEL DISCUSSION

Another paper is called "Guidance for Assessing Risk Transfer in Property Liability Reinsurance Contract," and this is the old question of, Was there transfer of risk and, therefore, is it a reinsurance contract or was there no transfer of risk? This is, again, a paper that has been cleared with AICPA and FASB and will get exposed in summer 1991.

Another paper that's in progress is "Disclosures for Fronting Arrangements by Fronting Companies," and this, again, is typically property/casualty, so I'll just go through it quickly. It has been approved, and we'll be going to what's called the Accounting Standards Executive Committee (ACSEC) in June 1991. That is the top technical committee of the AICPA and literally nothing gets issued out of the AICPA unless it goes through that committee on accounting issues or the Auditing Standards Board on auditing issues.

I mentioned there's a task force on auditing loss reserves. We do have a paper that has been cleared by the AICPA Auditing Standards Division and is expected to be exposed in summer 1991. That paper is also currently going through an editorial process before exposure.

One other publication by the AICPA Insurance Companies Committee that you may or may not be aware of is something called, *Audit Risk Alerts*, and again, it's a small pamphlet. This one comes out every fall, before we all start audits of life insurance companies, and it is about 25 or 30 pages. It is effectively what the title says it is. It discusses what the AICPA and the Insurance Companies Committee feels are the major issues that an auditor should be focusing on for the current year's audit of a life insurance company. And you can guess that this past year it is saying we should be focusing on investments, obviously, high-yield securities and the like. It really goes through a number of different areas, SFAS 97 accounting issues, A&H insurance, and reinsurance. It basically is trying to guide the auditor to the areas that need concentrated audit efforts.

As I mentioned before, there have been some differences of opinion between the FASB and the AICPA as to what the AICPA's role is. Clearly, the FASB is the senior body regarding accounting principles, and typically, the AICPA will only issue accounting statements on issues that the FASB has decided not to deal with. AICPA is still issuing all the auditing statements. And to go back to some of the papers I mentioned earlier, the way the process of dealing with an auditing or accounting issue starts is the AICPA goes to the FASB and says, look, we have an issue. We believe it's important. Do you want to deal with it? In that case the FASB says, no, we don't feel it's that major why don't you? So there is some tradeoff between the two bodies as to setting accounting standards.

While we're talking about the FASB I should mention that it has just put an item on its agenda on reinsurance. It relates mostly to property/casualty companies, but my sense is that, when it comes out, it will relate to all insurance companies, and that is on reinsurance offsets. As you know, when you're carrying reinsurance or have reinsured part of your business, that reinsurance is a deduction from your policy reserve liability or in property/liability companies your loss reserve liabilities. The FASB is seriously considering eliminating reinsurance offsets completely. The sense is that will happen. It will happen sometime in the summer of 1992, which means there will

INDEPENDENT AUDITS -- AN ACCOUNTANT'S PERSPECTIVE

be some exposure by the fall or winter of 1991. The SEC is also interested in that topic. The SEC has informally polled several companies asking, what do you think about this issue of reinsurance offsets? What if the FASB says no more offsets, and you have to blow up your balance sheet to gross loss reserves? At least three or four major casualty companies responded they don't really care; they know it's going to happen sooner or later. It will probably affect the smaller companies more because they probably have a larger amount of reinsurance relative to their net liabilities. So this change could have some major effects, obviously, on leverage tests and the like.

I think something was mentioned earlier about the NAIC uniform rules. Let me just mention quickly there is a project by the NAIC to put together uniform statutory accounting practices so that there would be something to compare to when a New Jersey or New York insurance company files its statutory statements in accordance with its domiciliary state. How does somebody in Nebraska or Oregon know all of the particular practices in New York enough to interpret those statements? So the NAIC has a project to come out with uniform accounting standards, and then the statutory statements would have to have a footnote saying, if you're a New York company, you'd still put together your statements in accordance with the New York practices, but then you'd probably have to have a footnote listing the differences between the New York and the NAIC standard practices. Then there's some question as to how the auditor is supposed to report on all these varying practices, NAIC versus a particular state.

