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Current Development s in Financial Reporting

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Moderator: CHARLES D. FRIEDSTAT
Panelists: JACK F. MYERS†
ARTHUR V. PANIGHETTI
HENRY W. SIEGEL
Recorder: CHARLES D. FRIEDSTAT

Summary: The status and future impact of new and emerging issues in financial reporting and taxation will be discussed, including the latest developments at:

- *FASB*
- *AICPA*
- *NAIC*
- *SEC*
- *ASB*
- *IRS.*

Mr. Charles D. Friedstat: We have an excellent panel for you. What we're trying to do is touch upon a smattering of issues in the financial reporting area. Henry Siegel will begin. Henry's a vice president with New York Life Insurance Company in the mergers and acquisitions area. Henry's going to be concentrating more on statutory NAIC-type matters, codification issues, and things of that nature. After Henry, Art Panighetti will be the next speaker. Art is director of tax planning for Northwestern Mutual Life Insurance Company. True to his title he'll be talking about federal income tax matters and he will be tying in a few things such as the codification project with the NAIC in terms of tax related matters. Our last speaker is Jack Myers. Jack is a senior manager with KPMG's department of professional practice in New York.

†Mr. Myers, not a member of the Society, is Senior Manager of KPMG Peat Marwick LLP in New York, NY.

He'll talk more about the GAAP and the SEC side of things. That will cover the gamut of the financial reporting area.

Mr. Henry W. Siegel: I'm going to deal with codification and other NAIC matters in a very cursory and brief manner. The one thing that strikes me is this panel is called "Current Developments in Financial Reporting," and as I'm talking things are developing. For instance, the last I heard there was an all-day meeting of the Life and Health Actuarial Task Force of the NAIC to discuss the standard nonforfeiture law. At the same time, there's a meeting of the NAIC Codification of Statutory Account Present Value in Working Groups. I know there are two people attending one meeting who are going to talk about it at a future session at this meeting. Things will be changing at that time.

The codification project has been going on in various forms for several years, at least in the NAIC. It is an attempt to codify or write down all those rules for statutory accounting that have never been written down before and merge them with the ones that have been written down before and put them all in one place. The accountants can have one place to find out what the right statutory accounting is for everything. The goal was to do just that—not to change anything and to be surplus neutral. I should mention that statutory accounting importantly includes reserving. There are several issue papers that have come out that deal with reserving and are of importance to actuaries, I'll talk about those briefly in a minute.

Deloitte & Touche is currently the consultant for the project. I believe it's the second, possibly the third consultant that they've gone through both from the accounting perspective and the actuarial perspective. Why are they doing this? Several years ago the FASB learned that the accounting firms were giving an opinion on statutory accounting for mutual companies and stating statutory accounting met GAAP requirements. At the same time, the accounting firms were giving opinions on statutory accounting for stock companies, which made the accounting firms very uncomfortable. The problem was that there was not one place to write down the definition of statutory accounting. Statutory accounting in New York was different from statutory accounting in Massachusetts which was certainly different from statutory accounting in Texas and California. So the AICPA got together with the FASB, the AAA, and the NAIC. They decided they would have a project to write down all the statutory accounting rules.

The first attempt was to say, why don't we just use GAAP? If you want to make a few changes for statutory accounting that's OK, but we'll basically say that codified statutory accounting is GAAP accounting with a few exceptions. This was rejected for reasons that I don't want to go into because they're more mystical, I think, than logical. But it was rejected and this project was set forth to write down all statutory accounting in its entirety.

As of last week there have been approximately 90 issue papers prepared by the Codification of Statutory Accounting Present Value in Working Groups. They've covered everything from the definition of cash to the definition of an asset, to the definition of a reserve, and how you account for derivatives. Some of them have been fairly straightforward; some of them have been reissued three and four times. Some of them were just incorrect and had to be redone. After the latest meeting of the NAIC Working Group in Kansas City basically all the issue papers that are going to be issued will have been issued and all the comments that will have been received have been received. They have been responded to comments in public at meetings the NAIC Working Group has been having. What will happen next is the consultants are going to sit down with the issue papers and draw up an accounting manual. If they do they're expecting a six-month exposure period during which time we'll all have a chance to restudy what they've done and comment again. (Note: the NAIC Accounting Practices and Procedures Manual became available as of 6/97)

I was told by the NAIC that this manual is supposed to take what's in the issue papers and write them in a manual format. In theory, if we've all agreed on what was in the issue papers, there should be nothing to comment on when the manual comes out. Unfortunately, I don't think we've all agreed on what's in the issue papers, so my suspicion is there will be more to comment on. The issue papers have been commented on by many, many people. The NAIC Industry Liaison Committee has done a tremendous job under Dave Nachman's chairmanship of commenting on every one of the issue papers. The Academy has commented on those that it thought had actuarial content, and there have been many other people and organizations such as accounting firms and companies that have commented on them as well.

What are the issues that are outstanding on codification? Primarily, from an actuarial perspective, what happens to the variations among the states? If you read the issue papers on reserves, which are Issue Papers 50, 51, 52, and so forth, codification adopts all the model laws that have been passed by the NAIC. So what does that mean? To start with, it means that if you have Actuarial Opinion JJJ or XXX and your state hasn't adopted them yet, codification will adopt them. If your state hasn't adopted the Universal Life Insurance Model Regulation yet, codification will adopt it.

