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- SEC/FASB
- NAIC
- IRS
- Office of the Superintendent of Financial Institutions (OSFI) Canada

MR. GLEN M. GAMMILL: Our panel covers the waterfront in financial reporting in the United States and Canada. Leading off, Mike Kavanagh of Mutual of Omaha's Canadian branch will review the financial reporting scene in Canada and will provide us with a historic perspective of accounting north of the border. Mike graduated from the University of Toronto and taught for several years before beginning his actuarial career more than 20 years ago. He's the appointed actuary for the Canadian business of his company under the New Insurance Company Act of Canada. Mike is a Fellow of the CIA and a Fellow of the Society of Actuaries.

Ted Schlude is a consulting actuary and FSA with Milliman and Robertson in Chicago. I've asked Ted to cover a wide range of financial-reporting topics as they relate to the NAIC and its Life and Health Actuarial Task Force. Ted comes highly recommended to the panel by Walt Rugland and the other M&R actuaries for whom he monitors NAIC financial developments.

Bill Freda is the national insurance partner for Deloitte & Touche. As its representative on the AICPA Insurance Companies Committee and as chairman of that committee's Mutual Life Insurance Task Force, Bill will review recent reporting developments from the perspective of the AICPA and to generally describe the AICPA's role in the accounting and auditing standard-setting process. Bill is a CPA, a member of the AICPA, and is an active participant in several insurance organizations. He also serves as his firm's technical advisor on insurance, accounting, and auditing matters.

Wayne Upton is a project manager at the FASB. Wayne will review current developments at the FASB as they relate to the insurance industry. I've also asked Wayne to provide us with an overview of FASB's organization and how it addresses the promulgation of accounting standards in the United States. Wayne joined the FASB's research and technical activities staff in 1984 with more than ten years of public accounting experience. He has been active in a number of FASB's projects over the

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years, including *FAS 97*, and is now the project manager on present-value measurements.

Following the panelists' presentations, we'll invite your questions or comments regarding the subject matter of this panel discussion.

MR. MICHAEL KAVANAGH: One of the things that I would like to make clear is that I'll be giving my own personal opinion. I might ascribe certain feelings to the CIA or to the federal regulators in Canada, known as OSFI, but I'm really just guessing from my own experience and practice. I'm not able to present official views of either of them, but one gauge is my inference from their actions.

I presume that some of you may have reviewed Canadian practice in your previous work or through the exams, but Glen has asked for a general overview. The primary financial regulation is done by the federal government through the OSFI. A few life companies are registered in provinces such as Quebec, Ontario, New Brunswick and, I believe, Saskatchewan. The dominant form is federal regulation, and my own experience has always been with federally regulated companies. Financial reporting in Canada was derived from an old model similar to the U.S. statutory basis in the law up to 1978. In this previous reserve scenario, the mortality and interest rates were prescribed, and the net-premium method of valuation was required.

In 1978, a significant change was made. The actuary of a life insurance company was allowed to set the interest, mortality and other assumptions, including lapses, according to his or her own judgment of the company's expected experience. Then there was an additional requirement that provisions for adverse deviations be put into the reserve assumptions and on top of that, the federal regulator, really being interested in solvency, said the actuary could make provisions for adverse deviations, in essence, as high as he or she wanted. This was then the only allowed type of reserve that could be used in financial statements in Canada, and it had to be signed by the valuation actuary under the legislation at that time. This was still a net-premium valuation.

There has been a great deal of pressure from some of the companies because of the fact that this method did not conform to GAAP for the financial statements, and the CIA and the Canadian Institute of Chartered Accountants (CICA) spent a number of years trying to establish a uniform method of setting reserves. I think we finally settled in about 1987 or 1988 on the policy-premium method. This uses a rather different approach. The actuary was able to use his or her own estimates of company experience, but the premiums that were to be deducted from the future liabilities were the actual premiums expected to be paid under the policy terms. The reason for going away from a net-premium type of valuation to a modified gross-premium form of valuation lay in the fact that we were in an era of change. Therefore, one expected that the actuary would be required to change the assumptions frequently. In fact, the standards require that the actuary review the assumptions each year to see if they're still appropriate and to change the assumption about the future experience if determined to be material. If you get involved in a net-premium type of valuation, anytime you change your basis, there is a significant problem with determining how to treat the past. In the gross-premium type of valuation you simply look entirely toward the future.