I'll lastly just touch on the authority of these pronouncements because I've obviously mentioned FASB statements and AICPA guides and statements and the like, and this is the general order of the authority of the statements. FASB statements come first -- technical bulletins, Emerging Issues Task Force (EITF), and then AICPA statements of position, audit guides and the like. But for the AICPA right now, there is a lot of confusion over what the authority of say a practice bulletin is, particularly Practice Bulletin No. 8 on application of SFAS 97. Is that automatic GAAP? Does it only establish preferred GAAP? Does it simply put out guidance which you could or could not conform to based on choice? There is some confusion. The AICPA has a project to try to write a paper on defining what the hierarchy of these pronouncements is. If you are an SEC reporting company, practice bulletins are automatically in force, and you must follow them. If you're not an SEC company, there is some variance in practice even among the big six firms as to what each of these pronouncements means in the GAAP hierarchy. That is why it's trying to be cleared up by the AICPA itself.

MR. BUCK: The final speaker is Don Caste. Don has been with Ernst and Young for 17 years and a partner for six of those years. He's a CPA, a member of the AICPA, New Jersey Society of CPAs and the New York CPA Society. He's been specializing in accounting and auditing services to the insurance industry since 1983. From 1989 to 1991, he served as the firm's Associate National Director of Insurance Industry Services and recently assumed the position of Director of the firm's New York insurance practice. Don is going to be talking about relationships with other bodies, the FASB, the SEC, and the Society of Actuaries.

MR. DONALD J. CASTE: As an auditor for 17 years and, in particular, as an auditor of insurance companies for the last eight or nine, I've given people in the insurance

PANEL DISCUSSION

industry a sense that sometimes I act in a very confused manner, and they don't ever seem to be able to get a clear, crisp answer from me as to what's the proper way to account for a particular issue. I'd like to try to defend myself a little bit by showing you why we accountants and maybe just me in are often confused about giving an answer on an accounting issue because there are so many different bodies of authority that have different views and different needs that are dictating to us. So it really sometimes comes down to which statements you are talking about, the statutory statement, the GAAP statement, or if you're a public company, the statement that gets filed with the SEC. I will try to take you through the various bodies that influence accounting policymaking, and I would also like to finish up with an example which relates to, I think, the very controversial issue that we've got at the moment involving market-value accounting, which will particularly affect the insurance industry as it evolves.

With that let me first start with the FASB. The FASB, established in 1973, has as its mission, to establish and improve standards on accounting and reporting for the guidance and education of the public, including issuers, auditors and users of financial information. As Ruben said, this is the highest body of authority. Now that's got to be qualified. It's the highest private body of authority. In a sense we have some control over that because the sponsoring associations of the FASB are private industry with accountants, industry representatives and so forth. And there isn't that much direct public influence.

The board has seven full-time members, and recently, the rules were changed for any FASB pronouncement to get out, it has to have a five-to-two vote in favor. It was four-to-three, but there was a decision made that there ought to be more of a consensus for something as important as accounting issues to be promulgated and have such effect across the country. When these members are appointed to the board, they have to sever all ties to former firms or employers. They're usually and, hopefully, experts in accounting and financial reporting, and they each serve a term of five years. Their typical pronouncements are statements of financial accounting standards, and there's been 106 to date and climbing. There have been 38 FASB interpretations, six statements of financial accounting concepts and 48 FASB technical bulletins, and as Ruben said, some of them are not easy to obtain, but if you're interested in reading all those we'd be happy to get you copies any time you'd like. That briefly is FASB.

