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International Aspects of U.S. Generally Accepted Accounting Principles (GAAP) Accounting

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Summary: This session provides an overview of the various situations in which U.S. GAAP accounting for life insurance companies has international implications. Topics to be covered include the following:

- *U.S. GAAP reporting for foreign insurance companies: when it is useful or required, such as the Securities and Exchange Commission (SEC) reporting relating to raising capital in U.S. markets, and*
- *issues relating to foreign branches or subsidiaries of U.S. companies and consolidated GAAP financial statements.*

Mr. Frank J. Buck: I have two speakers, Dana Lang is a guest speaker of the Society of Actuaries (SOA). She is a certified public accountant (CPA) and is the director of corporate affairs and financial reporting for AIG Life Insurance Company in Bloomington, Delaware. She is responsible for consolidation of their international operations. She has been with AIG for five years and was with another domestic insurance company before that.

The second speaker is Dan Kunesh, who is with Tillinghast, a Towers-Perrin Company in Chicago. He has been at Tillinghast for eleven years. When I first met him, over 20 years ago, he was with an accounting firm. For the last five years he

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has been involved in international operations at Tillinghast. He and I have met on a couple of occasions in Rome, where we have a joint client. This session is designed for people with little knowledge of the subject. And we thought that I should start by spending a few minutes giving general background on GAAP, and leading into some potential international problems. Dana will take this from the point of view of a U.S. company that has international subsidiaries and how they file various returns in the U.S. Then Dan will look at it from the point of view of international companies filing in the U.S. Dana is going to take the accounting aspects and Dan will take the actuarial aspects.

Before I start I would like a show of hands from the audience telling me whether you know a lot about GAAP, a modest amount about GAAP, or little to nothing. Most of you have a modest knowledge. For the two or three who know very little there is a two-day seminar that the SOA holds on GAAP accounting.

I am going to go through a quick review of the accounting pronouncements and I am going to talk about loss recognition, shadow deferred acquisition cost (DAC) and international issues.

Imagine that you are an international company and you want to file your statements in the U.S., and you look at the situation over here. What do you have? There are three accounting pronouncements that govern the business, whether it's traditional business, interest sensitive, or participating business. There are all sorts of Financial Accounting Standard Board (FASB) pronouncements and they all are very confusing.

Financial Accounting Standard (FAS) 60 arose out of the Industry Audit Guide to audits for stock life insurance companies, which started in the early 1970s. The reason that they needed to report differently was that the income from statutory statements made no sense to outside investors. The more you sold with the heavy acquisition costs, the worse the business looked. They wanted to match revenues with benefits and expenses, and the idea of GAAP accounting was applied. You make realistic assumptions about the reserves and you take the acquisition costs and spread them over the lifetime of the business.

Assumptions were made, not only about the typical statutory elements of mortality and interest, but also on expenses, inflation, in fact, anything that would go into pricing the product. You make assumptions and these assumptions are locked in. You added margins for adverse deviation. You project the business out, as if you were pricing the business. You project all the cash flows in the business, the benefits, the expenses, etc. Then you split the premium into three pieces: one piece to cover the benefits, one piece to cover the expenses, and the rest would come through as profit.

This was all done in a similar way to statutory accounting. The reserves and DAC are put in the form of factors and these factors were locked in because the assumptions were locked in, and they would be applied to the actual in-force as you went along. So to the extent that the in force was different from expected, you would have some sort of balance to that. If the experience followed your assumptions, the profit would emerge in proportion to premium. And it could be that 60% of the premiums are needed to meet benefits, 30% to meet expenses, and 10% for profit, that is, if you were pricing generously. So that's all that *FAS 60* was; it just spread things out and smoothed the earnings relative to premium.

FAS 97 came along principally dealing with other things, but it also modified the treatment for traditional business with limited payments. There had been some abuses where companies were reporting earnings over the premium paying period, and if you were paying a single premium or a few premiums, there was a lot of front-ending of profit. It was modified so that it just spread the profits out over the lifetime of the business, and that's really all you need to know about this slight modification at this point.

The GAAP statement under *FAS 60* is similar to a statutory statement. Cash flow is cash flow in any accounting system. But essentially, instead of statutory reserves, you have benefit reserves, and on the asset side you set up the deferred acquisition costs as an asset. On the income statement you have the change-in benefit reserves instead of a change in the statutory reserves. And you have change in DAC coming through the income statement. That's *FAS 60* traditional business, very simple.

In 1987, *FAS 97* came along dealing with three things: investment contracts, limited pay contracts, and universal life (UL) contracts. Investment contracts are essentially those that do not have any insurance risk and the payments are not reported as revenues. It is deposit accounting and they are accounted for just like in interest-bearing instruments. An equivalent yield method is used for things like guaranteed investment contracts (GICs) and other investment-type contracts. Single premium deferred annuity (SPDA) is slightly different, but we needn't get into that.

We essentially talked about limited payment contracts. And the final piece, and obviously the biggest piece, of *FAS 97* was UL. Under *FAS 97*, you are essentially saying that the monies received by the insurance companies are deposits that are going to be accounted for as deposits. You are not going to report the premiums as revenues, they are going to deposits. What you report as revenues are the same as banks. So when you deposit money with a bank, the bank reports the spreads it earns. The revenues are the difference between the interest earned and interest credited, plus any charges it makes, less any benefits it pays out, in addition to the underlying deposits.