Further, there has been an agreement between the CIA and the CICA to implement the policy-premium method since about 1987. However, the regulator, OSFI, was not satisfied with the introduction of a completely flexible type of reserve system for the statutory statements. As a precondition for allowing the policy-premium method to be introduced, it required that the CIA introduce a significant amount of guidance to the practicing actuaries, such as myself, and this took some time.

The other area that OSFI was interested in was solvency. As a regulator, it took the position that policy-premium-method reserves could be inadequate for solvency purposes, although they might be appropriate for GAAP measurement. During the period from about 1987 to 1991, the CIA set up a task force to establish a solvency methodology, which evolved into a dynamic solvency test. This received agreement from the OSFI as an appropriate method of valuing or evaluating the solvency of a company. However, the OSFI was not totally satisfied with details, and at the time of the 1992 Insurance Companies Act when the policy-premium method was allowed, the OSFI introduced a formula-based, minimum, continuing capital and surplus requirement. The formula depends on a percentage of the face amount of life insurance in force, a percentage of the premiums for health insurance, a percentage of the assets to cover default, C-1 risks, and C-3 risks, and other items. This has generally been incorporated by the CIA in the dynamic solvency testing on an interim basis, until there is a final dynamic solvency test.

You must realize that we're also in the middle of a transition to a new form of accounting. It has not all been finalized, even though we are operating under GAAP. I believe one of the most important things that needed some work was defining materiality within the actuarial reserves. The CIA has just this year published a guidance note on materiality. To somebody like me, that's extremely important, because it means it's going to govern the types of approximations that we can use and the simplifications for the reserves. In addition to some of the guidance notes, such as the one on materiality, the CIA has set up a set of recommendations for life insurance financial reporting, which all appointed actuaries are required to follow.

Where there's some ambiguity or some question and the OSFI has disagreed with the position of some appointed actuaries, the CIA has come out with rulings. These rulings are on specific matters, and they're called technique papers. There are seven technique papers currently, with a new one to come into force on January 1, 1994. They deal with matters such as the lapse rates that one can use for lapse-supported products, mortality assumptions for individual life insurance, and a few other topics.

Again, the CIA is giving help to some of the appointed actuaries by providing a list of compliance questionnaires. The compliance questionnaire is a fairly straightforward extract from professional recommendations. But each appointed actuary has to go through the list of topics; have you done this, have you done that? And it's about five pages long. The actuary must certify that, in fact, he or she has been following each of the professional guidelines. I worked on the compliance questionnaire committee, which reviews these reports from the appointed actuaries and I must say the number of answers received in which there are special circumstances is amazing. However, the compliance committee can't justify any departure from the recommendations. If there are any actuaries who are working on Canadian statements here, the CIA has a financial reporting committee. This is the proper body for people to go to for exemptions in cases in which there is a very small block of business or if you're going to save a significant expense by using larger-than-standard approximations. The financial reporting committee has the authority to allow an actuary to make such approximations and to certify that they are in compliance with GAAP. The legislation does specify that the actuary must make a report based on GAAP.

I work in a branch of an American company, so last year I was able to use materiality standards that were very high as long as they were over the GAAP reserves. In 1993, however, the CIA came out with a formal statement that we will not be allowed to deviate from GAAP as determined by financial reporting committees. This will cause some problems in some companies, but to say that we are complying with the agreement between the CIA and the OSFI and the CICA, it is necessary to eliminate exemptions from GAAP.

This was a very short talk on some of the items that were important to me in preparating financial statements in the last few years.

MR. RAYMOND T. SCHLUDE, JR.: Recently, the Life and Health Task Force received a directive from the Life (A) Committee to have a law for exposure in December 1993 and be adopted at the June 1994 NAIC meeting.

LIFE VALUATION

There are a number of enhancements to the actuarial opinion and memorandum being proposed. Such proposals include a confidential executive summary to be submitted along with the opinion. This executive summary would include a discussion of the impact of any assumption changes from prior work, a summary of the results under the New York seven scenarios, disclosure of additional assets that would be needed to pass any of the failed scenarios, and disclosure of the number of additional scenarios tested. The requirements for the memorandum would also be expanded to include explicit documentation of certain assumptions that the regulators viewed as lacking in the memorandums that they reviewed for 1992 year-end. Proposed modifications also included yield-curve normalization when the yield curve is abnormally flat or steep.

