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CURRENT DEVELOPMENTS IN FINANCIAL REPORTING

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This session presents the latest findings of both the AICPA and the FASB.

MR. FRANK J. BUCK: I am the chairperson of the Financial Reporting Section Council. The outgoing vice-chairperson and the incoming chairperson is Doug Kolsrud of Aegon. The incoming vice-chairperson is Craig Raymond of Hartford. The continuing treasurer is Bob Beuerlein of Franklin Life. Three new members this year include: Tom Herget of PolySystems, Doug Menkes of Milliman & Robertson (M&R), and Larry Rae of North American Life in Canada. They'll join the three continuing members of the council: Helmut Engels of Manulife, Bud Friedstat of Peat Marwick, and Peter Duran of Ernst & Young.

A couple requests have been presented to the Financial Reporting Section Council. One is from a new task force on consumer education, and the charge of this task force is: "Develop a database of resources and research that will measure consumer awareness and knowledge regarding financial security systems and actuarial related issues. Identify and recommend any further research needed to develop program proposals. Identify target audiences, topics, and objectives for consumer education efforts. Develop consumer education program proposals for presentation to the board of governors, form advisory groups to assist with implementation of consumer education programs."

The other area is a request for volunteers in the area of research into mortality differences by sex. Barbara Lautzenheiser will be the chairperson of a research group. If anybody is interested in either of those two topics, please call me. I can put you in contact with the appropriate people.

Bill Freda will talk about recent developments at the NAIC and at the AICPA. Bill is the chairperson of the AICPA Insurance Companies Committee. He is a CPA and a partner at Deloitte & Touche. His main responsibility at Deloitte & Touche is for insurance and healthcare in the states of New York, New Jersey, and Connecticut. He is also the chairperson of our International Insurance Committee. Bill's other claim to fame is that he was chairperson of the AICPA task force that brought in GAAP for mutuals.

MR. WILLIAM C. FREDA: I'll start my presentation and talk a little bit about what I want to cover. It's been a quiet year from an accounting standpoint for the insurance industry. From the FASB standpoint, the only document that really came out was the GAAP-for-mutuals document, *FAS 120*, and *Standard of Practice (SOP) 95-1*. How many here are involved with GAAP for mutuals? I think most of you would agree that, although that's the only thing that FASB came out with, for those who are involved with it, it is

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really a big effort. I, personally, am involved in a couple conversions, and I can testify to the amount of work goes into doing that. But other than that, there really haven't been any new pronouncements this year.

As Frank mentioned, I am chairperson of the Insurance Companies Committee, and we've been working on a number of different projects but not that many on the life side. Most tend to be on the property and casualty side. But before I get into that, let me talk about something I thought you'd be very interested in: the ACLI's effort to come up with a fair-value-of-liability model.

At the September 1995 meeting, the ACLI board approved a recommendation from its task force on market value accounting, that will result in the ACLI advising the FASB that the life insurance industry is unable to suggest a liability method. When I heard that, I was in shock. What happened here? I couldn't understand it.

Just in terms of background for those of you who may not be familiar, when *FAS 115* came out in 1993, there was a great deal of controversy and much fanfare about marking the asset side to market and not doing anything with the liability side. As you know, the ACLI created a task force to study fair value of liabilities. I thought the ACLI was making some headway. In fact, I understand a conference is being held in December and something will roll out from that. But something went awry, and from what I hear, and you're probably closer to this than I am, there is a little controversy among some of the big companies. They couldn't get a consensus on what to do. They thought this was going to be a hassle. They didn't like *FAS 115*. Really nobody liked *FAS 115*, and the little companies became upset, but they jumped in, too. After going through the GAAP-for-mutuals incident, it's clear to me that the industry, on the life side, is really having a difficult time in coming to a consensus on what I would consider to be some major issues, whether that be a *FAS-97*-type model, or a *FAS 115* model.

Let me, however, share with you an explanation of why they couldn't come up with a liability method. The majority of the task force members believe that in this situation serious drawbacks were continuing to push the FASB to reopen *FAS 115*. These drawbacks include, first, the possible extension of *FAS 115* to other assets such as real estate. Second is the elimination of the held-to-maturity category for marketable securities. Third is concern over how to deal with a possible cash value floor for life insurance. And fourth, I think, is the real reason: concern that the FASB would deviate significantly from any recommendation that the ACLI may suggest.