Once again you need assumptions, and in this case you are making best-estimate assumptions. No margins for adverse deviation and, in this case, the assumptions are not locked in.

The benefit reserve is just the account value. There are situations when you would add a little bit more to it for various things. But for the benefit of this discussion, the account value is all you need to know about.

You calculate gross profits, and they're more like banking gross profits. They're margins; interest earned minus interest credited, any charges, anything that's paid out, in addition to the account balance. Surrender charges would come into income in this case. You take deferred acquisition cost and you amortize it over this gross margin.

FAS 97 says that you have to review the projections regularly. Now GAAP is wonderful in that it has these terms, like best estimate and regularly and reasonable, but it doesn't really define these terms anywhere. To some people regular means once a day. In the context of reserving and amortizing DAC, most of my clients will look seriously at the assumptions on an annual basis. During the year if anything significant happens, like collapse of the junk bonds or the collapse of real estate, that would cause them to look very carefully at what is happening. Profit emerges in proportion to these margins and the balance sheet is similar to the other GAAP balance sheet. You have the benefit reserve, which is the account value instead of the factor reserve, and you have the DAC set up. The income statement looks a bit different. You do not have premiums going through there but the margins. You do not have a change in reserve. You have benefits in excess of account balances and the change of DAC.

I have a couple of simple examples to go through. This is a very, very simple one. The interest rate is 0%. I have assumed gross profits of a hundred each year for five years. We are deferring one hundred. The ratio of present value of deferred expenses to present value of estimated gross profits is one hundred over 500 or 20%. So you're going to take 20% of each of these estimated growth profit streams and use that to amortize the DAC. None of you are going to have any problem working out the final column of 80, 60, 40, and 20.

Then let's take an example where perhaps mortality is bad in the third year, and you investigate. You find it's like one of my clients, who had sold business in Florida and in South America using the same mortality bases for both. He quickly found that the experience in South America was a lot worse. Upon investigation he found that one of the agents down there had sold a lot of policies to members of one of

the drug cartels in Columbia. And the mortality level was, shall we say, a little bit higher than expected.

Suppose that is the case. You suddenly find this year you have zero profits and you say, what on earth is going on? How could that be? You have to put in zero profits in the gross profit stream, and you say, well maybe mortality is going to be worse in the future, so we only expect profits of 50 in the future.

Go back and do these present value of deferred expenses divided by present value of estimated gross profits. You have to go back to the outset to do the whole calculation. The answer is now 33%. Had you known that initially that, at the end of the first year, the DAC would be 67, and at the end of the second year it would be down to 33, and now you've got zero profits coming through, then you would have known to recognize the DAC as 33. This is really demonstrating that the whole thing is dynamic. In the third year, there will be a cumulative catch up. You haven't written it down to 33 at the end of the second year because you didn't know that the gross profits were going to follow this pattern. But now you do, and there's this cumulative catch up.

Finally, to complete the picture, a couple of years ago the SEC and FASB decided that the mutual companies should no longer report statutory earnings and say they are GAAP earnings. *FAS 120* came along and defines accounting for participating businesses. It tried in many ways to follow *FAS 97* and has many of the same attributes as *FAS 97*.

You now have estimated gross margin rather than profits, and they look more like statutory profits rather than the spreads you're getting on *FAS 97*. They really wanted to set up reserves something like the *FAS 97* account balance, but there are no account balances in the participating business. About eight or nine different attempts were made, and eventually they decided upon a net-level reserve on the statutory basis of mortality and interest as a proxy for the account balance. A bunch of actuaries convinced the accounting group looking at this that it was a reasonable approximation.

To amortize the DAC, you project out the gross margins over the lifetime of the business, and you dynamically adjust the margin in the same way that *FAS 97* dynamically adjusts it. You review this on a regular basis. You have no margin for adverse deviation. If you have terminal dividends that you can estimate, then you have to accrue it as well. Similar to *FAS 97*, the profit emerges in proportion to the margins with a cumulative catch up, and the balance sheet and income statement effects are very similar to what you saw under *FAS 60*.

Can you imagine the confusion of someone overseas coming over here and saying, you know, I've got this product; which of the three buckets does it fall into? Is it traditional, or interest sensitive, or participating? And do I make the assumptions on one and have them locked in as in *FAS 60* but not on the other two?

Do I have margins for adverse deviation, as I do in *FAS 60*, but not on the other two? Do I review the assumptions regularly as on 97 and 120? Do I report premiums as revenues? You do that on 60 and 120, but not 97. And what interest rate do I use for DAC amortization? Is it the earned rate or the credited rate? Earned rate on 60 and 120, and the credited rate on 97. Whoever said that accounting was logical?

I am going to cover loss recognition very quickly. We talked about amortizing deferred acquisition costs. The first thing you need to look at is how much of the expenses can you defer? The definition is, those that vary with, and are directly related to, the production of new business. Obviously commission is something that is going to vary with new business and be directly related to it. For a sales operation, like a branch operation, probably some of it is deferrable and you can justify deferring some of those costs. Advertising certainly isn't. This is a good example of a cost that doesn't vary. You can spend \$1 million in advertising and get zero sales. Industry practice has grown up over the last 20, 25 years as to what is reasonable and what isn't.