In the NAIC blanks, there was a carryover from the property and casualty blank that basically required the actuary to notify the company within five days if there was a material misstatement in the financial statements. The Life and Health Task Force considered limiting the definition of material to ensure that subsequent events and actual-versus-projected differences, for example, were excluded from the definition of what constitutes a material misstatement.

Another area concerning life valuation addresses how the regulator can feel comfortable that the actuary is using information that is valid. The NAIC wants to put a schedule similar to the P&C blank for claims into the life blank. That schedule would have an in force that the independent accountant would audit and that the actuary would reconcile to the information used in the valuation process. If the actuary is doing a Section-8 opinion, this schedule would include asset data as well.

ANNUITY NONFORFEITURE

There have been continuing discussions on what the minimum interest rate should be. The Life and Health Task Force had specified that it should be 3% at one point. Currently, the task force supports the lesser of 2.5% or the five-year treasury, less 1.5% for GIC rates specified by the commissioner. The task force removed the additional 10% load on the first 9,500 considerations. The draft now has a 10% flat amount on all amounts.

ANNUITY VALUATION

A working group is studying the issues of annuity valuation. It has proposed at the recent meeting of the task force that the commissioner's annuity reserve valuation method (CARVM) be redefined as a present value of maturity benefits. It would propose to establish certain floor-level reserves, which I won't get into, but it would limit the amount of the surrender charges that you could take into account.

The group says that 90% of the products would be unchanged. The valuation rates would be completely revamped to reflect the treasury yield curve as opposed to a Moody's index.

JOINT LIFE AND HEALTH MATTERS

The task force has received reports from the American Academy of the Actuaries on insurance solvency, which would be the next step from the valuation-actuary concept.

PROPOSED ACTUARIAL GUIDELINES

The task force is also studying various guidelines that have been proposed. The first one, which is very close to being completed, is an update of Guideline IV, which would be the regulation for valuing life insurance policies.

Guideline GGG has had a lot of activity lately. GGG specifies minimum reserves for two-tiered policies. The most recent draft removed the 95% floor if current interest rates were being offered. The draft added a safe harbor for use of type-A interest rates and a five-year grade-in as opposed to a three-year grade-in.

Guideline COC involving the cost of collection liability will be voted on. That would require establishing a COC liability regardless of the type of accounting reserve methodology used in your statements.

Guideline VVV involving reserves for variable annuities was very controversial. Originally, it was going to force fund values for variable annuity reserves because of the treatment of the CARVM expense allowance in the general account.

MR. WILLIAM C. FREDA: As Glen mentioned earlier, I am the Deloitte & Touche representative on the AICPA Insurance Companies Committee, and I'll give you a brief overview of the activities and initiatives of that committee. Glen thought it would be a good idea for me to spend a moment talking a little bit about the AICPA and how it's organized and talk about the standard-setting process. I thought I'd do that by using the Insurance Companies Committee and the insurance industry as an example.

The Insurance Companies Committee (ICC) comprises CPAs who are volunteers working together on emerging insurance industry accounting and reporting issues. The committee comprises representatives from each of the Big-6 firms, some representatives from small- and medium-sized CPA firms, representatives from industry (life, health, property/casualty, and reinsurance), an NAIC representative, and a general accounting office (GAO) representative. Because the issues are complex, the ICC will often form a task force or subcommittee for recommendations, papers, guidance, audit guides, etc. Such task forces and subcommittees, in effect, report to the ICC, which in turn reports to the Accounting Standards Executive Committee (ACSEC). The ACSEC is the parent committee of the ICC and has the final say before going to FASB on what's coming out of the AICPA.

