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The Forthcoming International Accounting Standards

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Summary: With the globalization of commerce and industry, pressure has been building for a uniform set of worldwide accounting standards. Instructors addressed the following questions in a lecture format:

- *What form is the International Accounting Standards expected to take with respect to the life insurance industry? How close will it be to GAAP?*
- *How rapidly have the coordinators progressed toward their goals for the life insurance industry and others?*
- *How soon will the substantive issues be concluded upon?*
- *What will the implementation deadlines be?*
- *What will the transitional rules look like?*

Mr. Sam Gutterman: I have a caveat first. First, the International Accounting Standards (IAS) covering insurance have not yet been defined. As a result, it is a little difficult to tell you exactly what they will be. We don't know yet. Therefore, this should be more accurately labeled a preview session. Hopefully we'll get everyone here up to speed in terms of what we think will occur over the next couple of years.

I would like to introduce my fellow instructor, Dan Kunesh. Dan is from Tillinghast Towers Perrin. He has had extensive experience in life insurance and life insurance financial reporting. He is the incoming chairman of the Committee on Life Insurance Financial Reporting of the Academy for the 1999–00 term, during which he will have to address some of the same issues in the U.S. context, which we will talk about a little bit later. He also has a number of international clients, and, therefore, he will have to deal with the IAS as they impact some of his clients.

My direct relationship with this topic is that I am currently chair of the International Actuarial Association's Committee on the International Accounting Standards Committee (IASC) Insurance Accounting Standards. As such, this committee has been active for the last year-and-a-half addressing this topic.

The agenda for our discussion has several points. First, I will begin with an introduction to accounting and all that you need to know about accounting in this context. Dan will then proceed by discussing how we got to where we are in the current insurance accounting environment. I will then proceed with a discussion of the current international project and actuarial involvement in that project. Then we'll talk a little bit about the future.

We'll be focusing on general purpose financial reporting, not specifically on regulatory accounting, although I will make a few comments as to the potential future of international regulatory accounting. The focus is on the international level, and is increasingly relevant because of the growing globalization of the insurance industry as well as all industries.

This is more a description of what the international standards might be, rather than what the outcome will be, although certain forces, certain directions, and certain positions are already being staked out in this multi-year project. There has been some discussion in the last couple of months about the relationship between general purpose financial reporting and regulatory accounting, but, again, more on this later.

The following will be an introduction and overview of accounting. I know that most of you have gone through several courses on this. However, this may provide a useful perspective. I will hit the history highlights first. The earliest accounting was on a cash basis. The first change in accounting structure was a movement from cash to accrual. Since then, the focus has fluctuated several times between an emphasis on the importance of the balance sheet versus the importance of the income statement. We are now entering an era where accounting policy and philosophy are moving closer toward a balance-sheet emphasis, but as we will discuss, that is not a sure thing.

The objective of accounting is not to show the value of the enterprise, which was a surprising revelation to me. I've always thought that the purpose of a financial report was to prepare and to present the financial value of a company, but as I have been told by my accounting friends, that's not the purpose. It, indeed, is more to provide information so others can form their own conclusions as to the value of an enterprise. As a result, this is a significantly different focus than that of regulatory accounting, where the focus is more in terms of solvency of the organization. In fact, due to the difficulty of assigning an objective and comparable value to things like intangibles, human capital, and brands, it is difficult to assign a value to the enterprise as a whole for the use of the capital markets.

The initial view of accrual accounting was measurement based on historical cost. Historical cost views initial measurement as having a focus objectively measurable. You will find much of today's accounting policies and statements based upon historical cost. This may be viewed as being an historical anomaly caused by a lack of technology. The emphasis of an historical cost basis was to amortize that value, typically through a very simple method of depreciation. Simple bond amortization came next, and then came things like the lower of cost and market, which introduced an impairment concept. This is the fact that we should be conservative,

or prudent, as well as practical. Since we don't want to value or revalue everything in our balance sheet every period, every year, or every month, we produced values that were nice and smooth, with an emphasis on being objective and easy to measure. Unfortunately, this proved not to be particularly responsive to changes in real value, although it did provide smoother results. A key focus on much of early accounting was on prudence; prudence compared to realistic values.

In many big countries such as the U.S. or the U.K., there are a number of accounting standards defining specific rules to use and to apply in insurance companies. In small countries there are no accounting rules. These countries were the original users of IAS.

In order to proceed, we have a few simple definitions. First an asset is a resource, according to the IASC, controlled by an enterprise as a result of past events and from which future economic benefits are expected to flow to that enterprise. A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources seemingly embodying economic benefits. Those are two simple definitions, which turn out to be complex in practice. They contain a few key elements.