Because there hasn't been much out of the FASB, I will talk mostly about what's going on at the AICPA Insurance Companies Committee, and I'll also talk about what's happening at the NAIC. I thought I should tell you just briefly about the Insurance Companies Committee. What do we do? We're there to foster communications among CPAs, the industry, regulators, including the SEC, the NAIC, and state insurance departments. I was looking at our charter; I have to get actuaries put in there. We don't have actuaries in there, and you're a significant part of everything we do. So I'm going to get that changed. Also, we promote the use of GAAP and we develop guidance on GAAP. We're really the senior rulemaking body for the insurance industry short of the FASB. We come up with the recommendations. We go to a senior committee in the AICPA, and then we wind up going to the FASB.

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If there's one frustration I have, and I just completed my first year as chairperson of this committee, it is that it takes so long to get anything done. I understand you need due process, and I understand that you have to hear what everybody has to say, but it just takes too long. So I'm trying to accelerate what we do. I am very proud of the task force on GAAP for mutuals. They came out with a model in 18 months. I know not everybody likes it, but at least we did get something done relatively quickly. As a profession, if we're going to have an impact, we have to do a much better job of getting things out quickly.

One thing we're working on is codification; I'll talk about that later. The other thing that seems to happen is that every other day another state's coming out with an audit rule, or tweaking an audit rule, and we have to respond. It just takes an inordinate amount of time. I don't know how you do it dealing with 50 states.

In terms of membership, all our members are CPAs. That's part of what we do at the AICPA. Seven are from public accounting; that would include the big six and one medium-sized firm. Seven are from industry. One is an NAIC member. We have three-year terms with one-third of the members rotating each year. We meet six, or seven times per year.

We have a number of task forces. Meeting only six times each year, we need task forces to develop statements of position, accounting papers, auditing documents, and so forth. Right now we have a number of different active task forces, and I thought I'd share with you what those task forces are and what they're doing. The NAIC/AICPA Task Force is all about relationships with the NAIC and the regulators. That task force meets with the regulators at each of the NAIC meetings, and we try and get things done together.

I'll tell you a funny story though. Although I've been in my business 20 years, and for the majority of that time I spent it in the insurance industry, I had never gone to an NAIC meeting until I became chairperson of this Insurance Companies Committee. The NAIC invited me to the New Orleans meeting and said it was going to have an NAIC/AICPA Task Force and to remember that the purpose of this was to foster communication and develop relationships. I went to the meeting. There were more people there than are here at a meeting. Microphones were lined up and reporters were taking down every word. I said, How can you develop relationships this way? Apparently, the NAIC has this open-door policy which, in my opinion, makes it difficult to get anything done. While this NAIC/AICPA task force is getting things done, because of the way they get together and the process, it's still very difficult.

The Deposit Accounting Task Force was set up primarily as a result of *FAS 113*, which was the FASB standard on reinsurance. The FASB said to use deposit accounting for reinsurance transactions that fail those FASB tests. Somebody said, "What is deposit accounting? There's no literature out on deposit accounting." We took on a project to develop accounting for deposits—those contracts which, if you will, fail *FAS 113*.

Most of you are familiar with guaranty fund assessments. Many companies were accounting for these transactions on a cash basis. People got wind of that and said, "Well, is that really the right way to do it? Why don't we go off and study it?" Well, the Assessments Task Force has been studying it for a couple years, and in a couple minutes I'll report to you where we are on that topic.

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The Life Insurance Audit Guide Task Force is rewriting the life insurance audit guide. We put out the last guide in 1972. Life has changed a great deal in the life insurance industry in 20 years. This one's taking us a long time to get out. It seems as if whenever it is ready to go, something else happens. It'll get out soon.

The Agents and Brokers Task Force has been working for 12 years. When we started the project, many brokers were interested in this. I don't think many are interested in it now. So it just kind of goes on and on.

The Mutual Life Task Force, for the most part, is inactive at this point. We did our job. We got that paper out. We came together in early March 1995 to talk about implementation issues, and for some reason there were no implementation issues. All these projects were going smooth. There were no questions. That always makes me nervous, particularly when actuaries are involved. So we will probably convene another meeting. This has to be done for the 1996 financials. We'll probably convene another meeting in the January-February 1996 time frame just to see if we can help on some issues. I know some consistency issues are out there in terms of how different companies are handling different transactions, so we'll probably have one more meeting. But, for the most part, that task force is dying.