Let me use the GAAP for Mutuals Task Force of the ICC that I chaired for the Insurance Companies Committee as an example of how things get done. The ICC formed a GAAP for Mutuals Task Force. That task force drafts a standard of practice (SOP). That SOP will go back to the ICC. The ICC reviews the draft and sends it back to the task force with comments and suggestions. The task force revises the SOP and returns it to the ICC. The ICC then goes to the ACSEC. The ACSEC's process with the ICC parallels the ICC/task force process. After the draft is approved by the ACSEC, it goes to the FASB for clearance. After clearance from the FASB, the document is then usually exposed for public comment. The public, in this case, includes insurance companies, etc. Those comments, in turn, go back to the task force and you go through that whole process again. In other words, it takes about 18 months to negotiate this standard-setting process. The good news is that there is a lot of effort, thought, and consideration involved in the standards-setting process. The bad news is that it's kind of tough to react quickly to emerging accounting, auditing, and reporting issues when a standard-setting process takes that long.

I'd now like to talk a little bit about some of the activities and initiatives of the ICC. One issue that I know is of interest to many of you is GAAP for mutuals. As I'm sure many of you know, when the AICPA developed the Audit Guide for Stock Life Insurance Companies in 1972, mutual life insurance enterprises were excluded. At that time, the AICPA formed a task force to study what GAAP should be for mutuals. During the last 20 years, there have been a number of false starts to develop GAAP for mutuals. Quite honestly, I don't think there was a lot of pressure to get GAAP developed for mutual life insurance enterprises. Not too long ago, *FAS 40* concluded that statutory accounting would no longer be considered GAAP for mutual life insurance enterprises. At that time, it also concluded that this would become effective in 1995. Restatement of prior years would be required, and until 1995, the interpretation requires that mutual life insurance companies disclose the fact that GAAP will be required in 1995.

Now, what is GAAP for mutual life insurance enterprises? Well, as Wayne Upton will talk about later, there are 117 or 118 FASB Statements that are currently effective. For most of those statements, the mutual companies will adopt them as stated. However, for two of them, *FAS 60* and *FAS 97*, which really represent the basic life accounting models for insurance policies, the task force that I am chairing has been charged with developing a model for mutual life insurance companies to follow.

Let me spend a couple of moments talking about our task force. We formed an ICC task force that has members from each of the Big-6 firms and four members from the ACLI. In addition, the AAA and Glen Gammill have helped us considerably. Our charge was not to look at all of GAAP, but to look specifically at the mutual life insurance activities that are unique to those companies within the context of *FAS 60* and *FAS 97*. So, in other words, we weren't starting with a clean sheet of paper. We concluded that we would probably spend most of our time on participating life insurance products. As we looked at the other products that mutual life insurance enterprises issued, we concluded that, for the most part, they would be covered and governed by the requirements of *FAS 60* and *FAS 97*. So, what we spent or are spending the majority of our time on are participating life insurance products.

One proposed accounting model we studied was basically a *FAS 97* approach in which earnings would be based on margins. Many on the task force believed that participating whole-life policies were very similar to universal-life policies. In that proposed model, we also concluded that premiums would be reported as revenues and that we'd adjust amortization on a prospective basis only. One of the issues we had to deal with in adopting a *FAS-97-type* model was what the account balance in a participating life insurance product was, because there is no explicit account balance like there is in a universal-life policy. After considering a number of different options, we settled on a net level premium reserve based on guarantees as the account balance for our proposed accounting model.

A group on the task force, representing a minority view, thought that a *FAS 60* model was appropriate and that profits should emerge as a percentage of premiums. The current draft SOP being considered by the ICC specifies the *FAS 97* approach with premiums reported as revenue and with retrospective adjustments to amortization as required by *FAS 97*.

In November 1993, the ICC will hear the results of the task force. We hope the ICC will approve the draft SOP and send it to the ACSEC in December. Presuming we get through the ACSEC, it will then go to the FASB and, we hope by February to have a document that would be out for public comment.

I will mention few other projects or activities so you can get a feel for the different projects we work on. As you know, we developed an audit guide in 1972 for stock life companies. After 20 years, we thought that it was about time that we updated that a bit because there had been so many significant changes in the industry. By December 1993, we hope to have a draft document out which represents a new guide.

The new guide encourages the use of actuaries. Under our generally accepted auditing standards, we are required to use specialists in areas where we don't have the expertise. I think you will find that most of the big firms and many other firms have used outside actuaries to assist the auditor in auditing the life and health insurance company. This guide basically requires the use of an actuary.

Another project we're working on is an update of the property/casualty audit and accounting guide. We had come out with a new audit and accounting guide just a couple of years ago, but because of new FASB statements that are out there, we're in the process of updating that. There's been a task force that has just been formed for that project.