Ruben covered the AICPA. I'll just briefly overview. Established in 1887, it is to act on behalf of its members and provide necessary support to assure that CPAs serve the public interest in performing quality professional services. It is, in effect, like your Academy of Actuaries and your Society, working in terms of promulgating and developing research and promulgating standards, including ethics and other reporting and auditing standards, in particular, that we all live by. This is a society that has over 300,000 members. It's all the CPAs. You have to be a CPA to be in it and our dues support the efforts of that. It's a little unclear to me just what the AICPA does vis-a-vis the FASB in connection with promulgating accounting pronouncements. However, I think it's easiest to understand that, while there's enough issues that are out there, there's probably not enough resources in either case to address all the issues, so the two aren't arguing terribly about turf. They're working together and

INDEPENDENT AUDITS -- AN ACCOUNTANT'S PERSPECTIVE

communicating, and when it gets to be a very large issue, the AICPA, and I'll show that as an example later, defers to FASB as being the highest of the private authorities.

As I said, the AICPA sets audit standards, ethics, provides continuing education, prepares and grades CPA examinations and on and on. Ruben mentioned in a little bit more detail the kind of pronouncements the AICPA comes out with, but effectively here you'd look at the Accounting Standards Board and ACSEC, as being the key committees that issue accounting standards.

Now if we were just a private organization or if the companies you worked for were private and not in a regulated industry, we could stop here. This would be all the accounting authority we would need to deal with. However, many of you work for public companies and that brings in the SEC.

Created by Congress through the Security Exchange Act of 1934, the SEC has direct authority over the accounting principles used in SEC filings and reports. It has significant indirect authority over auditing and accounting standards used. It is the granddaddy that is the watchdog for all publicly traded companies, and therefore, it exercises its influence both directly and indirectly as to the standards of reporting and auditing that are lived with. And the SEC usually relies on the AICPA and the FASB to set acceptable accounting and auditing standards. However, if it doesn't feel these two bodies are acting quickly enough or strongly enough, it will exert its influence by threatening, if you will, to issue its own standards to superimpose on all publicly held companies. The SEC prods and pushes the other two bodies to deal with the public issues that are at hand.

The SEC has five commissioners each appointed by the President. Not more than three may be of the same political party. I think there are over 2,000 employees of the SEC and several divisions. The divisions that deal with accounting and auditing and registrations are the division of corporate finance and the office of the chief accountant. The authority and the pronouncements that exist today promulgated by the SEC relate to two acts, the Act of 1933 and the Security Exchange Act of 1934, which give the overall guidance and power and authority to the SEC to issue rules and regulations. Regulation SX dictates the form and content of financial statements, including special rules for insurance companies. Then there are accounting series releases and staff accounting bulletins which are ongoing pronouncements that the staff comes up with that deal with issues as they come along; these are important current topical issues of the day.

Right now the SEC is putting a lot of pressure on the insurance companies. It has requested special information not necessarily to be reported on in the financial statements but to be sent to the SEC about asset quality. It has requested information with respect to high yield bonds and real estate investments. And one avenue that it has, outside of the financial statements per se, is also in the registration document. There is a management's discussion and analysis (MD&A) of operations and financial position, and that is a narrative discussion relating to the company's position presented, prepared by management. It's supposed to deal with every important aspect of the company's financial position. In effect, you can read the MD&A and perhaps even ignore the financial statements if you want to, but you're

PANEL DISCUSSION

supposed to be able to get out of that MD&A everything that's relevant to the operations of the company. Of course, the MD&A should be read in conjunction with the financial statements. However, it is more of the SEC's domain. The MD&A is not audited. It's not subject to audit, but the SEC, when it feels the financial statements do not, as currently required, give enough information about certain areas, is insisting that companies beef up the MD&A. In the insurance company areas I mentioned, it would be perhaps quality of investments, such as the real estate areas, the high yield bond areas, and go into a significant description of what those areas mean, the timing, the liquidity issues, the matching issues and so forth. It's a constant battleground between the registrant and the SEC, and of course, the SEC continues to gain ground.