What is important for overseas companies and for companies who have overseas operations is that the definition of deferred expenses in other parts of the world is often quite different. It might be pricing, it might be a specific allowance, it might be something totally different. It's not necessarily the same as the U.S. definition, so you have to be very, very careful when looking at those definitions.

You have to show that an expense can be recovered before you can defer it, and on a regular basis you have to demonstrate that you can recover the DAC from future profits. If you can't, you have to take a write-off immediately, unless of course, it's an investment contract, in which case you can't. Once again, accounting is logical. And this would normally be done on a block-of-business basis.

Just one very quick example of a loss-recognition situation. We'll use the same product that we had originally with one hundred deferred and profits of one hundred a year. But in this case, interest rates dropped dramatically and you decide you were going to take a big capital gain, which means you are going to get losses in the future. This is, in fact, is a very real situation. A lot of companies sold annuities in the late 1980s when interest rates were in double digits. They were matched with bonds, and as interest rates came down the bonds were either called

or the investment managers decided to sell them. They realized gains and now they are going to get losses in the future.

You would essentially write off the DAC at this point. You would take the realized gain and you would have to set up a loss-recognition reserve in this year. Essentially, you would be taking all the profits into income this year and earnings would be zero for the remainder of the contract, which happens under loss recognition.

Just to confuse the issue further, *FAS 115* came along and said that you had to take your investments and classify them into three groups: held to maturity, available for sale, and trading. Most of my clients have no trading securities, at least they don't admit to holding trading securities. Probably 80% of the securities are available for sale and the rest will be held to maturity.

The held-to-maturity definition is very strict. You must intend to hold them to maturity. There are very, very limited circumstances when you can sell them. You can taint the whole portfolio if you sell them for things that might seem fairly obvious, like a change in interest rates, which is not an allowable reason. A need for liquidity is also not allowed. That is going to taint the portfolio.

When this first came out, the SEC was asked what the situation was and the chairman of the SEC back then said, "If you sell one security you're going to owe me a bottle of scotch. If you sell two securities you owe me a case of scotch; and if you sell three securities or more you owe me a restatement."

The SEC has been very tough with that requirement. On the financial statement, we hold held-to-maturity securities at amortized cost. Available-for-sale securities are at amortized cost on the income statement and fair value on the balance sheet. And trading is at fair value. Accounting is wonderful.

The shadow DAC relates to unrealized gains and losses on securities classified as available for sale. You report these, on the balance sheet only, as if they had been sold. If those gains had been realized there would be all sorts of offsets. There could be a different pattern of amortization of the DAC and any unearned revenues that might have been set up. Deferred taxes would appear in here as well. There could even be a change in policyholder liability. If you sold the securities and if that meant there was a change in the policyholder liability, that would be an offset.

Let's think more in terms of international and the sorts of issues that we're facing and a couple of things that I have seen. Maybe Dan and Dana will cover this. I have a company here that has international operations, and it was easier for many of

the international subsidiaries to set up the securities as held to maturity because that fit in with a local reporting. Then there could be a situation, it was a very real possibility in one country, that there could be a tax advantage to selling these securities and replacing them with similar securities. Would that taint the portfolio of the company over here? I don't know, but it's certainly a great danger that they could do something that could have significant impact on the need to restate in the U.S. and that would be very embarrassing.

Another situation occurred in the U.K. Participating businesses or companies with profits in the U.K. are backed by the portfolios of insurance companies which, for the last 50 years or so, have probably averaged more than 50% in equities or real estate. There is a very high-equity content in the U.K. You could have a significant amount of unrealized gains in the portfolio, and dividends will be paid on the basis of those unrealized gains. Now with GAAP you can't recognize the unrealized gain. You have to set up the liability for the dividend, so you could have a mismatch on the U.S. GAAP basis between recognition of the earnings and the recognition of the expenses.

The third problem I've seen is with unit-linked business in the U.K., and there's a whole class of business where instead of a front-end-load product, they set up a product with very high annual charges out of some early year purchases of units. Once again there's a mismatch because they manage them as if it were a front-end-load product. When you start reporting them in the U.S., you can have some significant mismatches as the value of the units jump around. The earnings can jump around disproportionately.

The final thing is something that Dan and I worked on together in Italy. They have some policies over there called revaluable policies. These products are typically 15-year endowments. Both the face amount and the premiums can be changed according to interest earnings. Sometimes the face amount changes and the premium doesn't. In other cases the face amount and the premium change in the same way, and in some they change in different ways. How you classify these products defied both of us for a while, but eventually we came to an agreement.

That's a very brief overview of GAAP. Dana is now going to talk about the accounting side and her experiences at AIG.

Ms. Dana Lang: Over the last few years we've seen an increasing globalization in many industries, and insurance is no exception. Despite this increasing globalization there continues to be a variety of accounting differences, and this causes some major confusion. My part of the presentation will try to compare a U.S. insurance company under GAAP and a non-U.S. or foreign insurance

company. I really don't want to spend a lot of time showing line-by-line comparisons. What I would like you to take away from this presentation is to get a good feel for a content of a foreign income statement and balance sheet. I'll give you some key things to look at when you're analyzing the foreign income statement or balance sheet. All the numbers that are presented here are completely fictitious, so don't spend a lot of time trying to calculate any ratios or numbers.