As you know, risk-based capital (RBC) goes into effect in 1993. This is a good example of an emerging accounting, reporting, or auditing issue that the ICC has had to deal with as a result of new events. We are in the process of coming out with a document that will be twofold. One part will address auditing guidance: what the auditors should be doing in connection with auditing RBC. The other will address accounting and disclosure guidance: what companies should be required to disclose with regard to their RBC. The auditing portion of the document gives the auditor guidance on how to report when RBC percentages aren't good. For example, to the extent that a regulator is getting involved or the RBC isn't within specified criteria, the auditor may want to consider a going-concern opinion on the financial statements of the company. The document also requires disclosure of the RBC information by management if the regulatory capital falls under 250%. This is a document that we have to get out in a hurry, because it's going to be effective this year (1993).

We tried a joint project with the NAIC with regard to inquiries of representatives of state insurance regulators. One of the auditing procedures that most of us apply when we're auditing an insurance company is that in the event that there's a state exam going on, we like to sit down and talk to the examiners about what their findings are to date. And a lot of this emanated out of the banks and S&Ls a few years ago. Regulators would go in two weeks after an auditor had just issued an opinion and then close the place down without talking to the auditors. The auditors didn't have any knowledge of it. So a document came out with regard to the banks, which basically required the auditors to be in touch with the regulators of banks. The reason that it didn't come out at the same time for the insurance regulators was that in the NAIC examiner's handbook there was some language that basically precluded the examiner from talking to the auditors about company business. So, I think, at this point, we've worked something out. There will be required discussions between the auditor and the state regulators.

There's also a big issue with regard to permitted accounting principles. As you know, statutory accounting is prescribed or permitted. We're finding more and more instances in which insurance regulators have permitted certain accounting practices that may not have been codified in the NAIC accounting manual. And this has been a cause for concern. If you don't get it in writing, there's really no evidence that an insurance department had approved that permitted practice. So, one of the things that the auditors were pushing for here was getting written acknowledgement and having the auditors confirm with the regulator that, in effect, the regulator was permitting a practice that wasn't codified.

Speaking of codification, I think most of you know that the NAIC has had a project to codify statutory accounting practices. Again, because of a number of reasons with regard to prescribed or permitted and the whole statutory accounting model, the Insurance Companies Committee recently recommended to the NAIC that it consider a GAAP-based model for statutory with certain exceptions. In other words, because GAAP has a conceptual framework, the AICPA recommended that it should consider using that conceptual framework and have statutory be GAAP based with specific exceptions to get back to statutory. That recommendation was presented to the

NAIC in June 1993. From my understanding, there was a mixed reaction. Although the door is not closed at this point, there are still discussions going on between the NAIC and the AICPA with regard to this topic. There is, for your information, a committee of representatives from the Insurance Companies Committee and the NAIC who do get together from time to time to talk about common issues and to move issues like this along.

When *FAS 40* on mutuals was issued, there was a lot of concern about the type of opinion mutual life insurance enterprises would get if they chose not to adopt GAAP. And added to that is this whole issue of prescribed-versus-permitted accounting. A number of regulators permit accounting that isn't codified, and this has led to the whole issue of how auditors should be reporting on statutory financial statements and whether statutory accounting really is what the auditors refer to as another comprehensive basis of accounting for which there is enough information for them to express an opinion. Usually when an auditor expresses an opinion on something other than GAAP, he or she has to mention GAAP in the opinion unless the auditor restricts the use of that opinion to regulators or management. Currently, the ICC is studying how auditors will be reporting on statutory financial statements in the future.

As a result of a number of insurance failures, we decided to create a task force to deal with guarantee funds and pool assessments. It has been our understanding that there has been diversity in practice with regard to how different companies were recording these assessments. Some were recording them on an accrual basis, and we understand others were reporting them on a pay-as-you-go basis. In addition, this task force will study a number of issues with regard to assessments related to insolvencies, which includes whether those assessments can be discounted, whether you can offset those assessments with premium tax credits that you can get in the future, etc. I think we're a little bit slow on this one. This should have gotten going a while ago, but for a number of different reasons it didn't. But it is about to start and we hope to get some guidance out in the near future.