What does that mean for you? Well, we don't know yet, but what it might mean is if your state, for instance, requires you to reserve for something on a basis that's old and the codified rules require a different basis, you will not get a clean opinion. You will get an opinion, assuming that the difference is material, that says something like this company's numbers are OK except in a few situations where they varied from codified rules and these are the situations. In my opinion, it will put a lot of pressure on companies to put a lot of pressure on the states of domicile to pass the model laws more or less as they were passed by the NAIC. That's what it looks like to me.

Those of you who are familiar with GAAP know that there's a hierarchy of GAAP. If you don't know what to do, you look in sources that will tell you what you should be doing. There will be the same kind of hierarchy for statutory accounting. Two important issues for all of us are: What is the status in the hierarchy of the various model laws and regulations? and What is the status in the hierarchy of the actuarial standards of practice (ASPs)? Most of the reserving issue papers recognize that there are ASPs with regard to reserving and they suggest that they be followed. Exactly which ASPs and how they get into the hierarchy and which ones get adopted are issues which we will have to work out when codification is in place.

In the course of doing the codification many GAAP concepts were adopted or proposed. In the reserving papers there is a concept of deferred income that states if you collect income for services that are going to be performed in the future you should defer that income. Those of us who commented on it thought that was a really dumb idea, because if you're not allowed to defer any expenses at all why should you be deferring income at all. But it's still in there the last I heard, and I'm looking forward to seeing the accounting manual to determine whether it made it through the first process.

There's also the concept of deferred taxes, and I think we'll hear more about that in a minute. For those of you who have large amounts of deferred acquisition cost (DAC) tax credits outstanding or large differences between tax and statutory reserves, this could have a very material effect on your surplus from a statutory perspective.

Finally, the industry put up a big fight with the task force on whether nonadmitted assets were truly needed. One of the issue papers defined quite clearly what an asset is and what an asset is not as far as when it should be recognized. In many of these papers there are descriptions of various kinds of assets and when they're admitted and when they're not admitted. So the argument was you didn't need a discussion of nonadmitted assets. Basically, you had it already and if you had a new asset come in that nobody had every thought of, you follow GAAP treatment until statutory caught up and decided what to do with it. This didn't go well, and I don't think it will make it. As I said, we will have another chance to comment.

One of the last issue papers that came out was on separate accounts. The problem with this separate account paper is it's outdated. There's so much going on now in the way of product development and new products on separate accounts that this issue paper just could not possibly catch up. So that particular aspect of codification, in my view, will be an evolving process as time goes on. In fact, Bill Ward from Aetna will be representing the industry at the NAIC meeting to discuss that very issue.

State variations is a subject that we've been worrying about at the Academy for a long time. Those of you who do valuations know that the current rules require you to mention in the opinion you file in every state that the reserves meet that state's valuation requirements. There was a task force under Shirley Shao of Prudential which was established to try to do something about this. The current proposal is to have the actuary opine only with regard to reserve requirements for his or her state of domicile. The second part of the task force's work is to help the NAIC establish a central depository of information. Each state will put information about its own valuation laws into that central depository. Then, if you are a regulator in a state that is not the company's state of domicile and you want to know whether you can accept the statement and determine the qualifications of a state other than your own, you can go into the central depository and look up the rules. Then you'll know whether or not you can live with a statement as filed in the state of domicile or whether you have to require companies in certain states of domicile to refile using your own valuation law.

The Life and Health Actuarial Task Force originally asked for restoration of the good and sufficient language that was taken out of Section 7 opinions when it was put in. The task force looked at this and decided it didn't know what good and sufficient meant. It sounded similar to adequate and adequate was not well-defined in Section 7. Because it was in Section 8, the task force made a proposal to eliminate Section 7 opinions. This did not meet with great enthusiasm from all the small companies that filed under Section 7. It was debated long and hard not very long ago, and a decision was made to simply review what the exemption requirements are that get you out of filing a Section 8 opinion. That work is ongoing as well.

The Central Depository is working. There's a proposal coming out of what information should be in there. For anybody who's interested, they're looking for volunteers to help review the stack of papers. I suggested it come out on a compact disk (CD), because if you think about it, you have 50 states, about 20 products, and different years of issue. I figure it will be a large stack of paper when you get all done. So I'm hoping they're going to give it to us on a CD. If you're interested in being involved in reviewing what goes into the central depository let me know.

Finally, as I said, there is work going on with regard to the standard nonforfeiture law. Walt Rugland chaired an Academy committee that has written a report. If you want a copy of it you can get it from the Academy or you can get it from Actuaries Online. There's an all-day meeting of the Life and Health Actuarial Task Force to rewrite it. If there's anybody who was there and wants to give us current events I'd be glad to hear that later. The interesting thing about this is the current requirement that you have a cash surrender value in policies. Under the proposal you have the option of doing away with cash surrender values. If that happens there will undoubtedly be accounting impacts that we'll need to keep track of.