Finally, how many people know about the Task Force on Relations with Actuaries? My understanding is that the Task Force on Relations with Actuaries meets twice a year. The relations are good.

What have we done recently? Well, a number of SOPs are out. An SOP is basically authoritative literature that we have to follow. In the last year, about four came out that I thought I'd mention to you. *SOP 94-1* is "Inquiries of State Insurance Regulators." Permitted insurance practices by states have become a big issue for the accountants, and I will talk about this a little bit more when I talk about codification. But it seems as if every state was permitting some usual practice at some companies. It wasn't prescribed, but the commissioner, I guess, had cut them a break and permitted it. Consistency of the application of statutory accounting principles in the different states became an issue.

One of the first things we did before urging this NAIC codification was to say, let's see if we can inventory these permitted practices. So we put out this SOP: all the auditors who are doing audits for the 1994 financial statement year have to confirm in writing with the regulators any permitted statutory accounting practices. Guess what? The auditors go out and try to confirm. There were some, but very few permitted practices. How many here were familiar with permitted practices? Not many. All of a sudden, all the permitted practices dried up. Why? I'm not so sure, but I guess we'll find out more after the NAIC is done with the codification.

We also came out with an *SOP 94-5* "Additional Disclosures in Insurance Financial Statements." The reason I know that there weren't that many permitted practices is because this SOP said that if you have permitted practices, disclose them. When I go through all your financials, I can't find any. I guess that one was a waste.

SOP 95-4, which will come out at the end of this year, is "Auditors' Reports on Statutory Financial Statements." I guess that GAAP is the most important basis of accounting in the AICPA's mind. In the past, auditors were permitted to give more or less clean opinions on statutory financial statements. The AICPA now has said that any basis of accounting other

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than GAAP isn't really acceptable for general purposes. Auditors have to say that these financial statements for statutory fairly present except that they're not in accordance with GAAP. Many people didn't like this, particularly the mutuals, because the mutuals, historically, were able to say that statutory is GAAP. Now, in any financial statements, if a mutual wants to keep statutory, it has to say, in its opinion, that these financial statements do not present fairly in accordance with GAAP, and not many people want that.

What are we working on currently? Many of these tie projects into the task forces we're working on. Guaranty fund assessments is a project, as are deposit accounting and NAIC codification. We're commenting on certain issue papers that come out, and I'll cover that in a couple of minutes. We've prepared a statement of position to comply with the NAIC model audit rule. We accountants have to issue many different letters to the state regulators in connection with the audits we do, and all the accounting firms are issuing different kinds of letters. We thought we'd try and have some consistency in our life, and we're coming out with recommended letters to issues to respond to the NAIC's model audit rules.

I mentioned the agents and brokers guide. I mentioned the 1995 audit risk alert. Both may be helpful to you. It'll be out probably within the next 45 days. Annually, the AICPA and the Insurance Companies Committee prepare a risk alert. The risk alert is really for auditors, but it's designed to give them a heads-up on what's happening in the industry and informs them of areas they should be concerned about in connection with doing their audit. It may be beneficial to you in terms of doing your due diligence on your financial statements, and so forth.

I mentioned GAAP for mutuals. I mentioned that huge implementation efforts are required. The one item that is still open is the SEC. Many mutuals with wholly owned stock life subsidiaries file with the SEC because of the registered products, universal life, variable life, etc. Not many mutuals register with the SEC because of debt filings, but most of the stock life subsidiaries do. Historically, under Article 7 of the SEC's rules, you could file statutory financial. You could file the mutual on the statutory financial basis, and you could file the wholly-owned stock life subsidiary.

Now that GAAP will be out there in 1996, some believe the SEC may change its mind and say, "You can't file statutory anymore, you have to do GAAP." But the SEC hasn't come out and said anything. If I had to bet my bonus, I'd bet that it will require GAAP, but it hasn't said it yet. Some mutuals are saying, "Maybe we shouldn't go to GAAP because the statutory will still be permitted." I don't know how many are still taking that bet. Most of the larger and many of the medium-sized mutuals are starting to go to GAAP. So we hope that the SEC will act in the next year.

This is another good example of long delays. Well, this time it isn't the profession. This is the SEC. But I don't know why it just can't decide one way or another and tell the mutuals what will happen. So that's really the only open item in my mind in terms of the mutuals conversion. There may be implementation issues, some accounting issues, and a number of actuarial issues, but for the most part that one's behind us.