Ted mentioned the life actuarial opinion. Going back a year or two, the property/casualty actuaries were required to give an opinion on the loss reserves and to comment, if you will, on the data. And they looked to the accountants to determine whether the data that they were using for opining on the loss reserve was appropriate. And, at that time, we worked out an arrangement together in which we covered the needs of the actuaries. Well, now it's spilled over to the life side, and as Ted mentioned, at some point, probably in 1994, the auditors will be issuing an opinion on an agreed-upon schedule that the actuaries and the auditors are working on at this time. This would cover all the needs of the actuary in connection with expressing his or her opinion on the life insurance reserves.

Regarding the disclosure of certain matters in financial statements of insurance entities, the AICPA had a project relating to risks and uncertainties in general in financial statements. It concluded that the profession and companies needed to do a better job in talking about the different risks and uncertainties in financial statements. The Insurance Companies Committee took on the project to deal with this broad issue, specifically with regard to insurance enterprises. And really, for the most part, I've come up with three areas that needed clarification. One was on the property and casualty side, the liability for unpaid claims. Right now, in Form 10(k), for most public companies, many detailed disclosures show some good information about the movement of loss reserves. The Insurance Companies Committee is recommending that there be a basic requirement for disclosure in financial statements. This should include disclosure about prescribed or permitted accounting as well as RBC issues.

MR. WAYNE S. UPTON: Let me introduce my remarks with a short disclaimer. The FASB encourages the expression of views by members of the Board and staff; however, many of the comments that you'll hear are my personal opinion. The official position of the FASB is reached only after extensive deliberation and due process. That's the $5 disclaimer. The 50-cent disclaimer is that if I insult anybody, and Glen and Bill will attest to my ability to do that, it's a personal insult from me. Were the FASB to insult you in its official capacity, we'd have to issue a neutral discussion memorandum, followed by public hearings, exposure drafts, several more public hearings, and a final statement.

Glen asked me to kick this off with a short discussion of what FASB is all about. Those of you who have been exposed and/or victimized by our activities probably have a fairly good feel for that. The "F" stands for Financial, not federal. The FASB is a private-sector organization formed in about 1972. FASB is the latest of a series of private-sector organizations to set accounting standards for public companies, or for that matter, for anybody who wants to assert that his or her financial statements are presented in accordance with GAAP. The FASB is unique in that it is the first in that series of organizations not to be an arm of the American Institute of CPAs. The impetus for the FASB being formed was, in large part, a concern about letting the accountants do everything. Some suggest you shouldn't let generals make wars or accountants set accounting standards. And so there was a need to have a broader group of people involved. The other being a concern that there needed to be a group that was completely independent and separate from the day-to-day pressures of client interaction if you really wanted to set accounting standards. So, that's why the FASB was formed.

Private organization. No government money. Considerable government oversight. I leave here to spend tomorrow watching us visit with the Senate Subcommittee on Securities. Our oversight does come primarily from the SEC. Of course, Congress has the ability to oversee anything it pleases. With that in mind, I'd like to talk about a couple of projects that are on the FASB horizon. In looking at the program, you've already heard everything you want to hear about the fair-market-value disclosures under *FAS 107* and fair-market value under *FAS 115*. You've heard about reinsurance accounting. You've heard about other postemployment benefits.

I want to talk to you about a few projects that are coming up or are being worked on. As I do that, I'd like to introduce it with what, if I can beg the indulgence of Garrison Keeler, I'm going to call Upton's good principles of financial accounting. Upton's principle number one: financial statements make assertions. Accountants learn that word when they go to college and then we forget it. Financial statements make assertions about things that are in them. Those assertions, when looked at by people who understand them, should not cause people to giggle. There was a column by William F. Buckley who observed that before Margaret Thatcher, when you talked about England as a world power, people giggled. During Margaret Thatcher's reign, they quit. Now, they're back to giggling again. Whether or not that's accurate or not, that's good discretion of what you shouldn't have with financial statements. People shouldn't look at the assertions and giggle.

Let me give you three examples of assertions that have always caused me to chuckle. First is the assertion that a company active in the financial market has the ability and intent to hold its securities to maturity. That's always been worth a chuckle. The second is that stock options given to employees are properly recorded at zero because they have no value. The third is that statutory accounting by a mutual company is GAAP. All three of those, at least in my case, fail my giggle test. So that's principle number one.