Both refer to results happening due to past events. This is significant, in that they do not reflect the value of new business that has not yet been written. It doesn't recognize losses that haven't occurred. Second, they place an emphasis on the use of resources controlled that will provide benefits and resources that will provide economic benefits. These sound like esoteric definitions but, as we'll find out in our discussion, they may become very significant in terms of a definition of IAS.

The next concept is a definition of fair value. This is something the actuarial community has not used to date. The IASC defines it as the amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arm's-length transaction. Some at the IASC and FASB in the U.S. are committed to moving to the use of fair values. In fact, they are so committed that if you suggest otherwise, some individuals may get very angry at you because they think you are not being consistent with the current accounting paradigm. Often it is really a quest to define the difference between entry and exit measurement: entry being historical cost and exit being settlement cost. These sound like fairly simple concepts, but, in fact, where there is not an active market, you might be led to very different conclusions.

Next, the definition of market price, is a transaction amount. That is an amount for which two parties have transacted something; in our context, it is typically a financial exchange. The market value becomes (because we don't have transactions in everything every day) what a transaction would have been had there been a transaction that occurred or if a market value can't be determined. As a result, in these cases, you are forced to use surrogate values. Thus, a fair value is the amount at which a transaction would have been transacted if there were a transaction, whether there's a transaction or not.

Several issues arise with respect to fair values, both with regards to initial measurement and remeasurement; that is, at the time of acquisition. Obviously, a measurement problem occurs in an inefficient or nonexistent market. Even though you have a specific initial price, if you're supposed to remeasure the value of an asset or liability based on fair market values, a discontinuous series of values may result.

These are some of the issues that you have to deal with. The first question you may raise is, why fair values in the first place? First, assuming that there is a market, part of the answer is that it is a practical and measurable basis of value, as transactions are measurable. Thus, they should be able to be counted, which is a concept that accountants particularly like.

In fact, market assessment is deemed superior by some in many cases to individual estimates or assessments. The feeling is that in an efficient market, the aggregation of buyers and sellers will come up with the most appropriate fair-value price that can be found on either an asset or a liability. In some cases, this has come about because of the influence of the growth of financial economics which has developed as a result of the growth of markets. As more and more financial instruments are traded, including derivatives, it has been deemed that this has become a much more fundamental approach and a more appropriate concept than historical cost. In addition, the financial analysts have been pushing to move to this concept and to increase the importance of the market in the first place. Accountants and analysts have recently emphasized fair rather than prudent values. The investor doesn't want to find out what the prudent value of a company is. He wants to more readily ascertain a realistic value of an enterprise.

In fact, some people believe that there will always be a mixed attribute model of accounting, one in which there will never be a strictly historically based or a strictly fair-value-based accounting system, due to both practical and historical reasons. The resulting hodgepodge of accounting will hopefully be a logical hodgepodge that people can interpret.

I've already alluded to some of the problems with fair values. The following is a more explicit list of them: 1) What if there's no market? 2) What if a financial instrument (or anything else) has an unavailable or unreliable market? For example, what if it's a large building or has a catastrophic exposure? How can you ascertain what the fair value of a very large building is, or in fact a very small building, if there's no available comparables through which to compare them? In some cases items are unique. 3) Markets can reflect emotion. Some people would put Internet stocks in this category right now since a "fair" valuation may not provide a realistic value or fundamental values may not result in the value close to what the Internet stock is being valued by the market. Therefore, there may be some bias either upwards or downwards. 4) The use of fair values may result in more volatility in financial results and, therefore, potentially more volatility in stock prices. 5) Some feel that if you treat assets in one way, for example, by using a fair-value method, and you treat liabilities on a historical cost basis or a book-value method, you may come up with a worse situation with possibly resultant misleading results. This latter position has been expressed by the IAA, which has, in essence,

said that in some cases it may not matter what accounting system is used. Please be consistent or worse problems may result. In addition, problems may arise after the transaction occurs. It may be impractical to remeasure an asset or liability. In addition, management may not wish the value to be effective immediately after a transaction occurs.

I have alluded to the problem of how real property appraisals may not be reliable. I don't know the last time anybody has had a house appraisal by different real estate brokers or appraisers, but you can get very significantly different appraisals on the same property. Trying to identify an "objective" appraisal that should be put into a financial statement may be very difficult. That is one reason why the concentration has recently been to value financial measurements on a fair-value basis. In addition, accounting doesn't deal well with intangibles. As a result, one has to ask, how do you represent and report on intangibles? What is the fair value of human capital? Then there's also some dispute as to whether the market or fair value should use risk adjustments.

Mr. Daniel Kunesh: I have three comments. First, there has been a lot of talk about fair value. I think we all better get used to it. Internationally, there is a major push towards fair-value accounting. *IAS 39* talks about fair value of financial instruments. Unless changed in the future, the standard will consider insurance contracts to be financial instruments.

A second comment relates to the first. It has been known for quite some time that the SEC chairman hopes to move all accounting in the U.S. to a fair-value basis. Fair-value accounting is something that we all must get used to over the next year or two.