The annuity valuations—all the new products that I was talking about including the separate account products—are undergoing a great deal of work right now, as most of you who are familiar with this probably know. The new Actuarial Guideline, MMM, that has to do with minimum guaranteed death benefits on annuities that the Academy has developed for discussion and possible approval at the December 1996 NAIC meeting. There is also a proposed regulation on GICs that is out for exposure and there is work going on as well about equity indexed annuities. It was summarized by Donna Claire who said they don't know what to do about equity indexed annuities—but they're neither comfortable on the liability side nor the asset side because they don't know what to do. You can expect further things coming out on this, but I have no clue right now as to what they will be.

Mr. Arthur V. Panighetti: As I was compiling a list of all the tax events that affected life insurance companies this year, I was reminded of a remark I once heard. I was in a cab stuck in very heavy Washington rush hour traffic. The person I was with stared at the traffic wistfully and said, "It's a good thing we don't get all the government we pay for." Well, this year with several significant pieces of legislation that were enacted and a major overhaul of the statutory reporting process underway, we're sure getting our money's worth.

My personal perspective is life insurance company taxation. My remarks will be mostly a smattering of the current developments that have a bearing on that topic. However, I'll deviate from the company taxes a little bit and I'll also talk a bit about product tax issues given their importance to life insurance companies. There have been several significant legislative changes affecting products. Given the time allowed, I'll be able to discuss these issues only at a general level and, particularly, in cases like Guideline XXX where there's a lot of facets to the issue, I'm just going to focus on tax.

Congress finished the summer with a flourish of activity and sent three major bills to the President which he signed. The Health Insurance Portability and Accountability Act and the Small Business Job Protection Act both contained very significant legislative changes that affected life insurance companies. There was a third bill that was very important to welfare reform, but that didn't have specific impacts on insurance companies.

The health act has a significant and severe impact on corporate-owned life insurance (COLI). The health act would disallow a taxpayer an interest deduction for any interest paid or accrued on life insurance, annuity, or endowment contracts that cover officers, employees, or someone who has any financial interest in the insurer or in the taxpayer. There's an exception for policies up to 20 key employees. This disallowance is affected for the interest paid or accrued beginning in 1996. There's also a transition rule for those contracts that were grandfathered when the law changed in 1986. This creates a deduction phase-out beginning in 1996 and lasting until 1998.

The health act also enacted, finally, legislation that allows the acceleration of death benefits to those who are terminally ill, effective January 1, 1997. The law generally awards tax-free death benefit status for those expected to die within 24 months. It also allows for vatical settlements to receive tax-free death benefit treatment. The law recognizes the reduction in benefits approach to accelerating the death benefits. It's not quite so clear on the lien approach.

The health act also clarifies that qualified long-term-care policies are treated as accident and health insurance contracts. Benefits received under these contracts are not taxed and premiums paid for the contracts are treated as medical expenses that can be utilized as itemized deductions subject to the 7.5% of income limitation. For employer-sponsored coverage, the employers can deduct the premiums and exclude them from the employee's income. In exchange for these very liberal tax benefits, the federal government takes on a role that's a cross between a regulator and a consumer advocate. It limits the benefits to a maximum of $175 per day. The bill establishes a somewhat uniform definition of a long-term-care contract such as allowing for no cash surrenders, requiring it to be guaranteed renewable, and requiring that the individual be unable to perform at least two activities of daily living. Although the long-term-care provision has become effective January 1, 1997, in many cases the state laws and procedures aren't ready for this flood of new policies. The federal government might be ahead of the state government in this case.

There's also a very beneficial change to the tax reserves on long-term-care contracts. This is effective January 1, 1998. It changes Section 807 to allow for the one-year full preliminary term method to be used for these types of contracts. Prior to that, the two-year full preliminary term method applied as it does for all accident and health (A&H) contracts. Now the tax reserve prescribed method is aligned with the statutory method.

The health act allows small employers the opportunity to offer medical savings accounts (MSAs). This is just a test program, but within limits contributions made by those covered in a high deductible medical plan will be deductible determined by their adjusted gross income. Also, any employer contributions are excludable. The earnings in the MSA are not currently taxable nor when you use MSA funds for medical expenses. If you use the funds for other purposes they're taxable, there's also a 15% penalty that applies. This is an experimental plan, as I mentioned, and it's limited to 750,000 participants.

The Small Business Job Protection Act finally gives certainty to the tax treatment of modified guaranteed contracts. Modified guaranteed contracts, for those of you unfamiliar with how they work, offer a fixed return at maturity. However, if cash surrender occurs prior to maturity, a formula-based market-value adjustment applies which reflects the current interest rate environment. Companies generally account for these products in a separate account, although they're not variable contracts in the true sense. The account value is not directly linked to the return of the assets underlying the contract. The problem was a tax reserves mismatch problem and it arose when interest rates climbed sharply. This is because the annual statement separate account reserve would reflect the current interest rate and, therefore, decrease somewhat sharply when rates rise quickly. This creates the taxable income on the liability side. Market value of the assets will also decline. However, this impairment wouldn't be generally recognized unless the assets were sold.