Principle number two: life is volatile. It has ups and downs, peaks and valleys, and bad and good times. And if we want financial statements to portray economic reality as closely as they can, they better show that volatility. They better be every bit as volatile as the world is volatile. Now, that, for example, raises some real serious questions about whether concepts developed for statutory reporting such as interest maintence reserve (IMR), or various gain/loss normalization, are ever going to be historical, because they tend to distort and eliminate that volatility that's really part of life.

Upton's third principle: assets and liabilities are king. Net income is the last number that emerges from the accounting process, not the first, unfortunately, as is the case in some people's minds. One really ought to measure assets and liabilities and have net income be what is left over. The notion of starting with what you think net income ought to look like and working backward to the financial statement fails Upton's third principle of financial reporting.

Upton's fourth principle is that consequences are a natural byproduct of information. If information didn't have consequences, it wouldn't be worthwhile compiling it. As a matter of fact, information theory people would tell you that if it doesn't have consequences, it's not even information. So we ought to expect that what we do in financial statements has consequences. That's what we went to school for.

Finally, Upton's fifth principle: cookbooks are for cooks. Accounting standards or financial reporting standards that are cookbooks inevitably fail. They just don't work. We address a world that is far more complex than our ability to quantify and place into a set of precise standards. And our attempts to do so in other situations have been dismal failures. Witness the accounting for leases. Now you'll never find these principles in any FASB literature, but if you keep them in mind, you may understand why the FASB and the broader accounting community think the way they do, or why we are occasionally irrational from your point of view.

But let me add a caveat. Accounting standards and financial reporting are done by human beings, and often what happens in that very human process is the politics of the possible, not the ideal, that we would all hope would emerge from this kind of an exercise. And so, for an example, I heard people say that *FAS 115* is a halfway job, and they are right. *FAS 115* on fair-value accounting is a halfway job. As a matter of fact, it says it is. It's a halfway job because it emerged from a human process. It was a bunch of human beings trying to work their way through a problem.

Three projects that are on FASB's agenda right now or that may be on the agenda in the future should be of special interest to actuaries. The first obvious one is fair value of liabilities. The Board is committed to looking at whether it can revisit that issue. We're working actively with several groups, including the AAA, in trying to work our way through the problem of fair-value measurement of liabilities. We hope yet, this quarter, to reach a decision about whether we will actually add it to our agenda and try to push it ahead. That decision is going to rest in large part on our perception of whether we can do anything.

Let me suggest to you that there are still two fundamental problems that have to be resolved, and I'd ask you to think about these in the context of Upton's five good principles. The first question that we need to resolve is which liabilities or how many of them? Even if we marked all of the financial instruments on the asset side of a balance sheet to market, we'd still have many assets that are at some historical cost notion. Now for an insurance company, that's probably not as significant. For a manufacturer or a commercial company, it's a significant issue. So we're going to have some kind of apportioning problem if we define our objective as attempting to match up a certain set of liabilities with a certain set of assets. Alternatively, one might make the argument that the reason we mark certain assets to market is because of their characteristics, and we'll just identify the characteristics of liabilities that should be marked to market and we won't even try to match them all up. That would certainly be consistent with the way accountants usually approach the problem. We look at a class of assets or a class or liabilities and decide how to measure. That's not consistent with a notion of wanting to get net income right; or perhaps wanting to reflect the management strategy. You get a little bit of a conflict there, and that's going to be a tough one to resolve. *FAS 115* describes the attempts that we made to resolve it from being possibly complicated or unacceptably permissive. Doing whatever you want is not really much of an accounting standard.

The second problem that we're going to have to deal with, and this is where I think the actuarial profession can be especially helpful, is some concept of what the fair value of a liability is when that liability has an imbedded put option at a specific price. And the imbedded put option I'm talking about in your industry is cash-surrender value. There's a serious question of whether the fair value of a financial liability can ever be less than the value of the imbedded put option, the cash-surrender value. So whether, if we start to look at the fair value of insurance liabilities, we can ever go below cash surrender values, is a tough one that we're going to have to deal with from the get-go. That's going to be a tough one. Frankly, it's a tougher argument to deal with in the life insurance industry than it is in the bank or savings and loan industry. A bank or a savings and loan has a demand deposit to churn that turns over regularly. I know my account does. It comes awfully close to zero at some points of the month. It's tougher in your industry. It's going to a tougher issue. We're going to look to the Academy for a lot of help on this one if we're going to be able to move through. But those are the two issues that we're going to deal with.