Another comment concerns the fair value of properties. Companies overseas own a lot more properties than companies in the U.S. In addition, what's complicating the situation is the fact that many non-U.S. companies sell participating business (or "with-profit" business) that pays bonuses and (dividends) on the unrealized appreciation of properties. Unless you are on a fair-value-based accounting system, the balance sheet becomes a bit unwieldy and deceptive without specific disclosure as to the company's dividend practices. U.S. GAAP is one such accounting basis in its current format.

I will outline some of the initiatives of the IAS setters and what drives those initiatives. Who are the key players? How does it compare with the U.S. standard-setting process? I will compare five different international accounting models in several areas. This will give you a better appreciation of the differences between various systems around the world and of the difficulty that is faced by the IASC. Finally, I am going to give you the results of a survey that was conducted by Ernst & Young in Europe on investment analysts.

Starting out, what are the key initiatives? Several exist but two stand out. First, there's a strong desire to develop a common set of IAS for use in the capital markets. We're talking about the various stock markets around the world. The

second objective is to converge the national accounting standards that exist in the various countries around the world.

In reality, there aren't as many accounting systems as there are countries in the major capital markets. Many countries today already use the IAS, as they currently exist. Many countries have dual standards in place: local government standards for statutory reporting and the international standards for reporting in the capital markets. Nevertheless, there is still substantial divergence between the standards of the various countries that comprise the major global capital markets. I believe that most European systems are similar to each other and, in many respects, similar to the statutory system we have in the U.S.

What are the key forces that drive the move to IAS? First, we have seen an increase in the importance of the global capital markets. In recent years, we've seen a large number of entities seeking to attract capital in various foreign markets. This has been particularly true in the U.S, where many European and, to a lesser extent, Asia/Pacific companies have been coming into the U.S. to attract capital and trade their shares. There is a growing number of Australian companies as well, and I believe you're going to see more from Southeast Asia, as that region recovers.

Second, we are in a global business environment. In my view, there are two terms that are most frequently raised in business circles today. They are global and Internet. I think both are somewhat related. The world has indeed become smaller, and having a global presence is no longer only restricted to large multinationals. It is the goal of most companies. They believe that they're going to have to have an international presence because of the Internet. Many also believe the Internet creates opportunity.

The organizations promoting IAS are twofold. The first is the International Organization of Securities Commissions (IOSCO). This organization is an umbrella group, similar to the NAIC, that comprises members of all the major securities exchanges from around the world in over 80 countries. That includes all three major exchanges in the U.S.: the New York Stock Exchange, the American Stock Exchange, and the National Association of Securities Automatic Quotation System (NASDAQ). It is informal in nature and has little direct enforcement power over the rules it sets for all member exchanges.

IOSCO has defined four objectives: 1) promote high standards of regulation and effective enforcement; 2) exchange information and experiences among the various exchanges so that they can develop and improve the member markets; 3) unite efforts to achieve consistent standards and improve the surveillance of major international transactions; 4) promote integrity of the markets in order to gain the confidence of global-minded investors and registrants. Since this is an informal group, it is my view that surveillance will have to be largely the result of self-regulation for some time. In addition, a self-discipline among the players will be required. Whether or not that is achievable is yet to be seen. The focus, of course, will be on cross-border transactions, not domestic transactions.

What are the key initiatives of IOSCO? In the early 1990s, IOSCO commissioned the IASC to develop a complete set of standards for cross-border filings in the 80 or so nations that I discussed. In 1993 they agreed to a list of core standards. I believe there are 13 on that list. In 1995, IOSCO's Technical Committee agreed that these standards would comprise comprehensive core standards for all member exchanges.

That is quite significant because the New York Stock Exchange, the American Stock Exchange, and NASDAQ are all members. Thus IOSCO's initiative would include them as well. Whether or not the American exchanges will be permitted to go along is somewhat at the discretion of the SEC, as you can well imagine.

The second group I'll talk about is the IASC, formed in 1973 to develop and promote worldwide accounting standards. Most of their efforts have taken place within the last five to ten years, and most of the standards have been developed in the last five to ten years.

Recently the IASC has gained momentum. It now represents 142 accounting organizations in 103 countries, representing over 2 million accountants worldwide. It has a 17-member board whose responsibility is to develop and approve all standards. It has a 10-member advisory council that meets annually and a 16-member consultative group to advise the board. You can see from this structure that it is fairly top-heavy and perhaps political in nature.

All standards are currently developed through steering committees, which work with a number of other outside groups including the FASB, the European Commission, the Organization for Economic Cooperation and Development (OECD), the United Nations, and the World Bank. The IASC's objective is to try to capture worldwide trends and to solicit the impressions of various influential organizations, including key accounting groups as well.