I mentioned earlier that a number of years ago when we began having a number of insolvencies, guaranty fund assessments became an issue because the numbers started getting bigger in the financial statements of your companies. We created a task force to figure out how to account for guaranty fund assessments, and we came up with a couple

different recommendations. One said to use the retrospective premium-based assessment amount. If you knew about the insolvency, and this was primarily on the life side, accrue the whole amount. Another was the prospective premium-based assessment, which is more on the property and casualty side in which the companies are assessed based on the premiums they write in the future. So the task force came back with a recommendation to use the prospective premium-based assessment.

But all along, very similar to the GAAP-for-mutuals project, there was a lack of consensus on this issue. If 15 members were on the task force, there would be an 8-to-7 vote all along the way. The task force couldn't come up with a big majority. The Insurance Companies Committee didn't come up with a big majority. The Accounting Standards Executive Committee (AcSEC), which is the body that the Insurance Companies Committee reports to, couldn't come up with a big majority.

Then it goes to FASB and, in my opinion, FASB punts. At FASB five votes are needed. A super majority is needed to get something to pass, and they go and vote four to three. Now four to three is as good as doing nothing. After two-and-a-half to three years of doing all this work, we're stuck. We don't know what to do. They don't like our answer. So I met with some of the staff members and I said, what do we do? They said, if you want to accrue everything, we can get the guys to vote for it. Well, yes, that's a real easy answer. Who wants to accrue everything today? That's not necessarily the right answer.

There are good arguments on either side of the fence. Let's take some action. Again, here's where, as an accountant and as a professional, I am a bit embarrassed at our lack of action in terms of coming out with something. So now I told them, "This is what's going to happen. My colleagues and I are going to get up in front of audiences and make speeches and say, look, I guess pay-as-you-go is OK and so is cash-basis. If you want to accrue it all, I guess that's OK. And if you want to accrue some of it along the way, I guess that's OK." Because nobody could agree on what the accounting should be.

I am bringing this back to the Insurance Companies Committee in November. My guess is that if we vote again, we'll probably get the same vote, and then FASB will have to put it on its agenda. It has bigger fish to fry than this. We came up with a decent answer, but I don't know where this one is going. Probably, for the most part, most of your companies are accruing these in the same manner. You have to have some type of liability on your books.

Interestingly, the NAIC, in its codification, came out with an issues paper. It could make up its mind. It said to accrue it all, which is basically what the FASB would let you do. I don't know that accruing it all is necessarily the right answer. The question is, what really is the event that triggers booking something? Is it the insolvency? Or on the property and casualty side, you do have to write business in the future to get assessed. If you decide to leave the state, you may not get assessed. So there are some tough issues, but we should be able to come up with answers.

Regarding the NAIC codification project, there will be many papers. It is talking about 500 issues papers, and it says it will get it done by 1996. My firm is involved as a consultant. I'm not close to this, but I say, to my partners, "You're going to get 500 papers done by 1996? I'm not so sure you're going to do that." We at the AICPA Insurance Companies Committee have agreed to respond to selected issues. Because there are 500, I could quit Deloitte & Touche and respond full-time to these papers; that's how

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many there are. We tried to pick what we think are the more important ones, and we are going to respond to the ones that our members feel more passionate about just so we have an impact.

There's probably a high likelihood that we will also respond at the end. It's tough to get different papers without having a conceptual framework along the way to understand the basis. A couple of years ago, the AICPA did go on record and recommend to the NAIC that it should adopt GAAP and then have certain exceptions to GAAP, but to use the good conceptual framework in GAAP. "Use that as your basis." That recommendation was rejected.

The statutory authorities wanted to keep what they had. They say all they're doing is codifying existing practices but I've been reading articles, and some of what they're doing may not be surplus neutral. More CPAs and more people in industry are saying they're not so sure that what the statutory authorities are doing is surplus neutral; people are starting to get concerned.

NAIC codification is going to be here with us for a while; it is a big project. I hope as a result of this codification that permitted practices will go away and that there will be some consistency among the 50 states in the application of statutory accounting principles. To the extent a state does not adopt the NAIC principles, or there are permitted practices, it will see "except for's" in its audit opinions. In other words, we will say, "These financial statements fairly present except that they are not in accordance with the NAIC statutory accounting principles." That may be an impetus for people to adopt GAAP.