The second project that's on our agenda right now and that ought to be of interest to actuaries is our project on employee stock compensation. It is without doubt the most controversial project the FASB has undertaken, at least since oil and gas back in the 1970s. It's an enormously controversial project in which we attempt to deal with another one of these giggle factors. That being that if I give Bill a stock option as compensation and it's at the money and we both know how many shares there are, I record zero as expense. I never record a single penny as expense for that compensation even if I pay 100% of his salary in stock options. That's not a credible assertion.

As I say, this is the most controversial project the Board has ever undertaken. And I understand that stock-option compensation is not a big deal in the life insurance industry. The reason I suggest that you take a look at this one is that if I were an actuary interested in practice development, I'd be looking at the computation of the value and the use of option pricing and mathematical methodology to value the amount that would be recognized in the financial statement, because it seems to me like a natural for your talents and skills. It's a natural extension of a lot of the work that you do in pension and postretirement benefits other than pension (OPEB) work.

Beyond that, though, remember what I just talked about when I talked about the problem of measuring financial liability, the imbedded option. The more we look at the entire area of financial instruments in all its permutations and glory, the more time and time and time again we come up against an option, or a contingent claim, or more broadly a conditional payable or receivable. If financial reporting can't come to grips with that problem in as simple and pedestrian a transaction as an employee's stock option, I despair of us ever being able to deal with an awful lot of the rest of the financial reporting issues that surround the whole growth of a new and strange world of financial instruments. But again, I recommend this one to your attention even if you're not a likely recipient of stock options, or even if your company doesn't use them. I recommend it to your attention because it's a significant extension of a set of mathematical tools and financial accounting measurements that most accountants find sort of akin to black magic. Put simply, most accountants of my generation don't really know the difference between Black and Scholl and Black & Decker. They're both tools, we know one of them drills holes, but we're not sure what that other one does at all. It's natural for actuaries to get involved.

The third project I want to just brush across quickly is another piece of our financial instrument project that has to do with hedging and hedge accounting. I know that many of your companies are very active in this area, and if you're active on the investment side of the house, you ought to be paying careful attention to this one. Two assets or an asset and a liability under normal circumstances would be measured in a certain way. Hedge accounting, in a nutshell, arises when, because of either a contractual, a notional, or an asserted relationship between them, we abandon that measurement and try and get them measured in tandem with one another. A class example is a futures contract. A futures contract would be measured at its market value every day as a future settlement in cash. If the future is attached to something else in a hedging relationship, we defer all those gains and losses. There's a significant problem, again, as your companies get into more active management strategies and start to use some of these hedging-type instruments to control primarily, I would think in your case, interest rate risk. Keep a close eye on this one.

At this point, we've yet to reach a common language between the Board and its constituents or among the constituents with one another. Just exactly what is the risk that they are hedging against in most situations? You can talk about two companies that have very similar strategies, and you get incredibly different views about what the objective of the exercise that they're entering into is. The most honest one I ever heard was from a fellow who said his chairman would let them do whatever they wanted as long as they didn't lose money. I understand what his strategy is. Now whether it's hedging or not is a different issue, but at least I understand his strategy.

MR. JOHN MICHAEL HARRINGTON: I was wondering what the status was of Guideline EEE, the one on the term insurance.

MR. SCHLUDE: I believe it's wrapped into the regulation for life insurance, and there's a five-year period in which the deficiency reserves will be waived. Provided your guarantee is five years or less, you're all right.

MR. KAVANAGH: Just a note. There seems to be a real philosophical difference between the Canadian approach to GAAP and the U.S. approach to GAAP, insofar as the position of the appointed actuary. The appointed actuary in Canada is going to be a person who has to be directly involved with the company and be virtually on site to be able to get the opinion and to have the details in the backup. The statute allows the auditor to use the work of the appointed actuary, the standards between the CIA and the CICA, to require an exchange of correspondence primarily to verify that each one is a professional in good standing of the other organizations.

One of the disclosure items the appointed actuary has to make or should make to the auditor and to the regulator is whether the individual belongs to an incentive compensation scheme.