This whole structure is now in the process of change. The IASC feels that there is a need to improve their organizational structure, to get away from the current political structure, and to gain greater confidence of the various publics that they are going to face. IOSCO will insist on compliance with the core set of IASC standards among all member exchanges.

There are currently 35 active international standards. Some are still in the process of development and are not yet effective. The standards are supported by a number of interpretations of the Standing Interpretations Committee of the IASC. The core set of 13 standards is generic in the sense that they are not industry specific. If you go through the 135 or so standards in the U.S., you will see quite a few that are industry specific, and several that are specific to the insurance industry. An international insurance standard is now in the process of development and will be talked about in depth by Sam.

There are about a dozen international standards that are quite important to the insurance industry. Examples are the standards on revenue recognition and employee benefits. The standard on business combinations has been changed a number of times and is in the process of being changed again. I believe the

objective is to follow the activities of the FASB and Canada, especially in relation to the concept of a "purchase" versus a "pooling of interest," goodwill amortization, and so forth.

Two of the most important standards are numbers 32 and 39 on financial instruments, particularly number 39, which has just been completed and will become effective in 2001. This is the standard that relates to the measurement of financial instruments at fair value. I believe that insurance has been temporarily exempted from that definition.

As stated, one key ongoing initiative of the IASC is to develop an insurance standard. This project was added in 1997. A project to update the standard on business combinations was added last November and a new project on discounting, a very interesting one, was added in April of last year. We have already briefly mentioned the comprehensive project on financial instruments, which is now largely completed.

By way of comparison, let us examine the U.S. structure of standard setting. I think you will find that the U.S. structure is more complex and formal. The organization that has ultimate responsibility for standard setting is obviously the Securities and Exchange Commission (SEC). They have the statutory authority to establish accounting standards for all publicly traded companies. There are five commissioners appointed by the President, who report to the Congress of the U.S. They administer the federal securities laws; regulate all trading firms, investment advisors and investment companies; and delegate most standard-setting responsibilities to the Financial Accounting Standards Board (FASB).

By comparison, the FASB has seven full-time members, each with five-year terms. They meet weekly and work through a full-time staff of qualified technical people, project task forces, and a group called the Emerging Issues Task Force, which is very active in interpreting the standards when questions arise.

In support of this process is the American Institute of Certified Public Accountants (AICPA). This group also helps to interpret the standards and helps implement and enforce them among the 358,000 members in the U.S. who are certified public accountants. There are also a lot of chartered financial analysts who are qualified accountants that work for private entities. The AICPA provides membership services like certification, licensing, and professional standards, and, of course, technical support and guidance to the FASB standard-setting process. The AICPA also issues statements of position (SOPs) that provide interpretive guidance to members.

Let us for the moment compare the way accounting standards are set in the U.S. and internationally. As stated earlier, the primary standard-setter in the U.S. is the FASB. It is responsible to the Securities Exchange Commission and thus to the U.S. Congress. Internationally, the standard setter is the IASC.

In the U.S., there are also several supplemental standard-setters, the SEC, the Emerging Issues Task Force (EITF) and the Accounting Standards Executive

Committee (AcSEC). The SEC gets involved in both giving direction and interpreting some of the FASB standards. For example, they interpreted *Statement of Accounting Standards (SFAS) 115* in a number of timely interpretive releases. The EITF also has the responsibility to provide interpretations and guidance of the various standards. AcSEC (a part of the FASB) prepares bulletins that are interpretive of the standards. The only similar supplemental international accounting standards setter is the Standing Interpretations Committee of the IASC.

Regarding the focus and oversight procedures of these organizations, FASB's focus is domestic and the IASC is international. In the U.S., oversight is formal and is provided by "big daddy," the SEC. If that's not strong enough, you have the senators and representatives in Congress to satisfy as well. One would think that the process in the U.S. could be somewhat political. There is also the Financial Accounting Federation, an independent group that oversees the FASB. The international process is still somewhat informal, with oversight coming from an advisory council.

In terms of commitment, in the U.S., the SEC commissioners and their staff are employed full time. Internationally the IASC expends a part-time effort. The FASB meets weekly and the staff works full time on a long list of projects continually. By contrast, the IASC meets three or four times a year for one week. This may have increased recently, but it is still a far cry from the focus in the U.S. One can only wonder how the IASC can really be effective with this very limited time commitment.

In my opinion, public oversight is critical. In the U.S., all meetings of the FASB (or at least the most important meetings) are open to the public. Currently, international standards are done behind closed doors but this might be changing.

Sam informs me that the IASC board just had its first open meeting last month, so they are gradually opening up their procedures in response to complaints received about the closed nature of their deliberations.