The Small Business Job Protection Act generally adopts a mark-to-market approach when dealing with this problem and marks the assets and the liabilities/reserves to market. This is effective January 1, 1996. The Small Business Job Protection Act provides variable treatment for money held in the separate account for retired lives under group term life or group A&H insurance. The amounts paid in or out of the contract must reflect the investment return of the separate account. This change is effective the beginning of 1996.

Also, the Small Business Job Protection Act includes in income all punitive damages received on account of personal injury or sickness. Generally, this applies for amounts received after August 20, 1996. This would seem to impact structured settlement business to the extent contracts would be written for punitive damages in the past for these types of awards.

The Small Business Job Protection Act also authorized expanded retirement savings by authorizing a new type of plan called a simple plan through employer-sponsored

IRAs and 401(k) plans. Tax exempts and state and local governments are now allowed to establish their own 401(k) plans. Spouses are now allowed to contribute the full $2,000 to the deductible IRAs as long as the combined compensation of the spouses is sufficient. Also, several pension simplification provisions were included in the act. These changes are all effective January 1, 1997. Along with the long-term care-provisions and the accelerated death benefits, they have the potential of expanding the life insurance industry's marketplace. The Small Business Job Protection Act also addresses the so-called Harris Trust issue, and it provides some retroactive relief under ERISA fiduciary rules for pension plan contracts that are backed by the life insurance company general account assets.

There have been several judicial cases of interest to life insurers that have had a decision rendered recently. Trans Citi Life Insurance Company is the first case, I believe, to deal directly with the IRS' big stick against tax motivated or perceived to be tax motivated reinsurance. The U.S. Tax Court received an education on reinsurance, I think, that would equal any that you could receive at an SOA meeting. It concluded that Trans Citi's surplus relief agreements with Guardian had a valid business purpose. The court concluded this even while recognizing that a substantial tax benefit occurred. Namely, Trans Citi secured the small company deduction. The court found substantial risk was transferred compared to the tax benefits. It's interesting. I've heard that the IRS views this case somewhat of a victory also. That's because the court, in its opinion, did uphold the validity of Section 845, which was somewhat in doubt, because of the constitutionality of the section and the fact that there have been no regulations issued on it.

Mr. Friedstat: I think one of the other things about this case that was instrumental was the actuarial involvement. I want to mention that there were actuaries on both sides of the case. Diane Wallace, representing the victorious side, was evidently deemed more credible and was relied upon by the judge in this case. That's something I think that you might want to take into account. For those of you who are not familiar with the case, I think you will get some benefit from reading it.

Mr. Panighetti: It generated a lot of good promotional material, too, didn't it?

Mr. Friedstat: Yes.

Mr. Panighetti: The Indianapolis Life case is concerned with whether a negative differential earnings rate can be recognized by mutual life insurance companies under Section 809. It was decided in August by the District Court for the Southern District of Indiana. Although the court seemed to recognize the technical arguments of the taxpayer, the court determined that Section 809 provides rough justice and by offsetting the unavailability of the negatives with the indexing of the stock earnings rate. In the end, the court did give deference to the fact that there are Treasury regulations that prohibit the recognition of the negative deferential rate.

I mention briefly the UNUM case. It was decided in May 1996 in favor of the government. It involved the characterization of the amounts paid to policyholders upon demutualization. UNUM argued that this was a declared policyholder dividend and, therefore, was deductible given certain limits. The government argued that this was just a payment out of the ownership interest subject to general corporate restructuring rules. The amounts are substantial and certainly any mutual company that is looking at demutualizing would find this case interesting.

A couple of significant revenue rulings came in 1996. Revenue Ruling 95-80 had as its purpose making Revenue Ruling 71-367 obsolete. The old revenue ruling treated guaranteed renewable contracts as cancelable during the preliminary term period when the additional reserves are equal to zero. Because the 1984 tax act provided that A&H reserves used a two-year full preliminary term method, the IRS deemed that this entire revenue ruling was unnecessary. I think what the IRS really suspected in its paranoia was that some companies were using this old ruling to classify contracts as cancelable in order to avoid the DAC tax.

Also there was Revenue Ruling 96-2 that is issued every year early in the year. It provides an annual update to the prevailing state assumed interest rate assumptions and the applicable federal rates that insurers should be using to calculate their tax reserves. Pricing actuaries would find this ruling a helpful summary of both current and historical tax reserve interest rates.

There was one private letter ruling in 1996, Technical Advice Memorandum (TAM) 9623005 for those who like the cites. In that ruling, the IRS approved the exclusion from net premiums under the DAC provision of the value of new life insurance policies issued as a result of an internal exchange program. These internal exchanges occurred in 1991 prior to the issuance of the DAC regulations. The Treasury regulation then in existence for DAC provides that internal exchanges which result in a fundamentally different contract must include the value of the new contract in the DAC base. These Treasury regulation rules apply to the first taxable year after November 14, 1991. Prior to these regulations, the taxpayer relied on a reasonable interpretation of the statute and excluded these internal exchange premiums. The examining agent believed Section 848 required that the value of the exchange has to be applied prior to the regulations. The IRS determined that the taxpayer’s exclusion was a reasonable interpretation of the tax law prior to the regulations.