Now if you were private or public and not in the insurance industry, you could stop where I just was, because nobody else really matters in terms of dictating accounting policies. But being that insurance is a highly regulated industry, you have the state insurance commissioners coordinated by the NAIC, which prescribe, and the states permit, accounting practices for insurance companies. And these accounting practices differ greatly from the GAAP statements I was talking about up till now. GAAP is prescribed by FASB, the AICPA and the SEC and the pressure that the SEC puts on those two other bodies to come up with the appropriate accounting. The NAIC, on the other hand, comes from a totally different direction. It has different needs, different uses and a prescribed accounting which is in many cases significantly different than GAAP. Now you know why, when I walk into an insurance company sometimes, I look very confused and if it's a GAAP stock company it's even more confusing.

There are areas that are not yet in the NAIC guidance on accounting. I would characterize the NAIC as being significantly, in some areas anyway, behind the times with respect to certain current areas like the investment issues and some of the high tech securities that are out now being traded and sales of certain interest in real estate. Whereas, it's always been thought that the NAIC, and therefore, statutory accounting principles, are very conservative, there are actually some significant exceptions to that and some of those are coming to bear now. This is particularly in the asset quality area, where the aggressiveness at which the statutory accounting principles require certain assets to be written down or reserved for, is probably not as aggressive as GAAP would have it. So, in fact, you see some companies out there with statutory surplus, that may be overstated if you would have applied GAAP in certain asset areas to the company. So as an auditor and an accountant we often-times, when the NAIC guidance does not address the particular issue to a great extent, will defer to what the FASB and its affiliates and the AICPA and its committees have written and developed on the particular issue. Basically going to some guidance versus no guidance that may exist in the NAIC accounting practices. So that's how we can often shift from pure statutory accounting principles, look to GAAP for guidance, and come back. And, in fact, the NAIC has done that a number of times itself recently. It has emerging issues task force groups that deal with some of the more aggressive or unusual transactions that come up, which are brought to the table by certain companies and, for which the NAIC guidance isn't necessarily complete in the area. The NAIC will look at the GAAP guidance on that particular issue. It may not concur ultimately with the GAAP guidance, but it will look to it as a lead.

INDEPENDENT AUDITS -- AN ACCOUNTANT'S PERSPECTIVE

The actuarial profession has many times influenced the development of certain accounting principles as well. SFAS 97, as Ruben and Ken both mentioned, deals with accounting for certain insurance products and the actuarial profession was consulted on those issues. Actuaries were particularly consulted on pension accounting and the recently issued pronouncement on postretirement benefits other than pensions. There is not necessarily any direct way the actuaries influence the accounting principles. However, they issue position papers, comment letters, and have, as Ruben mentioned, the two committees, analogous to committees in the Academy and the AICPA on relations with accountants and actuaries. The actuaries are constantly asking for counsel informally to help accountants understand some of the dynamics of the complex issues that we're trying to develop accounting principles for.

Back to the FASB, I'd like to just go through quickly how are added to the FASB agenda. The SEC through its prodding and its concerns influences the ACSEC to go through the process. The issue gets brought up through the ACSEC and the ACSEC recommends going to the FASB, the Emerging Issues Task Force and all others. The FASB has its own agenda that it develops itself internally and listens to outsiders, financial executive institutes and so on. Through an example, the AICPA Industry Committee formed a task force to address an issue. The task force presents recommendations to the ACSEC, and the ACSEC reviews proposals and agrees to submit the draft statement or proposal to FASB. FASB can take the following actions: put it on the agenda, develop a technical bulletin, leave it with the AICPA, or reject the proposal.