This is an example of a typical GAAP balance sheet. Just for informational purposes, it's a multi-line insurance company. Normally a GAAP-audited statement will include the balance sheet, a statement of income, a statement of changes in capital funds, and a cash flow statement, as well as detailed notes of financial statements. The first thing that we want to look at on this balance sheet is that it's very structured. It's divided into three main categories: assets, liabilities, and capital funds. You can see that the first part has very detailed, invested asset information, and this is where you see the three categories of the *FAS 115* presentation.

Basically the two underlying assumptions that we deal with when we talk about GAAP financial statements are the accrual basis of accounting and the going-concern concept. The accrual basis deals with the recording of transactions when they occur, not necessarily when cash is received or paid. The going-concern concept deals with the fact that the company is going to continue in the future. Assets are accounted for on the basis of continued use as distinct from market value or liquidation value.

Now we're going to move to overseas. What I've decided to concentrate on primarily is the European community, primarily because we'll be able to look at 12 member countries who are basically using similar financial reporting requirements. Member companies are required to file financial statements based on directives. The European Economic Community (EEC) requires member countries to outline various reporting requirements in international legislation. It's up to the member countries to detail in their legislation how the requirements would be followed. So by doing this you get a variety of reporting differences between member countries. Sometimes they're not very consistent.

When we look at the major differences in reporting between U.S. GAAP and foreign reporting, we can break it down into two major differences. The first deals with format and presentation, which are fairly easy to understand and interpret. The second deals with conceptual and philosophical differences, which are a little bit more difficult to understand. One of the most important similarities with a foreign insurer, however, is that they do follow the accrual basis of accounting and they do follow the going-concern concept.

A balance sheet of a life insurance company located in France, slightly different format it's from our U.S. GAAP format. We have two sections now, the assets and combined liability sections, which include the capital and liabilities. When you're looking at the assets the first thing you want to find are the material assets or the invested assets, which are a little more difficult on this balance sheet. If you follow it down you'll find the term marketable securities, and that's primarily where your major invested asset categories are. It's, also, a little confusing to determine the basis of accounting for the securities. We know by research that France accounts for investments at cost, which is different from U.S. reporting requirements.

What I have found in dealing with various countries is that this is one of the areas that really is very different from country to country. One of the main areas to find out exactly how the assets are accounted for is in the notes to the financial statement.

The next area to examine is technical reserves. This is where the future policy benefits are reported. They also use the term mathematical reserves in many foreign balance sheets.

Another one of the major differences that you'll see slightly highlighted is the reserve for revaluation of assets. The revaluation reserve is a method used to account for inflation in the European Community (EC) countries. I've seen this in a number of other foreign countries also. Within the EC they allow what they call a countrywide approach, and it's predominately used by four of the countries: France, Greece, Spain, and Portugal. It basically allows them to write up assets based on their indexing method or another write-up guideline as provided by the government. It's done every few years and it's usually based on replacement costs. Where I've seen it primarily used is writing up real estate to an assessment value, an appraised value. In those EC countries that don't necessarily use the countrywide approach it's completely up to their discretion whether they want to use the write-up method. Another thing to keep in mind is that if the write-up or revaluation method is used it's going to impact the income statement because they are going to see the depreciation charge is on the increased basis of their assets.

Within the reserve section you'll see a few other categories that they use, and I guess this is another major reporting difference with a foreign insurer. Basically they use three types of reserves, and these are reserve provisions, not necessarily benefit reserves. The first are called statutory reserves. You may also see these referred to as legal reserves. This is where they maintain appropriation of profit. It's a reserve used to protect creditors and it restricts assets. A statutory reserve must be disclosed in their financial statement.

The second type I'll refer to is general reserves and you'll find within the EC countries that there is a greater tendency to set up loss reserves than you would find in the U.S. balance sheet. General reserves would generally have to be disclosed, though they may not be.

And the third type are called hidden or secret reserves. You won't find that listed on the balance sheet. These are reserves that are in a U.S. GAAP balance sheet, although I guess we don't want to say that they usually are. It usually happens when you have an asset understatement or a liability overstatement. You'll usually find it in the U.S. when you're taking excessive depreciations or if you set up additional reserving for estimates.

In the EC countries, though, you'll find a slightly different philosophy. Basically their tax law states that they can only take a tax deduction equivalent to the operating expenses that they report in their financial statement. Therefore, if their tax law permits a 5% write-up for bad debt, they'll report 5% operating expense for write off in their income statement, even though the write-off expense may be lower. So this generates a hidden reserve.

I'd like to move now to an income statement of our U.S. GAAP company. It's broken down into segment reporting. You start with general insurance, life insurance, and then other operating income. You come down toward total net income. It's very structured.

Primarily what U.S. GAAP reporting has always strived to do is to live up to investors' expectations. In order to do this it's always been a practice that earnings have to rise smoothly and predictably. Materiality, reliability, and comparability are very critical in presenting your financial statements. Also, for an insurance company, reporting segment information is also very important.