Finally, let's consider enforcement authority. The SEC, with the power of the U.S. government behind it, has a major advantage, one that puts structure and clout to the enforcement process in the U.S. By contrast, there still is no single major international body that would give clout to the enforcement of the new accounting standards, other than perhaps IOSCO, which is an informal group. Currently, IOSCO doesn't seem to have the legal authority to insist upon an enforcement of the standards on a member exchange.

In the U.S., we have a very structured set of accounting standards with three levels of hierarchy—A, B, and C. The actual accounting standards and the FASB are at the top, in level A. This includes the old accounting opinions of the Accounting Principles Board, predecessor to the FASB. In the middle are the AICPA's SOPs and AcSEC's practice bulletins. At level C are the Emerging Issues Task Force consensus or interpretations of existing standards. Internationally, there is currently a single set of accounting standards, with a small number of interpretations, and very little industry specific guidance.

Now, we are going to take a look at various accounting approaches from around the world—U.S. GAAP, Canadian GAAP (i.e., the policy premium method), the Margin on Services (MoS) methodology of Australia, embedded values, and South African GAAP. MoS is relatively new, being first introduced in 1995. It has been getting a lot of press lately and seems to be gaining popularity. Embedded values has gained favor in the U.K. and elsewhere with investment bankers and with a growing number of European companies as an alternative reporting method to the statutory reporting systems found throughout Europe. South African GAAP is rather unique and has just recently been implemented in the country. The system is called "financial soundness" valuation, and points in the direction that I believe most English-speaking countries have been heading in recent years.

We will now take a quick look at the following issues, to give you a flavor of the differences between the various systems: asset valuation, treatment of the movement in asset values on the income statement, revenue recognition, the nature of assumptions and how changes are handled, reserve valuation methodology, treatment of deferred acquisition costs (DAC), and profit recognition. We'll move fairly quickly.

Asset valuation. I think you will find a lot of variability in the manner in which assets are valued. In the U.S., we have generally been on a book value-based system in the U.S., under U.S. GAAP. However, with the introduction of *FAS 115*, all marketable securities were to be classified into one of three categories: trading, available for sale, and hold to maturity. The trading and available-for-sale categories require market valuation or fair valuation. Under the "hold to maturity" category, securities are to be recorded at book value and remain at book value. In many instances, liability valuation in the U.S. is not consistent with the valuation of assets. This is one of the major criticisms of our system. Canadian GAAP, on the other hand, is even more book value based than we are currently. Realized capital gains on bonds are actually taken into income on an amortized basis over a number of years, according to rules set forth in the regulations. They're amortized to market over time, not immediately as in the U.S. Both realized and unrealized gains on equities are handled in similar fashion. A book-value basis is used on everything else. In Canadian valuation, under the policy premium method, liability valuation must be consistent with the valuation of assets.

Australia's MoS is totally a market value-based approach and liability valuation must be consistent with the market valuation of the underlying assets.

The embedded values approach (EV) can take many forms. In effect, it is somewhat of a chameleon. It uses the same statutory rules of the country in which the company is reporting. It is generally statutory based. As a result, since most statutory-based systems use book value-based asset valuation systems, EV is a book value-based approach. However, liability valuation may not be consistent. Normally, with EV, the assets supporting the equity are valued on a market value basis.

South African GAAP is mainly a fair–market, value-based approach. However, actuaries and companies have the discretion to use a discounted cash flow

approach as well. Liabilities must be valued in a manner consistent with the valuation of assets.

Regarding the movement of assets, the U.S. has a hodgepodge approach. For a trading class security, the movement goes directly into income. Available-for-sale changes do not go directly to income, but fair market values must be reported in the balance sheet. Note that the asset value movement must be recorded as a part of comprehensive income. With "hold-to-maturity" securities, there is no direct recognition of the unrealized holding gains and losses anywhere in the financial statements.

In Canada, consistent with what I said before, realized gains are taken into income on an amortized basis. The same is true with equities, except that equities bring in net unrealized gains as well. Everything else is done on a book-value basis.

Under MoS, all gains and losses are taken into income as they occur, which is the same in South Africa. Under the embedded value approach, asset value movement is generally taken into income as realized gains are taken into income. The treatment of net unrealized gains depends on the applicable statutory accounting rules. For example, if the embedded value approach were being used for a Canadian company, the Canadian statutory rules would apply.

Revenue recognition. As you know, our three key standards—60, 97 and 120—each have their own way of defining revenue: premium for 60, profits for 97, and margins for 120. The Canadian system is primarily a premium revenue-based approach. Australian margin on services uses a rather unique approach. They define the concept of *profit carriers*. When a product is first introduced to the marketplace, one or several "carriers" representing indicators of the cost of providing services or the income expected to be generated from the services provided under the product are defined. A "carrier" could be premium, assets under management, investment income, fees, mortality charges, expense charges, or any number of other things. While once defined, the profit carriers generally do not change, companies do have an opportunity to change a product's carriers if appropriate disclosure is made. Certain rules apply.