I mentioned that the issue of deposit accounting was on our agenda primarily because when *FAS 113* came out that if a reinsurance contract didn't pass the stringent test in *FAS 113*, it said it should be accounted for as a deposit. Nobody knew how to do that. In addition, there are words in *FAS 60* that say to account for certain transactions as a deposit. Nobody knew how to do that either. Everybody, I think for the most part, thought if it was a deposit, you'd debit cash and you'd credit liability, and that's what I always did; that's what I thought deposit accounting was.

As this task force started digging into these issues, we found out it can get a little complex. One thing I've learned as chairperson is that when the task forces come in with these papers, sometimes people have their own motives. Not all the accountants always want and necessarily do what is in the best interest of the accounting profession. Sometimes these people get a little bit swayed, and I'm sure they get pressure from their bosses, and others. But the first thing I said when they came in with one of their first issues was, What is current practice? How many of these transactions are out there? How many transactions are failing *FAS 113*? Dead silence. I said, "Wait a second. If no transactions are current, why did we adopt this project?"

For some reason, people don't want to say that they have a reinsurance concept that failed *FAS 113*. In a couple minutes, I'll tell you about *FAS 113* and how the SEC has made a couple companies restate. Maybe that's why everybody all of a sudden became silent. But I'm a little concerned because things are too quiet. As they keep coming out with this paper and giving me these answers, I'm not so sure that I have the whole story.

What kind of contracts would qualify for deposit accounting? Well, you may have a reinsurance contract that doesn't have transfer of either significant timing or underwriting

risk, so you default to deposit accounting. You may have transfer of significant timing risk, but not significant underwriting risk. That will get you deposit accounting. You may have a transfer of significant underwriting risk, but not significant timing risk; that also will get you deposit accounting.

Finally, you have contracts in which the ultimate premium is not reasonably estimable, so that will get you to default to deposit accounting. Basically, the direction this task force is heading is to debit cash and credit liability. Then depending on the situation, depending on whether you were in category A, B, C, or D, you may account for some of them under the interest method. *FAS 91* tells you how to do that. You may consider them like option contracts and fair-value them. That one should be interesting. I want to see how they come up with the fair value, what interest rates they use, and so on. Finally, we have an SOP on how to deal with the ones where you can estimate the premium. That's accounting for foreign property and liability reinsurance, and in many instances we don't know the whole story about a transaction, and we wait really until the end to book any profits until we know the whole story.

This task force just presented a draft of this paper to us in September. We went back with a number of suggestions on tweaking their draft, and they're scheduled to come back at our November meeting with a final paper on which I intend to call a vote so we can get this one moving. After we get it done, AcSEC looks at it, the FASB looks at it, and then we expose it for comment. The comments come back, and the task force will review them. We'll give it to the Insurance Companies Committee. The Insurance Companies Committee will review the comments and give it to the AcSEC. We'll review the comments, and give it to FASB and it will review the comments. It will think about it for a couple months, and we'll all be old and gray by the time something comes out on deposit accounting. Again, the process just takes too long.

That's what we're working on currently. I've been sitting on this committee on and off for the last 20 years and now, as chair, I finally see a lull in the action. I said to the committee, with this lull in the action, maybe it's time for us to start thinking about the future. The committee, historically, has always been reactive. The FASB says to change GAAP for mutuals, so we do it. A couple reinsurance companies blow up and we go look at how to account for a reinsurance company. I said we now have a chance perhaps to be proactive. So I said, Let's do inventory; What are some of the future projects we should start working on?

We came up with the following list: accounting for managed healthcare providers; ACLI market conduct; surplus notes; accounting for reserve guarantees (*Actuarial Practices Bulletin [APB] #16*); International Accounting Standards; *FAS 113*; environmental reserves; alternatives to reinsurance; transfer of risk-insurance contracts; and separate accounts.

The one that's missing is *fair value of liabilities*. Fair value of liabilities may have been there, but after I saw the ACLI punt, there was no way I was getting near that one. I had that taken off the list. If they can't figure it out, we'll never figure it out either. You can see that most of these topics are on the property and casualty side as compared with the life side. I thought I would give you a brief overview of some of the issues and what we will be working on.

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The idea of HMOs as managed healthcare plans is a tricky one. For years if you asked an insurance accounting professional what an HMO is, he or she would tell you that it's an insurance company. If you ask a healthcare accounting professional what an HMO is, he or she will tell you it's a healthcare provider. So we always go off in different directions in terms of what the right accounting should be. If you look at how HMOs are regulated, some states have an insurance company blanks and others have healthcare-types of blanks. There's a great deal of synergy, if you will, between the healthcare industry and the insurance industry with regard to HMOs.