Now one of the issues that currently face us today is mark-to-market accounting. That is instead of preparing financial statements on a historical cost basis (that would be the amount that you paid for an asset or the amount you received when you initially set up a liability), it would change that historical cost accounting basis to a market-accounting basis, which would obviously change from period to period depending on the market value of the respective assets and liabilities. The failures in the S&L industry and, sad to say, recently the failures in the insurance industry have caused the SEC, in particular, to be very concerned that the public is getting appropriate information about the financial position of these companies, because what we're showing them on a historical cost basis may not bear any resemblance to what the company is worth on a market-value basis depending on the durations and the quality of its assets and its liabilities. This particular issue was sitting, actually, in a larger project on financial instruments with FASB, however, the AICPA was dealing with the narrow part of the mark-to-market accounting with respect to debt securities. AICPA had an exposure draft it issued in 1990 requiring certain market information about debt securities, which on insurance companies are permitted to be carried at amortized cost. Given the situation we have with high-yield securities, it's obvious that amortized costs may bear no resemblance to current market values. In any event, AICPA issued its exposure draft requiring in 1990 financial statements that disclosures should be made about the market value of debt securities. Well, the SEC Chairman, Richard C. Breeden, said that's not enough. He was concerned that the public doesn't know what these financial statements really mean, what this company is really worth today, and what its position is. The AICPA at that point said, "Well, if you want to go to a full market-value accounting, that means all your assets and all your liabilities mark to market. That's beyond us. That's not the duty of the AICPA." That has to go to FASB, in which case the AICPA brought FASB into it. The SEC,

PANEL DISCUSSION

the AICPA, and FASB sat down and agreed to proceed. FASB would accelerate this portion of its overall financial instrument agenda item and recently issued an exposure draft requiring disclosure (not accounting) with respect to more, not all, assets and liabilities on the balance sheet. And one of the major exclusions for the insurance industry is the draft doesn't include definition of liabilities that have to be mark to market, and it doesn't include insurance contracts except for investment-type contracts like GICs and certain long-term annuities. And that's an exposure draft, which if it moves along, will be a requirement for 1991. The comment period just recently expired, so we'll see what the comments say and whether the draft gets implemented for this year or not.

In the meantime, the Federal Reserve, Alan Greenspan and L. William Siedman, realizing that actual mark-to-market accounting, not just disclosure, from year to year could have some volatile and maybe negative effects on the banking industry, so they expressed that view loudly. And then our good friend Congressman John Dingell, who is looking to exercise his authority to introduce some federal oversight to the insurance industry, has asked the Government Accounting Office (GAO) to prepare a market-value accounting study and issue it by July 15, 1991. And again, Greenspan and Siedman expressed some concerns about the volatile effects of mark-to-market accounting on the banking and insurance industry.

With that, the SEC, and I don't know if this is politics or not, decided that the FASB had made a very respectable attempt at solving the issue, and maybe things shouldn't proceed quite as quickly as Breeden had once thought, so at this point that issue is proceeding. On mark-to-market accounting we'll have to wait and see if things heat up again. Pressure comes to bear because of more of the recent interest failures and concerns that exist relative to the insurance industry and other financial institutions. And just to note, the ACLI did respond in February 1991 and indicated it would not object to market-value accounting as long as it included all liabilities and did not exclude the insurance liabilities.

I would just like to discuss some of the other agenda items that are currently facing FASB. Financial instruments embody the market-value accounting. They also deal with some questions such as definitions of liabilities and equities and recognition and measurement and other disclosure items. Income taxes are an area of significant frustration for FASB. It has been trying to issue a new pronouncement on income taxes and recently came out with an exposure draft with certain amendments to a pronouncement deferred three years earlier. FASB has tried to it, which was what most of the objections were to the first pronouncement. And a lot of the accounting pronouncements that FASB and everybody else comes out with add a significant economic burden to the companies, so we try to not lose sight of that along the way.

There's also an agenda item regarding not-for-profit organizations. Here's an area where there were four AICPA guides dealing with various aspects of or various different types of not-for-profit organizations. FASB is going to try to consolidate that and have some consistently to not-for-profit accounting. Consolidations recently had a pronouncement to increase the amount of disclosure. Where companies were not formerly consolidated, and are consolidated now, there are other issues still to be addressed including, once we've consolidated all these companies, how do we

INDEPENDENT AUDITS -- AN ACCOUNTANT'S PERSPECTIVE

disaggregate some of that information in the footnotes so that we don't lose sight of the various businesses that the company is in? The impairment of assets topic was a discussion memorandum issued on December 7, 1990, and essentially deals with how and when to respond to or to recognize long-term assets that have been permanently impaired. Present-value-based accounting is on the docket. There is not a lot of present-value accounting done in historical financial statements. This agenda item will look at those issues and make determinations what assets, liabilities, or other transactions should get present-value treatment. Stock compensation plans are an agenda and item that has been around for a long time. FASB is attempting to determine how to identify and measure the expense associated with stock option plans in general. Right now most stock option plans are those where options are granted at market and don't result in any expense on a company's income statement, and there is a question as to whether that is a fair representation of the grant. If it wasn't worth anything, why grant it?