The embedded value approach follows statutory accounting rules for revenue definition, generally premium. In South Africa revenue is premium.

Assumptions. One of the more interesting items of our analysis is the nature of the actuarial assumptions. Under U.S. GAAP, best-estimate assumptions are pretty much used across the board, except that under *SFAS 60* the best estimates are made at the time the business was issued and provisions for adverse deviation (PADs) are added. The assumptions stay locked in unless a loss recognition situation arises. *SFAS 97* and *SFAS 120* do not use PADs. The best-estimate assumptions may be recast each year going forward. One thing to keep in mind under *SFAS 120* is policy reserves do not actually use best-estimate assumptions. Instead they use the dividend-basis assumptions. Best-estimate assumptions are used to calculate estimated gross margins, used in the amortization of DAC and any unearned revenue liability, and for accruing the terminal dividend liability. In the

U.S., actual estimated gross profits or margins (under *SFAS 97* and *SFAS 120*) are replaced with actual company experience as it evolves, with a restatement of the amortization percentage each year. Thus the effect of changes are to be spread both backwards and forwards under U.S. GAAP.

Canadian GAAP uses current best-estimate assumptions plus PADs. Guidance on how to set PADs is included in the valuation technique papers of the Canadian Institute of Actuaries. Changes are recognized immediately, so you can see earnings float up and down. However, the Canadian valuation actuary will apply considerable judgment and prudence before he/she will actually change the valuation assumptions.

Under the margin-on-services approach in Australia, the assumptions are on a current best-estimate basis without PADs. Changes are only spread prospectively and no change can be reflected in the current year's earnings. All changes in assumptions are pushed forward except for two types: 1) under a loss recognition situation, all future losses must be taken into income now, and 2) if the movement is in the economic assumptions (for example, a movement in the market value of the underlying assets), then the effect is taken into income immediately.

Mr. Gutterman: Note that we're focusing on general purpose accounting here and not regulatory because there are a lot of differences in the general purpose accounting rules internationally. There's even more under statutory.

Mr. Kunesh: Under an EV approach, cash flows are based on best-estimate assumptions without PADs and reserves are statutory-based. A risk discount rate is used to derive the present value of future profits. This rate is considerably above the earned rate. Changes in assumptions must be recognized immediately, with the exception of the movement in target surplus. In South Africa, best-estimate assumptions are combined with two levels of PADs, a prescribed level and a discretionary level, which are up to the actuary. The net realized and unrealized gains are both taken into earnings, and it is up to the company to determine how conservative or unconservative it wants to get. The assumptions can be changed annually. It's a rather open system.

From the Floor: Under MoS, are gains and losses resulting from assumption changes taken into profits as they occur?

Mr. Kunesh: No. MoS actually defines a break-even position at the time of the change; that is, the full effect of the change under the selected profit carrier is pushed forward and released in the future to shareholders in accordance with the profit carrier itself. There are really two parts to the liability: a best-estimate liability, which simply reflects the guaranteed policy cash flows, and a policy liability, which also includes the present value of future policyholder bonuses and shareholder profits released in accordance with the profit carrier. Both must be clearly disclosed in the financial statements along with any changes in the assumptions from year to year. Thus, earnings will flow in relation to the profit carrier.

From the Floor: How are taxes and dividends handled in the reserves under each system?

Mr. Kunesh: Reserves in Canada are net-level based and use a gross premium valuation approach but with PADs in the assumptions. They include dividends and taxes. By contrast, reserves in the U.S. are pre-tax and exclude dividends. MoS includes taxes and dividends. It includes a best-estimate liability, as I indicated, plus the present value of both expected future shareholder profits, which are released in accordance with the profit carrier, and future expected policyholder bonuses, based on the best-estimate assumptions and a continuation of the current bonus philosophy. EVAs use statutory reserves. South African GAAP is similar to Canada in the sense that it is a gross premium reserve but with two tiers of PADs.

DAC. Of the five systems that we are looking at, U.S. GAAP is the only one where a deferred acquisition cost asset is explicitly recognized. In Canada, DAC is implicit in the methodology itself. Everything is prospective. The same is true with Australia's margin-on-services approach. Under embedded values, the same thing is true; that is, there is no DAC. Instead, the asset is replaced by the present value of future pre-tax profits expected from the in-force business, discounted at a risk discount rate. In South Africa, again there is no explicit DAC.

Profit recognition. Under most systems, profits are comprised of the release of the margins in revenue as defined under the system plus the release of any PADs plus the recognized variations in the assumptions themselves plus interest on accumulated surplus (both shareholder and policyholder related). Under certain systems, like that of the U.S., profits are back-ended due to the conservatism in the assumptions or PADs. In Canada it is possible to take most profits at issue. However, that normally doesn't happen because of the prudence placed in the PADs by the valuation actuary.