In TAM 9620001 the IRS held that for the purpose of calculating tax reserves an option to purchase additional life insurance, regardless of insurability, continues to be a qualified supplemental benefit (QSB) even after the option is exercised. Generally, reserves for all benefits in the policy are calculated in a similar manner. The aggregate of the federally prescribed reserve for all of the benefits are compared to the aggregate net surrender value and the greater of these amounts is generally held to be the tax reserve. When you have a supplemental benefit present on the policy, this may not increase the tax reserve to the extent that the tax reserve on the base policy is equal to the net surrender value.

Section 807(e)3(C) allows companies to calculate a separate reserve equal to the annual statement reserve if they meet the requirements of a qualified supplemental benefit. The option in this ruling was the guaranteed insurability option and both the IRS and the company agreed that it was a QSB. However, the IRS agent argued that once the option was exercised it was no longer a QSB and merely an adjustment to the reserves on the base primary policy. The company argued that the additional insurance continued to be a QSB and that it could hold a separate reserve for it. The company's viewpoint prevailed on this on the basis that the law treated the QSB as a separate policy.

Private letter ruling 9609033 was released in 1996. It concerns the tax reserves for group long-term-care contracts. Not surprisingly, the ruling concluded that the reserves qualify under Section 816 for the company's qualification ratio and also under Section 807 for tax reserves subject to being recalculated under 807D(2). What I found surprising in this ruling was the IRS's expansive view of the net surrender value floor for the tax reserves. Under the ruling, the company would incur a liability to transfer policy funds to a new carrier in the event the group long-term-care policy was terminated. The IRS found this liability to be, in its words, analogous to the guaranteed net surrender value of a traditional life policy. This language seemed to suggest that the company's reserves were deductible at least in an amount equal to the liability held for transfer.

Much has been said and probably will be said about Guideline XXX. The tax aspect of XXX that I'd like to talk about involves the mortality table that was incorporated as part of Guideline XXX. It uses a new set of optional select factors for the 1980 CSO table. Section 807 requires when an optional table exists companies are required to use the table that generally yields the lowest reserves. When the IRS first considered the use of select factors for the 1980 CSO table, it concluded that the ultimate 1980 CSO factors generally yielded the lowest reserves. This was decided a few years back. There's a question I think that is still outstanding on whether this is still generally true under the XXX mortality selection factors given their application to term insurance reserves.

There's been a proposed new group and individual annuity table. I'm not sure of its status and whether it's been adopted or is about to be adopted. Regardless, the table won't be effective for tax reserves until at least 26 states formally adopt it. I know the ACLI has been considering pursuing rapid adoption of the tables once several significant states have adopted them.

Another issue that the ACLI has considered concerns the applicable federal rate (AFR). The AFR is the interest rate used to value tax reserves. If this rate is higher than the prevailing state assumed rate, then that's the rate you would use for tax reserves. The AFR is based on a 60-month average of the federal mid-term rates at the end of the prior year. A federal mid-term rate is the yield of mid-term federal Treasuries. The AFR being based on a 60-month average and having the lag results in it seriously lagging the current interest rate environment. When rates decrease rapidly as they have in recent years, the AFR remains artificially high and it stays high for a given time. To the extent that your tax reserves aren't equal to the cash surrender value, you could have a substantial drop in your tax reserves. The ACLI Section 807 Task Force has been studying the AFR issues and recommendations are being considered to shorten the AFR period, possibly by product (life versus annuity) in order to match the 12- or 36-month averaging period in the valuation rate. Of course, this would take some legislative changes and is probably not likely to happen in the near future.

Henry talked a bit about the codification issue. I'll mention the deferred tax asset. A very significant issue paper is Issue Paper 83. It allows companies to hold an asset for deferred taxes. This is a very unique idea for statutory accounting. I think it is being done to counter several earlier issue papers, which resulted in changes that would substantially reduce the industry's surplus. Now, as written, this issue paper doesn't adopt a GAAP approach. It's a unique approach. There's some interest in possibly conforming the calculation to be more like GAAP. Depending on your current tax and statutory positions taken, this paper could result in a material item to your balance sheet. One thing's for sure, this "give back" to the industry won't be evenly distributed by companies. It's going to impact companies very differently.

As Henry also mentioned, there have been several issue papers dealing with reserves. Some could have some effect on taxes as well. Generally, statutory accounting is the basis for tax accounting, so it will be interesting to see how much or whether the IRS and Congress recognize codification efforts that significantly change statutory accounting. It will be interesting to see whether they relate those directly to tax.

There have been a few issue papers which deal with reserves. Generally, one item I see as significant is the netting of deferred premiums directly in the liability essentially requiring mid-terminal reserves. Depending on how companies do their statutory cap on tax reserves, this could have an impact.

Another change is the new classification on the annual statement of deposit-type contracts. If the statutory accounting abandons a mortality-based reserve, it could cause some classification problems under Section 807. Generally, Section 807 requires that reserves be calculated using mortality tables.

Henry also mentioned the SNFL and the fact that, as proposed, it wouldn't require companies to offer a net surrender value. I remind everyone that the net surrender value forms the floor of the tax reserves. Without a floor to the tax reserves, you'd be subject to the entire reserve valuation based on the AFR. Thus, removing the net surrender value floor could drastically increase a company's taxable income. It certainly should be considered in any new product design and pricing if the new proposal is ever finalized.