We decided to create a joint task force of the Insurance Companies Committee and the Health Care Committee to look at the accounting for HMOs. A number of HMOs are now going public. Managed healthcare plans are here and they're here to stay. We think we need to get on a number of accounting issues. A statement of position tells you how to do some accounting for HMOs, but we're going to take another look at it, and here are some of the issues that we will address. It is a big and important project, particularly as more and more companies are looking to go public. Issues to be addressed by the Insurance Companies Committee future projects include: definition of premium revenue, revenue accrual, accounting for loss contracts, administrative cost accruals, and presentations.

Market conduct assessments is a very hot topic. As you know, the life insurance industry has been plagued most recently with investigations in sales practices, compliance issues, and so on. The ACLI has come up with a market conduct assessment program. Companies can voluntarily choose to participate and will go through various questionnaires on their sales practices and their market conduct policies and procedures. At the end of the day, it is hoped that they will be able to state that they're in good shape in that area. Companies also want somebody to attest to the fact that they're in good shape, so they are looking for independent third parties, such as CPAs, to come in, take a look at what the companies have done, and then provide some type of attestation.

I just got a call last week from the ACLI saying that it is going to its board in November. "Can you tell us something by November?" I said to the AICPA "You must be kidding; we don't go that fast, but maybe we can get something done by January or February." There are two ways we can look at this. We can issue an agreed-upon procedures letter, which basically tells what we did and what we found. Or we can give an opinion letter, and I would sense the ACLI would probably want more of an opinion letter that says, "In our opinion, the market conduct assessment questionnaire produced by X-Y-Z company fairly presents." It would also want to know what it is trying to present. This is an important initiative, in my opinion, for the industry and an important initiative for the ACLI. We're happy to be part of it. We think we can add some value to the process as CPAs.

Some people ask why surplus notes are on our list. They know how to account for surplus notes. I say, show me the GAAP accounting literature that tells you how to do that. Nobody can find any. For most people for GAAP, in my mind, the practice is you set it up as a liability, but many of these practices are out there now. I'm told that more than \$5 billion of surplus notes are currently outstanding. With the mutual life companies now adopting GAAP, and a number of the mutual life companies having surplus notes, we thought it may be a good idea to come out with something so that there is accounting literature to support how companies are booking this. What is the right way to book a surplus note? Is it debt? Is it equity? Is it quasi equity? We're trying to figure that out.

What is the appropriate accounting literature for accounting for reserve guarantees and purchase transactions? You see more and more transactions, particularly on sales of reinsurance companies, in which the parent company guarantees the reserves. There are some unique accounting issues with regard to retroactive accounting on *FAS 113* and traditional purchase accounting under *APB 16*. Depending upon which literature you use, you get different answers. We've talked to a number of the Big 6 firms on this. There is really no consensus. The SEC thought it was a good question; nobody really has the answer. We thought it might be a good idea for us to explore the different alternatives and see if we could come to a consensus on it, so it is something we'll be looking at during the next few months.

More and more companies are dealing in the international arena. For example, more and more U.S. companies are going overseas and more and more companies in Europe and Asia are coming into the U.S. An International Accounting Standards Committee has a group that is developing accounting standards for insurance companies in Europe. We thought this may be a good time for us to talk to them to see if there's some way we can get together to have some uniformity in accounting principles for insurance companies. Will it happen? I'm not so sure. They apparently have come out with a number of drafts. I am in contact with the chairperson of that committee to see if there is some way to get together to talk about how we set principles, how they set principles, which ones should be the same, and which ones should be different.

FAS 113 is one of those standards, similar to *FAS 115*, which nobody liked when it came out. *FAS 115* is easy. You can figure it out and know how to do it. *FAS 113* has been nothing but problems. Significant interpretation is required on these contracts. The SEC has challenged a number of registrants and has made them go back and restate their financial statements because it didn't agree with how the transfer of risk determination was made. There are many gray areas. A wide band here, in my mind, is just causing more problems. It's almost like going to an amusement park and playing that game where you hit one of those hammers and little heads pop up. You hit one and another one pops up somewhere else. That's what these reinsurance contracts are starting to look like. You fix this problem, then another one suddenly pops up. We're going to take a look at *FAS 113*. The AICPA, the FASB, and the SEC met about a year ago to talk about this and nothing really came out of it. Now all has been quiet, but I know it's going to pop up again. We're going to take another look at *FAS 113* to see if we can figure this out. Maybe we have to build some fences or something on this one. This one's only trouble.