Under MoS, you can't take profits at issue and profits flow with the release of risk in accordance with the defined profit carrier. The embedded value approach is a total front-end profit approach, where profits represent the discounted present value of future profits in new business added each year plus the difference between the discount rate and the earned rate times the present value of future profits asset. Thus, EV tends to be front-ended in nature. It's more of a value based rather than an income statement based methodology.

Now I would like to go quickly through the Ernst & Young survey results, compiled in a study made earlier this year. A number of European investment analysts from several major investment firms were surveyed. They were asked what they thought was meaningful to them in several areas in respect of evaluating an accounting system. One of these areas related to the usefulness of financial statements prepared under each accounting system. In this context, usefulness speaks for itself and represents what the analyst can do with the published results for his/her own purposes. An example would be an investor evaluating an investment opportunity, and so forth. The EV approach ranked the highest at four-and-a-half, with five being good and one being poor. I guess zero is dismal. The analysts were asked to rate U.S. GAAP, embedded values, the margin-on-services

approach, Canadian GAAP, and the U.K.'s modified statutory solvency basis (MSSB) system, a modified version of U.K. statutory. A country's local statutory approach was also evaluated.

Under all measurement criteria the statutory approach got the lowest ratings from the analysts, as one would expect. Surprisingly, U.S. GAAP got a higher ranking than MoS or Canadian GAAP, perhaps because of its popularity.

The same thing was true with the transparency criterion. Transparency means understandability of the numbers, where through clear disclosure in the financial statements, the analysts understand and translate the numbers for his/her purpose. Again, embedded values got the highest rating with U.S. GAAP, Canadian GAAP, and MoS being somewhere in the middle. In respect of the comparability criterion, the same thing happened. U.S. GAAP got very high ratings but it still ranked behind embedded values, which refers to the ability to compare one entity with another in a clear, cohesive, and consistent manner. Another criterion, the adding of shareholder value, relates to whether or not the accounting system clearly measures shareholder value in a meaningful and understandable fashion. Embedded values received an almost perfect score from the analysts on this criterion. Overall, U.S. GAAP followed EV in popularity. MoS was fairly highly ranked followed by Canadian GAAP and finally the statutory systems.

Mr. Gutterman: Now I will turn our attention to the current IASC insurance effort. This effort started about a year-and-a-half ago. So far, there have been four IASC committee meetings on this topic. They are currently scheduled to issue their first issue paper in October 1999. They are holding their last preliminary meeting in June in Germany to discuss what it will be. It will be followed by a discussion draft sometime late in the year 2000. They plan lengthy exposure periods. This will be followed most likely in 2001 by discussion and exposure drafts. Implementation will possibly occur by 2004 or 2005.

This is clearly a very big project. There are lots of differences of opinion, with a growing consensus in many issues. The International Actuarial Association has been part of the discussions from the get-go on this. Actuaries have had input on the topic from the beginning. One of the major drafters of this is Wayne Upton who is, as some people know, a key staff member on the FASB in charge of its insurance and discounting efforts. A couple of weeks ago, FASB just announced that it will be starting to look at insurance accounting as part of its movement to fair valuation. Therefore, some of the same discussions or outputs from the IASC project may be forthcoming in the U.S. Anybody who is working on U.S. GAAP for insurance companies may very well see significant changes in U.S. practice in the intermediate future. Thus, not only is this an internationally important issue, but it is also going to be an important U.S. issue.

Dan mentioned some of the other related IASC activities. I would like to add that a key concept that Dan mentioned is that both insurance contracts and retirement benefit plans will be classified by the IASC as financial instruments. An implicit assertion in determining the financial value of financial instruments is that the market reflects present values, an important concept in a number of IASC-related

projects. The IASC financial instruments project has been split into two pieces. The first one was done in order to get the core standards of the IASC implemented by the IOSCO deadline (which was the end of 1998). The second one of which is a comprehensive project that is trying to move the accounting of financial instruments toward fair values. The first project places some, but not all, financial assets on fair value. The second project will be an even more significant project.

Although I will go into the topic of discounting, I will note that accountants currently apply discounting in an inconsistent manner. In one situation they will apply discounting, while in another they will not. For example, nowhere in the world can you discount income taxes. Determination of new IAS regarding retirement benefits (*IAS 19*) involved significant disagreement between actuaries and accountants. It was resolved through a compromise. The actuaries won some issues, but didn't win the discounting issue. Actuaries wanted to discount pension liabilities in a manner consistent with their characteristics. In fact, it was decided that they should be discounted on the basis of low-risk corporate bond rates, which can result in misleading results. Depending upon the results of IASC's Discounting Committee, this issue may be revisited. So the actuaries may have a second chance on that topic.