Now let's discuss our French company income statement. Our French company divides their income statement into two parts. The first are the underwriting results. Much of what Frank was talking about earlier, as far as *FAS 97* statements, you won't really find in this income statement. Premiums are usually at a statutory basis, so you're not pulling numbers out for an *FAS 97* statement. It basically looks like our U.S. statutory income statement. You see premiums, investment income, benefits and expenses, to come down to a total net result of life operations. I think the main difference really is only that investment income is split between gross and expenses so you don't really see a net-investment-income number. Other than that it's fairly understandable. I think what you'll find overall is that EEC countries don't emphasize the calculation of annual profits as much as we do in a U.S. GAAP balance sheet.

The second section deals with profits and losses. This is where all miscellaneous other income and other deduction numbers come in. Normally what you'll find in this section are prior period adjustments, charges for doubtful accounts, and depreciation of fixed assets. Within our U.S. GAAP balance sheet, normally a lot of these types of expenses would have fallen into operating expenses, whereas the EC companies tend to dump them more into an other-income-other-deduction item. If our French company had set up a statutory reserve you would also see the deduction for that statutory reserve showing up in this section of the operating statement.

Another section that you see are extraordinary items. Usually on a U.S. GAAP income statement it is very rare to see an extraordinary item being reported. But I think if you had to, if you gave the U.S. GAAP reporting company and the French company the choice between what makes up an extraordinary item, U.S. GAAP would always lean toward operating and the foreign would always lean toward extraordinary. It really comes back to the emphasis of annual profits and comparability of years.

Another thing to keep in mind are the taxation rates. With the foreign companies, each country is going to be so different with respect to the rate that they use. So comparing the entire tax expense is going to be very different with the foreign insurer.

The last area that I'd like to cover deals with currency conversions. I've broken currency conversion into four main types. The first are transaction adjustments, and these occur when you are converting or when you are recording a transaction in one currency, for instance your functional currency, and you're settling it in a different currency. An example of this would be if our French company had, for instance, Spanish government bonds on their books, they would receive interest income in Spanish pesetas. They would take that to the bank and cash it in because they're keeping their books in French francs. So the impact of that transaction, of moving it from pesetas to francs, generates a transaction gain or loss.

The second type of currency conversion is in the exchange rate of holding a currency that is not your functional currency. Our French company, holding a Spanish peseta bond, would generate a translation gain when they would have to take that Spanish bond and report it in their balance sheet in French francs. This generates a translation gain or loss.

The third item is hyperinflationary adjustments. Some examples of hyperinflationary economies or currencies include the Mexican peso and Venezuelan bolivar. These

are economies where the accumulative inflation rate has been 100% over a three-year period.

The last item, and to me one of the most confusing areas, is monetary corrections. This occurs in foreign countries, predominately in Latin America, where the local insurers are required to report financial statements in an index format. It's where they have to take their local reporting currency and adjust it to a general, price level index and report in that index. They also restate the prior year numbers to bring both the current year and prior year in line with the current index.

The last thing that we want to address is just converting our French franc balance sheet into U.S. dollars. This would happen if this company happens to be a subsidiary or a branch of a U.S. GAAP-reporting company. Of course, the first thing that we need to do is to bring all the assets in line with GAAP reporting, so a lot of the reserves, reevaluation reserves, would be reversed. Basically what happens is we take the year end exchange rate between the French franc and U.S. dollar and convert to U.S. dollars. This happens with every asset and liability account with the exception of the profit and loss account.

The income statement is generally converted at an average rate. Depending on how the company reports, monthly or quarterly, it determines whether they use a monthly or a quarterly rate. For instance, if it operates or it reports quarterly, the first quarter's numbers would be translated at that quarter's rate. Then the second quarter would be translated at the second-quarter rate. So each quarter would build on to itself until you have your four quarters. So the four quarters' average rate is what you see in the profit or loss of the current year. So what you'll see is a new line now, accumulative translation adjustments, which is our balancing factor to bring all the French franc assets/liabilities in line with U.S. dollars.

Now what happens with our transaction adjustments? These were all the transactions that occurred when we were moving between one cash currency to another cash currency. All those adjustments flow through the income statement. You don't see those flowing through the accumulative translation line, it will flow through the profit and loss statement.

French francs are not a hyperinflationary currency, but if we had a company in Mexico where it was hyperinflationary, what would have happened with their balance sheet? We would have converted all the intangible and tangible assets at a historical rate, then all the monetary assets cash, investments, payables and receivables would have been converted at the current rate. Those translation adjustments would flow through the income statement also. Hyperinflationary

currency changes don't flow through the line accumulative translation adjustment, it goes through the income statement.

In closing, I'd just to like to bring up the fact that there is a movement towards an international accounting standards committee or a movement to bring foreign insurance companies in line with reporting international accounting standards. It's not quite the same as U.S. GAAP reporting. I think the problem that I have seen in working with foreign insurance companies is that they're very geared to local reporting. It's very difficult to make them see the emphasis that must be placed on statutory reporting if they're a branch of a U.S. company, or U.S. GAAP reporting if they're a branch or subsidiary of a U.S. company. There really needs to be emphasis put on moving more towards an international accounting standard. I feel that there will always be fundamental political and cultural differences that prevent us from getting to a completely comparable format.

Mr. Daniel J. Kunesh: I've had the privilege over the last four or five years to be involved with a large number of overseas companies. These companies are in Mexico, Europe, Australia, South Africa, and Southeast Asia, and it's been a challenge. I've been helping these foreign multinationals coming to the U.S. for a filing with one of our major exchanges, continuing those filing requirements with the SEC, and responding to their questions and problems over time.