So, I hope I've given you an overview of the various reasons why we often look confused and act confused about what the proper accounting is. You can find these pronouncements by writing to and getting on the mailing lists for the various associations and institutes that I mentioned. Of course, you can also call any of the big six accounting firms, and we provide analysis and summaries and updates of what's going on in each of these areas.

MR. BUCK: I have one question and it really concerns reinsurance. Ruben, you mentioned the accounting for property/casualty companies, but clearly, accounting for reinsurance in life insurance companies is very important. You've had the California department saying it is going to ban all surplus relief reinsurance as of the end of 1991. I recently had discussions with the Florida department in which it said it did not think an excessive lapse risk or an excessive investment risk counted as a transfer of risk for a reinsurance contract. You could well have situations when, on a statutory basis, if these deals are unwound, that there would be insufficient capital for the company to operate. Now how are you going to account for that on a GAAP basis? How are you going to cover the potential that the company can't operate?

MR. NAVA: As Don said, the first question you have to ask is, are we talking statutory or GAAP, which state, etc? There are going to be difficulties, and it's not unusual in some other pronouncements like SFAS 106, for instance, on accrual of postretirement, postemployment benefits. I mean there are companies that are going to have difficulties when you're talking large liabilities. I don't have a direct answer, but it is going to create problems. It clearly is. By the way, I mentioned reinsurance offsets that are on the FASB agenda. Part of that is getting recognition on reinsurance transactions, and the answer is obviously going to be no up-front gain recognition, but that is the GAAP side.

MR. BUCK: That could create some problems.

MR. NAVA: That's the GAAP side, but understand and Don also spoke about NAIC and its emerging issues working group, the NAIC is starting to look at almost anything FASB does to determine whether similar provisions should be adopted under statutory accounting.

PANEL DISCUSSION

MR. JOSEPH H. TAN: One of the significant developments in the actuarial profession is this valuation actuary requirement that's due to be adopted shortly by various states. The question that I have is, are there any corresponding developments on the GAAP side? My own personal thinking is that the closest thing that I can see on the GAAP side, which looks somewhat like it, is the DAC recoverability test and loss recognition test. On the statutory side we look at this sufficiency of statutory reserves while on the GAAP side we look at the adequacy of GAAP benefit reserve less DAC. However, my reading of statement of SFAS 60 seems to tell me that is done on a best estimate basis while on the statutory side we're required to do the projection under various scenarios. The question is, as audit partners of insurance companies, how will the results of the valuation actuary testing be used? And how do you use the results? In other words, would there be some rule that you use that maybe if the company fails a certain number of scenarios, that an opinion on the company as a going concern would be considered?

MR. KOREYVA: I'll give you at least my response to your question. I don't think the accounting profession is going to be able to operate effectively in this business anymore without the actuary sitting on the side, and in fact, some people would argue the actuary's going to be in the forefront and the accountants are going to follow the lead. And no matter what I think Don talked about a lot of regulatory types of bodies here. The first rule of thumb is, no matter what regulatory body you opine on or look at, if you're insolvent or you're deemed to be not in good condition by your applicable state insurance department, it doesn't matter what else you say because you can get shut down. So the valuation actuary concept in itself is going to play a very key role. It's my own opinion and I think to answer your question directly on the GAAP literature, it hasn't caught up with the problem. The literature refers to narrow balance sheet accounts, deferred acquisition costs, and benefit reserves. The valuation actuary basically is going to say whether the insurance company has a going-concern problem and how long that might continue. So from my perspective, the accountant's opinion is going to be more like relying on the valuation actuary to give him going-concern concept or at least supporting him.