I'd like to conclude my remarks with a look to the future of our tax system and some of the alternatives being considered. Although the likelihood of radical change, I think, is still very remote, given that tax reform has really permeated politics for a couple years now and because our industry is so highly influenced by the tax code, any significant change—whether positive or negative—is likely to be very dramatic in its impact in our industry. The Kemp Commission was to study reform. It finalized its report early in 1996. Most of the significant recommendations were muted by the politics involved in the process. However, the commission did recognize several principles that underlie any new tax revenue and those principles are that it should be a flat tax. No specific rate was quoted. The payroll tax should be deductible. There should be no capital gain or estate taxes. Generally, there should be the elimination of deductions. Thanks to the ACLI president being on the commission, promotion of retirement savings was one of the explicit goals.

I won't waste anybody's time talking about Dole's tax proposals. I talked a little bit about flat and back taxes. The whole purpose of Dole's tax discussions is that he's bringing tax issues to the forefront once again and possibly radical tax changes. In principle, a flat tax and a value-added tax (VAT) are fairly similar.

Several problems arise for the life insurance industry when either regime is adopted. First, our products generally enjoy deferral of the tax on the inside build-up. A flat tax or VAT would eliminate the tax, but they also will eliminate the tax for our competitors in the financial services industry. The application of a VAT to life insurance company taxes is problematic at best. Most countries seem to exempt life insurers from a VAT tax. The problem arises because of the fact that we may recognize a tax currently while under our product the benefit is delivered many years from now. The measurement of the value added by a life insurance company becomes very complicated by the situation. In any event, any tax change will bring lots of challenges and opportunities to actuaries.

Mr. Jack F. Myers: I get the clean-up batter spot. I'll cover the FASB, the AICPA, and SEC all at once. I'd like to start with some developments at the FASB. *FAS 125* is an issued pronouncement on the transfer and servicing of financial assets. Then I'll briefly discuss the exposure draft on derivatives that the FASB has issued.

FAS 125 distinguishes between transfers that are sales and those that are secured borrowings. *FAS 125* takes a financial component approach to recognizing whether or not you have surrender control of those assets. The financial component approach is one in which you may have an asset. Let's take a mortgage loan portfolio that you want to sell to someone else, but you're going to retain the servicing rights on that portfolio. The financial component approach to *FAS 125* is going to cause you to take a look at what assets you have surrendered, which are the underlying mortgages, and the assets you have retained, which are the servicing rights associated with them. In order to value the cost basis in the mortgage loan portfolio you have sold, you're going to use a relative fair value approach in which you determine the fair value of the mortgage loan portfolio and the fair value of the servicing asset. You would allocate the cost basis based on that relative fair value of the sale.

FAS 125 has some specific criteria for sale treatment. I'd like to go through the sale treatment and then we'll discuss collateral. In order for something to be classified as a sale under *FAS 125*, the transferor has to be isolated from those assets that have changed hands. In other words, in a bankruptcy situation someone cannot look through the transferor and attach themselves to those assets. They have to be isolated from the transferor. The transferee who receives those assets has to have the right to sell those assets, repledge them, or do with them whatever they want. The transferor can't maintain control over those assets through some arrangement in which the transferor would be required to repurchase the assets or redeem them at a later date. The converse of that is the collateral situation: if you don't have a sale treatment, as I said earlier, it's a secured borrowing. So the collateral would be recognized by the transferee, which is often a bank. In mortgage loans you don't record the collateral on your books, but this statement may require you to do so in the future.

The statement also addresses when you extinguish liabilities. There are only ways in which to do so, either you pay the debt or you're legally absolved from the debt. Otherwise, you have to continue to recognize the liability on your books.

This statement is effective for transactions beginning after December 31, 1996 and cannot be applied retroactively. Therefore, if you have a securitization program that you're actively participating in right now, you would continue to account for that securitization program as you have in the past under the former accounting standards. However, starting January 1, any securitization program you're in falls under *FAS 125* even if it were in existence prior to the statement.

FAS 125 also looks at items that have prepayment risks associated with them and mandates that you cannot hold those assets as held to maturity. Thus, an interest-only strip cannot be in your investment portfolio and held to maturity. It has to be deemed either available for sale or trading with the profit and loss impact of an available for sale on the unrealized gain going to equity. On a trading security, it would go through the profit and loss statement. Any transfers from the held to maturity category upon adoption of the statement will not taint the portfolio. Therefore, you don't have any problems. But besides interest only, any items with prepayment risk will be caused to be classified in accordance with either the available for sale or trading category. This does not just apply to financial securities.

Moving on to the proposed statement on derivatives and similar financial instruments and for hedging activities. Derivatives are not new. It's only that their use and complexity are getting more widespread in the financial community and have been growing more each year. As each year and each day passes, there are more financial derivatives out there that are used to manage and hedge exposures to risks. The accounting standards have not kept pace with them. There are only two accounting standards currently which address derivatives: *FAS 52* for foreign currency and *FAS 80* for futures. However, there are many more types of derivatives out there that have not been addressed in standards, which has caused a great deal of inadequate financial reporting with respect to the derivatives. It may have discouraged some legitimate use of derivatives, because people were apprehensive of how to report them or whether they were going to look right. Those concerns over the financial reporting have been heightened by the recent couple of entities that had problems with derivatives. Everybody seems to have this stigma that they don't want to use derivatives or shouldn't be using them.