What I would like to do very briefly is three-fold. First, why are foreign multinationals coming to America? What is their motivation? Second, why is this process of converting to U.S. GAAP so difficult? Why is it like putting a round peg into a square hole? Third, I'll expand a bit upon what Dana had introduced, the international accounting standards. It is probably the most interesting and exciting thing that you'd want to hear because changes are coming and they are coming soon.

Why do companies come to America? I'll start off simply by talking about four Dutch companies. A.B.N. Amro, which is a very large, Dutch bank with major operations in the U.S. ING Group; as you know they own Security Life of Denver, Life of Georgia, and a number of other companies. Aegon Corp, which very recently completed the acquisition of Provident and Fortis. I just decided to pick these Dutch companies. There is some commonality here, but they all illustrate some of the points I wish to make. First of all, A.B.N. Amro and ING and Fortis all have very recently used a common way of attracting capital in the U.S., and that is through the use of American depository receipts (ADRs).

To those of you who are unfamiliar with ADRs, why do foreign entities want to use them? Well, first of all, an ADR is a vehicle by which the foreign company can

deposit its own shares with a so-called depository, which is a U.S. bank normally, which in turn will issue the ADRs, which is the newest style security to the general public. It does three things. First, it allows dividends to be paid in U.S. dollars, and in today's marketplace there's fear about exchange rates, currency exchange rates, dealing in foreign currency, and dealing with foreign countries.

Second, a foreign entity will use ADRs to test the market before they go over to full-blown filing with the SEC with their own securities. And third, ADR can facilitate an acquisition.

I'm going to point out a couple of the reasons for entry into the U.S. capital markets. The first is to raise capital more efficiently. That's the key word. Overseas companies really look to the U.S. as the largest, most prestigious, and most efficient market in the world, in spite of our very onerous reporting requirements.

Another key reason that you always hear is they want to increase the demand for their shares. They see the U.S. markets, the New York stock exchange, and the other two, NASDAQ and AMEX, as being very effective and efficient markets, which are able to distribute shares at a lower cost much quicker, and also, to penetrate U.S. investors, which are very active.

Another key reason is that companies that have large U.S. operations create certain employee incentives. A.B.N. Amro and ING are two good cases in point. A.B.N. has over 11,000 bank employees, largely around the City of Chicago. ING has over 9,000 U.S. employees and now, of course, Aegon has quite a few employees with Provident. These organizations are using various stock incentive programs with employees, and the whole idea is to give their U.S.-based employees a chance to invest in the parent-company shares in U.S. dollars here in the U.S. They believe it creates a more liquid market, it creates certain incentives, and enables them to attract a higher quality employee.

What are some of the challenges? We already heard from Dana that there are many disclosure requirements. In fact, the disclosures required in both the original registration statement and in the annual 20F which, by the way, is comparable to the 10K filing of the U.S. company, is considerably more than you'll find in almost any other country in the world in both the narrative and the financial displays. The key difference between a 20F and the 10K is that in a 20F a foreign, non-U.S. company can file their own financial results from the country of origin and then they must file a reconciliation of those results to U.S. GAAP in footnotes. They don't have to present everything in detail in U.S. GAAP, although they probably will internally. That's the primary difference between the two, but there are other differences.

We already talked a bit about *FAS 115* classification problems. I would like to point to investment valuation differences and to two investments that have created a lot of trouble. One is bonds, of course, and even more importantly, properties. Many overseas companies invest heavily in property. As Frank mentioned, overseas companies, particularly European companies, pay bonuses or dividends out of unrealized gains in many situations. Suppose you have a property that went from \$1 million to \$15 million over time, the other \$14 million may have been distributed in a form of bonuses, (80% of it, or whatever percentage they would have distributed) and it's already on the liability side of the balance sheet. Yet you come over to the asset side of the balance sheet and U.S. GAAP says that you must show that asset as depreciated cost, which is perhaps \$600,000. Then you have a real problem.

There are suggested solutions. I will say one thing concerning a couple of experiences that I've had. If you have a problem, don't be afraid to approach the SEC with your accounting firm (that's the only way they'll listen). You need to ask for a private hearing and present your case. They will listen. All they're looking for is a basis in the literature, which means the linkage to the three accounting standards.

One of the key problems with overseas conversions is the fact that you just do not have data. Companies do not have historical pricing studies, and the companies haven't ever priced the product because of the product structure. They don't have experience studies. They don't have dividend scales.

How do you do *FAS 60*? Contingency reserves, as Dana pointed out, are very common overseas. For example, some new contingency reserves are setting aside large sums of money to convert to the year 2000 computer systems or to the Euro dollar when it all comes together under a single currency. You can't do that on U.S. GAAP. You can't really do it until the event or expenditure is actually taking place.

Let's discuss goodwill. Overseas, they either write off goodwill immediately or in a very short period of time, like five years. In the U.S., as you very well know, we do it over a much longer period of time, 20 or 25 years, up to 40 years sometimes. And we get this opportunity to play around with present value of profits (PVP), which allows you to amortize in a relationship to your in-force business. It makes a lot of sense, but it's currently not done overseas.