With regards to environmental resources, it's an interesting issue. Nobody had this problem a couple years ago. All of a sudden we figured out how to book it. As you know, in 1995 a number of companies have set up substantial amounts of liabilities for environmental events. I was at the SEC in May, and in a minute I'll share with you some of its areas of interest. When we got to environmental reserves, the SEC said it doesn't understand why anybody can't estimate these. In fact, in one 10(k) we just looked at, somebody set up many reserves by using nonactuarial techniques. We were shocked. How could you ever do this by using nonactuarial techniques? I guess somebody must have used the back of an envelope.

But you know the story; we can't figure it out, we can't estimate it, there are too many uncertainties. Slowly but surely that rationale will be taken away from you. Our buddies in Washington will point to Aetna and to CIGNA and say, "How come they can figure it out and you can't?" We thought we'd try and get ahead of the curve. I may be a little

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ambitious on this one because I don't know if I will be able to figure out how to do it; it is tough. I've been in this situation and it's very difficult to estimate. But the story that they're not setting anything up because they can't estimate it anymore is becoming old, so we must move forwards on this one.

About a year or two ago, the SEC came out with many new disclosures on how you should at least be disclosing what your exposures may be. But I think that the next year you will see many more companies booking reserves.

Another issue we have is that we go to the SEC with these clean audit opinions. In our opinion, the financial statements fairly present, but the footnotes say the environmental reserves could be billions of dollars, but can't be estimated. The SEC has come to us and said, How can you give the company a clean opinion? Isn't there a material uncertainty? We're going to take a look at that one, too.

Remember, I mentioned the amusement park—you hit one here and one pops up there. Well, now there are market loss covers, catastrophe futures, securitized reinsurance, and act-of-God bonds. These are all, in my opinion, different ways to get around *FAS 113*, but the accounting for them must be determined. The list of new items, products, services, and whatever you call them that are out there goes on and on. We'll look at some of the alternatives to reinsurance contracts and try to make a determination on what's out there and if there is some guidance we can give to companies and practitioners on how they should account for them.

Nobody can figure out how to determine transfer of risk in a reinsurance contract, but have you ever thought about transfer of risk in a regular insurance contract? *FAS 60* says that to qualify as insurance, it must provide indemnification. *FAS 113* has a 9A and 9B test. Many risk managers are working with companies and becoming very creative in the arrangements that are being made with one another. Should large deductibles, captives, risk retention, and self insurance be accounted for as insurance, or is some of it really financing? What are the disclosures with regard to this? Some say that this isn't an insurance company issue, that this is really a manufacturing company's issue. I'm not so sure. As insurers, we need to figure out whether we should be booking premium. Maybe we can help the companies figure out what they should be doing.

Finally, the last future project—we probably won't get any of these done under my term—is separate accounts. Separate accounts have been around a long time. Separate accounts just keep getting bigger and bigger, and a number of questions are now starting to come up about separate accounts. For example, in the general account financials, should you be disclosing separately the separate account fees, revenues, expenses, assets and liabilities? Should you have separate account financials in general account financials? Right now we have separate account assets. We have separate account liabilities. Should we have more? Like the financials of a material subsidiary that GAAP requires—should we have that? Right now we have segment reporting for products. Maybe we should do the same for separate accounts. Many good questions came up and we're going to look at those.

Regarding *FAS 115*, held to maturity, available for sale, I told the SEC that some companies sometimes have a problem. By mistake, they may sell a held-to-maturity asset. They really didn't want to, but these things happen out there in real life. You have to know what goes on in the real world. What do you think the SEC said? "One's a mistake,

two's a restatement." The SEC was serious, too. It was very serious on *FAS 115*. It is playing hardball.

FAS 109 was an issue on valuation allowances and the backward tracing. It is a complex issue in terms of when you set up deferred taxes, the components of stockholders' equity, and if you want to change it, it must go through the income statement.

Regarding GAAP for mutuals, I mentioned that Article 7 remains open. The SEC told me not to worry about fair value of liabilities; the ACLI is taking care of that.