The FASB started this project to address the existing problems within the accounting arena with respect to derivatives, and I'd just like to touch on some of the thoughts behind why the existing accounting literature was not appropriate. As I mentioned, only two standards address derivatives and, as a result, the Emerging Issues Task

Force on many instances was called into play to come up with a specific accounting treatment for that one transaction, that, as a result, left a huge gap in the accounting. This is because everybody had to go to the Emerging Issues Task Force in order to analogize to their specific transaction where it wasn't quite on point. Therefore, there are huge gaps in a lot of interpretations with respect to accounting for derivatives.

Additionally, the accounting literature that is available gives inconsistent answers. Sometimes things are reported on the balance sheet and sometimes they're not. Sometimes they're recorded at fair value and other times they're recorded at no value or they're not recorded. This lack of a single, comprehensive approach has led to the complexity surrounding the accounting for derivatives. Therefore, the FASB came up with four things that it wanted to make sure that it had a foundation to build the statement from.

Derivatives are assets and liabilities, because they have rights and obligations embedded in them; therefore, they should be reported in the financial statements. Currently, many derivatives are not reported in the financial statements, and this exposure draft, if it was finalized, would cause all derivatives to be reported on their balance sheet. Additionally, fair value is the only method that makes any sense to record a derivative. Historical cost has no basis for a future perspective on the derivative and, therefore, the FASB would conclude that all derivatives should be reported at fair value. Additionally, deferred gains and losses are currently, under certain circumstances, hung up on the balance sheet. However, a deferred loss is not an asset that someone would pay you any money for and, therefore, it has no purpose for being on the balance sheet. So deferred gains and losses would no longer be on the balance sheet. They would be treated differently, which we'll talk about in a moment.

Also, hedging transactions have many different accounting treatments. This proposed exposure draft would make sure that the hedge was expected to occur and be achievable. If it isn't, then you can't have hedge accounting. Under hedge accounting there are two types of hedges: a fair-value hedge and a cash-flow hedge. A fair-value hedge is one in which you change a fixed rate loan, for example, to a variable rate loan so that you hedge the fair value into the future. Under the exposure draft, if that hedge were to work or if you have an over-hedged position in which the hedge moves more than the underlying basis in the asset, that difference would be recorded in earnings. You would have to look at your portfolios and make sure though that the derivative that you're using does, in fact, have the characteristics of the underlying portfolio or will cause that hedge to work. What I mean by that is you cannot just say that you're going to hedge a mortgage loan portfolio. Embedded in that mortgage loan portfolio you may have mortgage loans on residential property, you may have commercial real estate, different maturity dates, different interest rates, and/or underlying collateral. You need to break apart your mortgage loan portfolio into individual pieces that have similar characteristics in order to get the hedge accounting treatment under the exposure draft.

For cash-flow hedges, ones in which you want to protect against future changes in the cash flow when you're looking at a forecasted transaction, the exposure draft introduces a concept of comprehensive income. Under this concept any changes in the fair value of the derivative that was used to try to accomplish a cash-flow hedge would be reported in comprehensive income, which would be another component of stockholder's equity. This treatment is similar to that of an unrealized gain or loss on available for sale securities, which is now required under *FAS 115*. Any amounts would remain in that component of equity until the time that the transaction was anticipated to be completed when the hedged derivative was purchased and, at that time, it would be reflected in earnings. It would not be reflected until that time unless you were to close out the transaction sooner. But in the case in which the transaction doesn't close on its anticipated date, for whatever reason, the exposure draft would cause the earnings recognition at that time.

Moving on to some of the projects of the AICPA, I want to talk about a proposed standard of practice (SOP) recently issued on auditors' reports and then move onto some projects of the Insurance Companies Committee. The proposed statement of position, The Accounting by Insurance and Other Enterprises for Insurance-Related Assessments, is very close to being issued for exposure. I expected that it would have been issued already. I have seen a draft that has an October 1 date on it, but I'm not quite sure why it hasn't hit the streets yet. I do understand that there's still a target date effective for years beginning after December 15, 1997, and so this would be effective for calendar year 1998 for the companies.

It looks at the big debate over which method to use for guarantee fund assessments. The property and casualty insurers do it one way and the life insurers do it another way. Well, the SOP comes to a compromise. It says let each group do it its own way, because it's looking at when the assessment is probable and estimable. In a life insurance arena, as you're well aware, when an insolvency occurs the assessment is based upon the prior year's premium volume. Therefore, at the time that the insolvency occurs you should be accruing for the guarantee fund assessment, provided that you can estimate it. However, the property/casualty insurers are not assessed a guarantee fund assessment until they write the premium. Therefore, they follow a prospective method under which they would accrue for the guarantee fund assessment with each premium dollar written.

Under the proposed SOP, discounting would be allowable for that liability provided that the timing and the amount of the payments is fixed or reasonably determinable. You could discount that. Similarly, under the SOP you are allowed to record the offsets for premium taxes and the like. However, that asset would also need to be discounted if you would discount the liability.