MR. NAVA: I would just add one point to that which relates to one of the papers that will be coming out soon, and that's auditing of loss reserves for casualty companies. Clearly, the paper is going to have some influence on Ken's task force regarding auditing life companies, and the property/casualty reserve paper refers to actuaries and loss reserve specialists. The general auditing literature today does not require an auditor to use an actuary in a life audit or an actuary in a property/casualty audit. This paper is coming out in exposure draft form. It will say the auditor must use an unrelated loss reserve specialist in order to evaluate loss reserves, and that concept cleared the Auditing Standards Board, so I think it was a good question. There's clearly going to be much stronger linkage between accountants and actuaries in audits of all insurance companies going forward.

MR. CASTE: I would just add that it occurs to me that the question jumps at Ken's comment in his talk about the expectation gap, and we could sit here as auditors and say, well, the financial statements on a statutory or a GAAP basis as of December 31, 1990, are fairly stated given the principles that guide us to that point. The public is out there saying, where were the accountants at the companies that have gone under and the S&Ls that went bust two or three months afterwards? So there is an

INDEPENDENT AUDITS -- AN ACCOUNTANT'S PERSPECTIVE

expectation on us that we can't ignore, and we've tried to fill that gap as best we can. Insurance companies are probably more sensitive today, particularly to the various economic scenarios that could play out over the next couple years. And so we must be aware of that. The fact that actuaries come up with standards to develop the different scenarios is very important for us. We can't help but want to look at that and use that information, and each of the firms represented here has a significant number of actuaries on our staffs to help us deal with those issues, because what happens in the future is very, very important in near term and long term. We have the responsibility of determining whether there's a major concern as to whether the company is a going concern or not. Some of us have said they would like not to have that responsibility and just say those assets are there and those liabilities are there and then everybody else out there has to worry whether this company can survive or not. But, no, the AICPA has said accountants have the responsibility to look for possibilities that the company cannot continue, and certainly the actuarial evaluation is one of those things we'd have to look at to help us make sure there aren't any major concerns in that area.

MR. NAVA: For those of you who are consulting actuaries outside of insurance companies themselves, I don't think it's too many more years before actuarial opinions are going to start getting published. They're going to start going into SEC filings. There is one company that I know of, it happens to be a reinsurance company, that publishes its actuarial opinion in its glossy end year report. It's called NAC Re. It's up in Stamford, Connecticut. It's a Tillinghast opinion and it's actually published right in the report. So there is clearly more liability being taken on by the consulting actuaries.

MR. BUCK: Also, since I've been in the U.S. for the last seven years, there's been a greater involvement of the actuary in life insurance company audits and as more information becomes available like Regulation 126, the accounting firms realize that Regulation 126 filings are required. I spent this year-end reviewing Regulation 126 filings for a whole load of companies. As more information becomes available, the accountants will look at it, and they'll look to their actuaries to interpret the results, and I think the same will be true of the valuation actuary requirements as well.

MR. MICHAEL E. DUBOIS: Given the recent events in the industry, solvency is really a major concern, and I'd appreciate the panel's comments on the following. If an audit does uncover questionable areas, is or should there be some requirement that there be direct disclosure to regulatory authorities? Second, with regard to reinsurance transactions, is there or should there be any requirement to examine the underlying financial strength of the reinsurers that are involved? And, finally, as was mentioned earlier if an asset would have a different value, a lesser value under GAAP accounting standards than it would under statutory standards, should that somehow be taken into account in expressing an opinion on the statutory statements?

MR. KOREYVA: The answers to your questions are yes, yes, and yes. I think your first point was, if you have questionable areas, should you communicate directly to regulators? Any day now there's guidance coming out with respect to how we should communicate with regulators, when, on what situations, and so on. So there's direct guidance coming out. The second question involves reinsurers. We have already got sufficient guidance, but your question begs another issue which we

PANEL DISCUSSION

talked about and at least touched upon, what is the internal control structure in a company? See the primary responsibility is not on the outside accountants. It's inside. The question you have to ask is, what has internal management done to satisfy itself that the companies it is doing business with are going to be around? And we're going to basically overlook that process and say whether it's okay or not okay. And the third question was when you have asset impairment issues, I think as both Ruben and Don have said, you're beginning to see a convergence of all these bodies come together because the profession and the industry cannot afford to have these big gaps between valuations.