So why is this so hard to do? I'm going to focus on a couple of things. We talked about the tariff rate structure, where premium rates are not competitive. They're like our participating business, where everything is priced at the end. The premiums are really based on statutory reserve interest rates, which can be very

low. In Italy we've seen it as low as 0%. And the premium rate assumed statutory mortality. Then they give it back each year, or a portion of it back every year, so as a result there's no pricing. So how do you do FAS 60? How do you go back in time and create a set of assumptions? How do you do the estimated gross profits or estimated gross margins for interest-sensitive products, if that's the method you want to use?

The other difficulty is participation. What is paid back is often controlled by regulation. For example, in Norway, 65% of so-called net result must go back to policyholders. In Italy at least 80% of the investment return must go back to policyholders. Unrealized gains and losses are likely to go to the bonuses, but they are coming from unallocated asset pools. In the U.S. the only way you can account for your assets on a market basis is if they're unit-investment trusts. They're legal trust assets associated with a book of business. They're natural in Europe, natural in South Africa, natural in Australia. I've talked to the SEC; I've talked to FASB. Under certain circumstances they are more than willing, if bonuses are directly applicable on the realized gains, to allow you to account for all assets on a market basis. This is one of those situations.

I should mention a couple of other things. The tax structure can vary in English-speaking countries. I minus E is investment income minus all expenses. Most parts of the world use an after-tax basis and U.S. GAAP says, you have to look at interest on a pretax basis. Well, what happens when you're crediting interest to the policyholders on an after-tax basis? Do you use a pretax interest rate or an after-tax interest rate? I've seen it done both ways, in the U.K. particularly. It's not true with pension products in the U.K.

I want to say one thing on policyholder and shareholder funds. You don't know what some of these things are. You have to dig them up like Dana said. What happens many times is that you might have what they call a prudence reserve or a special investment reserve. For many, many years Europeans have been hiding capital, until recently. The way their balance sheet looks, as you saw, you can't always tell where the line is drawn, what is above the line and what's below the line. But you have to know in a GAAP conversion.

What do you do with funds that look like shareholder funds but at the end of the day at least 90% have to be distributed to policyholders? You put 90% above the line and 10% below the line. These are the kind of questions that come up and are faced by foreign entities.

You're familiar with peer products, profit endowments with profit sharing, where the bonuses or dividends are tied either to investment forms of an unallocated asset

pool or tied directly to company results. Believe it or not the big issue on the linked policies, which look like a traditional ordinary policy, traditional, or participating endowments. It's a *FAS 60* product right? Wrong. Maybe right, maybe wrong. We don't know. The answer is you don't know, and there are reasons for that. Some of them are practical, others are perhaps tied into literature. Should we use *FAS 60*?

First of all, from a practical standpoint, can we really go back to time of issue and use time-of-issue criteria? Can we determine the assumptions? Can we determine the dividend scale? There is no dividend scale. It determines dividends on a year-by-year basis. How do you determine assumptions when you have no pricing assumptions? You didn't price the product in the first place. You may not have a good history. Dividend philosophy is changing at many of these companies several times over the years. So you're likely to be way off base if you go with an estimated dividend scale from the original issue.

What you need to do is to have your software system, if you have one to do *FAS 60*, ratchet up the reserve or correction between what you thought the dividends were going to be and what they actually are. In the U.K. most dividends are paid as so-called reversionary bonuses. This means that paid-up additions, as Frank pointed out, can also be reflected in increases in premium. This is very complex and can create certain difficulties in your reserve systems.

Some accounting firms believe that the SEC will challenge the level of guarantees within *FAS 60* contracts in Europe as being not significant, for example, a very low interest rate. If this is true, *FAS 60* cannot be used, and then it becomes a question between your auditor initially and what they believe the SEC will say in response.

So what do you do? Do you go to *FAS 120*? No. Why not? This is a participating policy, you know, and it seems to fit. It makes it a much easier on reserves. Every company has a statutory reserve system and all they have to do is change assumptions.

The problem is it doesn't meet the two criteria of paragraph five of *FAS 120*. The first one is easy; it has to be a long duration contract, and dividends have to be consistent with the actual experience of the company. No problem there.

The second criteria is it must follow the contribution principle. In other words, dividends have to be somewhat in proportion to the actual contribution of those policies for that business, and that's not going to happen in most European products. First of all, they're distributing on some kind of an unallocated basis, without direct association with the assets for a given book of business. And second, what may be even more important, very few companies in Europe actually include

in their bonuses, mortality gains and losses, and expense gains and losses (generally losses), and surrender gains and losses. So are we really abiding by the contribution principle?

If not *FAS 120*, what about 97? We hit the full gambit here. Sometimes this seems to be good because maybe these are really interest-sensitive products in disguise. At the end of the day, you set a certain amount into a fund and you dole out that fund based on the actual investment experience of the company. Maybe we ought to be considering if we can get to that fund fairly easily using the statutory reserve and adding in the bonus amounts every year. But really, what is an account balance? How far would the SEC go? Is there really basis in the literature to support this approach?