SOP 95-5 is effective for this year-end. It rescinds what I'll call the prior auditors opinion under which if an entity did not quantify the differences between statutory accounting and GAAP basis accounting, then a disclaimer on GAAP was issued in a general distribution report. This SOP states that if the differences between GAAP and statutory accounting are material and pervasive, then I am precluded as an auditor from issuing a disclaimer of opinion and have to issue an adverse opinion with respect to GAAP and a general distribution statutory basis financial statement.

When the codification project is finished, it will cause another comprehensive basis of accounting to be out there. As auditors, we are presuming that this will be the basis under which we will report on statutory financial statements. In the future, if that is the case and you have a permitted practice from a state, that would be a deviation from that other comprehensive basis of accounting. If it's deemed material, this may cause us to take exception to it in our auditor's report.

As a result of FASB interpretation 40 and *FAS 120* for mutual life insurers, in the past mutual life insurers were able to issue statutory basis financial statements and call those GAAP. This year they're not going to be able to do that because those two pronouncements that cause us as auditors a little bit of a predicament. It's conceivable that in a set of statutory financial statements this year we'll have the exact same numbers that we had in last year's financial statements. In 1995 we gave you a disclaimer of an unqualified opinion with respect to GAAP, because statutory equaled GAAP then. But those same numbers now are going to be in this year's statutory financial statements and because of the rules under the AICPA and the change that statutory no longer equals GAAP, I cannot reissue that same audit opinion on those financial statements. Based on *SOP 95-5*, I'll now have to issue an adverse opinion with respect to those exact same financial statements on a GAAP basis. All that boils down to is in that situation the auditor's report will include another explanatory paragraph stating why the opinion is different than it was in 1995.

Moving on to some other ongoing issues at the AICPA, the audit guide for life and health insurers is very close to being issued for exposure. All of the technical aspects have been resolved. It's just waiting for final approval to hit the streets, at which time then there will be a 120-day comment period. The accounting guide incorporates a lot of the accounting literature since the last time the guide was revised and, most importantly, it now incorporates the mutual life insurers that were previously excluded.

For anyone looking for the audit guide for insurance agents and brokers, that was removed from the agenda in May and will not be issued. So you shouldn't be looking for it.

The next item is financial reporting for prepaid health services cost. Right now there's a tremendous amount of disconnect in the accounting literature between *SOP 89-5* for health providers and the insurance companies. The AICPA has started a task force to look at those two different bases and come to an agreement on how this should be accounted for so that we don't have two different types of accounting. The Insurance Companies Committee of the AICPA is a very active committee which is working on several issues.

In regard to surplus notes, at the Accounting Standards Executive Committee meeting recently, a decision was reached that surplus notes should be classified as debt and interest should be accrued on those unless for some other reason the accounting literature says that interest does not have to be accrued. As an example, with a bankruptcy situation you would not be accruing interest on your liabilities if you weren't certain you were going to pay it.

The ACLI is coming out with what we affectionately refer to as the "Good Housekeeping Seal of Approval" in which a life insurer will voluntarily participate in a program in which the life insurer adopts the principles and code of life insurance ethical market conduct. Then, around the adoption of those principles and code of conduct, a life insurer will formulate policies and procedures to ensure compliance with those principles and code of conduct. Following implementation of its policies and procedures, a self-assessment questionnaire is being developed so that a life insurer can complete the self-assessment and ascertain where it falls on a scale related to its market conduct issues. Presently the AICPA, along with many other professions, are looking at how we could report on that. If someone were to say to us, "Here's my self-assessment. Can you issue an audit opinion or an attestation opinion associated with that?" The AICPA as well as many other professional groups are looking at how they can participate in the assessment of the company's own assessment.

In reference to the SEC "hot" topics, for the past several years the SEC has been hinting that it is going to take a hard look at all insurers as to their disclosures and their accounting policies and procedures. Each year passes and not much new comes out of it. Reinsurance transactions continue to be an item that interests the SEC. It feels as though many contracts don't pass the risk transfer criteria of *FAS 113* and so it's always looking at that. With derivatives, it feels as though there aren't enough disclosures. People don't have enough information to decide how a company is managing its risk through the use of derivatives. So the SEC, in addition to the FASB, has its own proposed disclosure requirements for use of derivatives.

As far as mutual life insurers are concerned, the SEC has continued to say that it will accept the statutory basis financial statements for filing with the N3 and N4 filings. My opinion is that some companies have gone through a GAAP conversion process and they have GAAP financial statements, but they don't have them available until later on. In the summer or nine months later, there's a risk that the SEC could come back and say, "You have GAAP financial statements. You just don't have them timely and, therefore, your filings aren't timely." It's something to watch out for as the SEC may take action in the future.

My final comment is on foreign filers. There's a tremendous amount of activity of insurers who want to tap into our capital markets in the U.S. It gives the SEC some difficulty, because the way in which our accounting standards are set up and the accounting standards in other parts of the world are set up with respect to life insurers are very product driven. Our life insurance products are very different from those of other countries. It's difficult for foreign filers in certain instances to GAAP their financial statements because their products don't fit into our accounting models, and that's something that the SEC is trying to grapple with.