MR. CASTE: I talked about market value a little bit before. It's going to be a while I think before a model comes out on market value. There are a lot of hurdles to overcome and there are a lot of assets and liabilities for which we don't have quoted market values and are otherwise difficult to measure. Comparability among or between companies would be impaired perhaps if market failure was done without a significant amount of thought beforehand. You know it's a question of severity as well. I think the auditor has to take into account just how far market is below cost in a specific asset or really in the aggregate on a balance sheet and whether that is going to cause a significant problem to the company going forward. Nonperforming assets or permanent impairment is a very ill-defined area as well. But I think again getting back to the expectation gap, the auditor's responsibility is still to not ignore something of a major and severe consequence on the balance sheet. There's always a way to find a reason to disclose something that ought to be disclosed, whether there's a pronouncement out specifically for it or not, whether it's a concentration of risk in one particular area or a severe market, possibly permanent decline, I think it is our responsibility to address those in certain ways. Without guidance, it is tricky, but we have to find ways to do it.

MR. NAVA: As an example of how precise we tend to get in some of these rules and why they take so long to come out, you've heard mentioned the words permanent impairment of invested assets. The accounting profession has now changed permanent impairment tests to impairment that is other than temporary, and I'm not sure I even understand the difference between the two.

MR. SALIM MANZAR: I'd be interested in the panelists' opinions of the role of the internal auditor. I'd also be interested in their opinions as to what are the advantages and disadvantages of having an actuary as the general auditor of an insurance company.

MR. CASTE: There is I believe a very key role of internal auditors in a number of ways. In an organization they can be part of the internal control structure. They can work with the outside accountants to make for an efficient audit of the organization. They can also be very effective in operational aspects and looking at the various operations functions of the company and making recommendations for improvement there. I would think just as I've seen many of the internal audit departments include a computer audit specialist, that an actuarial specialist could be very useful in an internal audit function because, while he's not the independent auditor, he is supposed to have an attitude of independence within the organization, both to fit in and be helpful to the organization. Nevertheless, if the organization, as an insurance company is, is a complex one and has complex areas like an actuarial area, then the department has

INDEPENDENT AUDITS -- AN ACCOUNTANT'S PERSPECTIVE

to have the weapon, so to speak, to be able to deal with that effectively. I think that's what you've seen with the independent auditors. Not only do we have them to help us with our audits and consulting opportunities, but also without them I think we'd have a very difficult time performing a complete, effective audit, so they could be useful. There are constraints. You know there are cost benefits. I'll presume to be able to make management decisions for the Metropolitan as to where it should have its actuaries, but as I understand there are not enough good ones to go around. There's not enough to go around to the other key departments anyway, not necessarily in the Metropolitan. So it's a matter of allocation of resources.

MR. NAVA: I would agree generally with those comments. I think for the most part internal audit departments have not had actuaries. It probably depends somewhat on the focus of the department, being operational auditing or financial auditing or looking at internal control structures, but I think we'll start to see more actuaries within internal audit departments in the future.

MR. KOREYVA: On a lighter side, I think it adds a new dimension to the definition of an actuary, because on the ride over from the train station the cab driver asked me where I was going and I told him. He says, well, what are you going to do and I told him I'm going to speak to some actuaries. He wanted to know what an actuary was. So I explained it had to do with insurance policies. Then he understood. But you think about it. What happened to the actuary over the last 10, 20, or 30 years? You went from product development to financial reporting to investments to real estate. I've got actuaries trying to convince me how to carry real estate now, so why not internal audit? Many people criticize the accounting profession that you see all these standards as to full employment act for accountants, why not for actuaries?