You've been reading about derivatives. Derivatives continue to be on everybody's hit list; that's sort of scary. I go to many different meetings of boards of directors, and they look at me and say, Can this happen to me? When I look at the controls of a number of companies and I say, it shouldn't happen. It shouldn't be able to happen but, yet, it still does. You have to be very careful in this area. You can't do enough, in my opinion, in terms of building up the fences.

The AICPA had a requirement to disclose risk-based capital and it's part of one of those SOPs I mentioned earlier. The NAIC and others said, You can't do that, that's illegal. You can't disclose risk-based capital, yet, the next day, I picked up *The Wall Street Journal* and risk-based capital was listed for the ten largest insurance companies. I said, forget it, we're not going to mess with the lawyers. If they really want to know what risk-based capital is, they can figure it out. We do have a requirement if companies are in trouble, if the risk-based capital levels are lower than they should be. Disclosures are associated with that. But, for the most part, I wasn't going to get going on that.

The SEC, from time to time, issues comment letters, particularly when a company is in registration. The insurance industry, for the last 18 months, has kind of gotten a buy. The SEC has been rather inactive with regard to comment letters on the insurance industry, but it assured us that this next cycle of insurance companies would be looked at thoroughly. If you're involved in the financial reporting of your company, and you're involved in the 10(q)s and the 10(k)s, be ready because I think this is the year they're coming back at us.

That summarizes my remarks. I would be happy to answer any questions anybody would have.

MR. EDWARD L. ROBBINS: This has to do with something outside of actuarial issues. It's a very minor question compared with the *FAS 113* issues you brought up. I have a situation in which a mutual company has a very heavy termination dividend scale. It is so heavy that on the face of it, on a self-supporting basis, the product is not self-supporting, and in GAAP terms unrecoverable.

The company's philosophy is that there are other lines in the company, nonparticipating lines such as group life and health, that are considered to be an investment of the mutual policyholders. Therefore, the termination dividend is considered by the company in its philosophy to be a return to owners rather than a return to customers and not a customer dividend.

FAS 120 doesn't appear to speak to this issue. If you go the normal *FAS 120* route, you get an unrecoverable situation. Can you give any theoretical justification? Is there a philosophy that says that part of the termination dividend can be considered owner return

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and the rest of it customer return? Is there anything you can think of? I haven't been able to find anything.

MR. FREDA: Who is the owner?

MR. ROBBINS: The mutual policyholder.

MR. FREDA: OK, so the owners own them. Our task force had a hard time figuring out whom the owners were. We came to the conclusion with termination dividends that you should accrue them along the way to the policyholder. We didn't have any of it dropping into equity.

MR. ROBBINS: This would be just an unrecoverable situation.

MR. FREDA: Exactly.

MR. WILLIS B. HOWARD, JR.: I have a comment on the issue of guaranty fund assessments. I'm sympathetic with FASB's four-to-three vote. We're dealing in an area of great uncertainty here, and I'm reminded of the problem that must keep accountants awake at night; how a company with \$10 billion or so of life insurance in force can only have a liability of the amount of the reserve equal to a billion dollars or so. In the recent Kentucky Central experience, for example, the liquidator asked for an additional \$80 million assessment and then changed his mind less than 30 days before the amount was due.

MR. FREDA: How much did he change to?

MR. HOWARD: Zero.

MR. FREDA: Zero. Eighty to zero

MR. HOWARD: Right. The guaranty associations had already assessed for \$110 million to fund the closing of the assumption reinsurance deal. There is potential for recovery, but it is not necessarily quantifiable. It was certainly not in the early stages because the information on which you might quantify it is often confidential. But we expect that \$0.50–\$0.75 on the dollar of the \$110 million of the Kentucky Central's assessment will be recovered by the guaranty association and, therefore, returned to the companies. I don't know how the accountants would quantify that opinion.

There's another example. I'm sure most everyone has read in the paper of the recent \$100 million litigation recovery of Guarantee Security Life. This may reduce the projected cost of that insolvency by 20% or more. Also, asset recovery possibilities there may reduce the projected cost further. There's simply a lack of data and a lack of certainty on how you might quantify some of these recoveries that would lead the FASB to not come out with a very strong position, in my opinion.

MR. FREDA: I think you make a good point that these are hard to estimate. But the fact of the matter is you can set something up. I don't know that you set up the full \$80 million if you know you'll get a recovery. Can you imagine booking \$80 million and then the month before you are told not to? That's a good problem to have—take it all back in income.