I have a couple of comments on unit-linked products. It was mentioned that a U.K.-style, unit-linked product has very heavy front-end loads. Let me just suffice it to say that there's a purpose for that design. This is the perfect square peg and round hole, however. Because the pricing is such that it will recoup all acquisition expenses and provide a large portion of all the profits right up front in the first year, or first two or three years, and many companies will tell you that they want up to 80% of all profits in the first three or four years. And they go one step further. They actually pay shareholder dividends out of those profits in the first two or three years. So if you're forced to take all of those front-end loads and defer them as revenue, you'll end up with negative GAAP equity. It wouldn't make any sense at all.

What's the solution? The solution that I have proposed is working; you only partially defer the front-end loads to the extent of deferrable acquisition costs, serving out that portion that is related to the profit element, you have deferrable acquisition cost and you have nondeferrable acquisition cost. But I have not been able to get it by all the accounting firms. I think you can come up with a very strong argument and base it in the literature on simply deferring an amount equal to deferrable acquisition costs.

Let's talk about product trends. I just wanted to point out that bank assurance is very big in Europe now in France, Spain, Belgium, U.K., Netherlands, Germany. Accumulation products and pensions are all what many companies are selling today in many countries. Life and nonlife combinations starting in France, like getting a mortgage policy and a homeowners policy, an all-in-one policy, and combining some savings element too. How are we going to GAAP these products? You know, there may be a combination of short duration and long duration in the same contract.

Will U.S. GAAP become worldwide GAAP? There is a very strong movement right now to have a set of worldwide accounting standards. People are fed up with U.S. GAAP, because U.S. GAAP is a bad model in many ways. If we really look at it, it's a bad model because it doesn't fit anymore. It certainly doesn't fit the European products. So the whole idea is, how can we have a consistent set of standards that everybody can be happy with, inclusive of the SEC and the FASB, which are the two biggest problem stepping stones on the way there?

Well, first of all, the IFC has been trying to do this since 1973 and most of the impetus has been coming in the last three or four years, when another organization, which I talked about, the international organization of security commissions, has invited their AIC to do something. Now let me just say, this is no small organization. There are 116 accounting organizations in 86 countries. Their objective is to come up with a set of worldwide accounting standards, which really will meet acceptance from all the countries. Also, they're interested in a general improvement and harmonization not only of the accounting standards, but of accounting procedures, and the reporting procedures of accounting regulations, and there are differences. There are currently 32 standards, and generally you'll find that those standards are less detailed than the standard coming from the Financial Accounting Standards Board in the U.S. They are more along the lines of benchmarks and some times provide various alternatives, which they call allowed alternative treatments.

Also they're currently working on a standard for financial assets and financial liabilities, which is very important. I think we ought to be following that one, because that's going to have a tremendous impact on the way the insurance standards are going to come up. IOSCO was formed in 1983 to promote open trade worldwide. It's kind of like the worldwide SEC. It includes every major exchange in the world, including the New York Stock Exchange, NASDAQ and AMEX. Its objective is to supervise capital markets, promote efficiency and yet protect investors. It sounds just like it came out of the SEC's manual.

About three or four years ago, it did commission the International Accounting Standards Committee (IASC) to come up with a set of worldwide standards to be effective on or before the year 2000, and it is my understanding that all of the member exchanges have agreed to comply with it once it is ready. Now 2000 may be a bit aggressive, but it's just around the corner. They have already endorsed 26 of the standards with some minor modifications, and they're about to come up with an insurance standard. It's on a very fast track. Already it's supported by France, China, 22 Arab nations, and 6 other countries. There are many countries, particularly in Southeast Asia, that want to get on the map and are willing to go with the IASC recommendations. It is interesting to note that early this month, the New

York Stock Exchange made a public statement that they endorsed the concept too. They're trying to get foreign capital, and at the same time they probably criticized the SEC and the FASB for dragging its feet on this issue. I also wanted to point out that major stepping stones are not only the SEC and FASB, but also Canada and Japan.

Moving on to current major initiatives. The standard on financial assets is driven by the derivative accounting issues that you're all familiar with right now. The insurance standard is also on a fast track. It is to draft a standard by next January. It is starting up with a work product of an accounting group in Europe called FEE. It's in French; I can't pronounce it, and is a federation of financial accountants. They will have a five-month exposure period, three months to fix it up, and a final vote in March 1999 for implementation in the year 2000. That is the current plan. When it's implemented, the SEC must accept IASC Standards for cross-border filings of say a European country in the U.S., and these countries will no longer have to convert to GAAP. I don't want to raise your hopes too high, but that is what is intended.

There are some key issues being explored. The only one I want to mention is the valuation of assets, which is likely to be on a market-value basis across the board. All assets.

There's a paper on financial assets/liabilities, which is on an even faster track. It was a joint effort between the Canadian Institute of Chartered Accountants and the IASC. It started in 1989, but when derivatives came into being it became a problem. It got the attention of the IASC and IOSCO in a bigger way, and now it's going to go through very quickly.

I just want to say in closing that our own profession is getting actively involved, and necessarily so I should say. Two groups, the International Federation of Actuarial Associations has a subcommittee on international accounting standards, Sam Gutterman is the chairperson, and a recently formed group of the American Academy of Actuaries is a working group by the same name, International Accounting Standards, covering life insurance only at this point. Bruce Moore of Ernst and Young is the chairperson. I happen to be a member of that group. And perhaps in one of the upcoming meetings we'll be able to provide some update on this topic.