I would start a project such as development of insurance accounting standards by finding out stakeholders' options. One of the important stakeholders would be the insurance industry. However, the insurance industry has been relatively silent with very few exceptions. In fact, there has been very little discussion of potential new international standards in the U.S. At least I haven't heard much outside of the occasional meetings of the SOA. To me, this has been extremely surprising because this is a quite important issue

Although the IAA has attempted to be very open about our discussions we have not yet seen public debate. In fact, with a few exceptions, the only community internationally where this has been openly discussed has been the actuarial community. The IAA Committee's list server has more than 80 people. Some accountants have complained that they do not receive as good information as involved actuaries have.

A significant outstanding issue is whether a fair value or another method should be included in the final standards. Some people assume that it will be fair value. It may be fair value, but there will be quite a discussion before it happens. I think it will be fair-value based, but I don't know what this means yet. It will be more balance sheet driven rather than income statement driven. Another controversial issue is whether best estimates will be used or where provisions for adverse durations will be reflected. Whether there is a role for lock-in or historical-based systems will be raised during the course of this project.

Two approaches have recently come to the fore and will be presented in the upcoming IASC insurance issues paper. Although originally discussion focused on the distinction between historical versus fair value, it is now focusing on a deferral and matching system and an asset/liability system, which is really income-based versus balance-sheet-based. The deferral and matching approach reflects either an

explicitly or implicitly deferred acquisition cost component and an emphasis on matching costs and reserves. However, the recent trend is moving overall to the latter. A result of the asset/liability system is that it would be permissible to have or to report an initial gain on sale of insurance contracts. It is obviously a key practical issue that should drive a lot of the industry discussions over the next year or year-and-a-half. It is likely that in the fair-value accounting system, there could be a gain or loss upon sale.

Another key issue is whether or not the discount rates or liability will reflect the actual assets held by the insurance company. Most accounting systems today reflect whatever assets are held. The IASC is against such an approach. I assume that the IASC board should be even more emphatic in saying that the liability calculations will be independent of the actual assets held. The last meeting of the IASC Insurance Steering Committee has made an exception to this rule if liabilities are directly tied to the assets, in cases of a variable life, variable annuity, or unit-linked type contract.

The IAA has suggested that, instead, the concept of a replicating portfolio should be applied; that is, ignore the actual assets that are held, but construct, on paper, a set of assets that replicates the expected future cash flows associated with those liabilities.

Another issue is what should be the basis for the discount rates used. So far, the Insurance Steering Committee has deferred addressing the question because there is a separate committee charged with recommending the methodology to be used in selecting the appropriate discount. There have been two meetings of the Discounting Committee (of which I am a voting member) so far. There should be an issues paper in the first half of 2000.

Another issue is deferred acquisition costs, which is clearly historically cost-based. Will it be considered to be an asset? A potential inconsistency in certain people's positions is they want to have fair values of their assets and liabilities, but they still want a deferred acquisition cost. This issue has yet to be resolved. Another significant issue is whether risk should be reflected, and if so, how should it be reflected? This is a significant issue. I think that recently FASB, in its U.S. GAAP statements, has not provided for a provision for adverse deviations. Rather, they have required the use of best estimates (or most likely, values) in a wide variety of applications. A significant reason for this is because FASB has been listening to financial economists who have asserted that nondiversifiable risk should not be reflected. Anybody in the market can diversify their risk (for such factors as geography or in terms of size) and diversifiable risk (sometimes referred to by casualty actuaries as parameter risk or uncertainty as to expected value) is impossible to estimate, and, therefore should not be reflected. Actuaries have consistently said that this logic does not make any sense. We have asserted that the market always prices for risk. This will be a significant debating point, both in the Insurance and discounting projects. I believe the IASC will try to put forth a balanced position issue paper asking for opinions, but I think a growing percentage of the Insurance Steering Committee members are moving toward the recognition of risk adjustment.

The question of how to recognize risk is an open issue; for example, it could be applied using a Canadian-type approach using a professionally predefined range of values or relying on the individual actuary's judgment. We're moving in the direction of a different approach. So far, the IAA has referred to this adjustment as a market-value margin, trying to tie it to the market's assessment of risk. The IASC is currently calling it an adjustment for risk. An important question that has arisen is whether an objective measurement of such an estimate is possible.

Here arises the issue of the appropriate role and responsibility of the actuary in this process and whether or not accountants will trust the actuary to be able to make such estimates. I think that the credibility of the actuary will be at stake. This will be an important factor in the determination of the method that will ultimately be adopted. I know that historically some accountants have not believed that actuaries are completely objective in their determination and should not be given the responsibility to determine this risk margin.

The definition of revenue is another issue. Dan discussed most of the issues earlier, but it is important to resolve in any accounting system. Another issue is reporting on embedded values, whether through the use of option pricing theory, treatment as embedded options, or possibly through bifurcation of contracts, depending on the values and significance of the options. FASB is investigating how to handle them now with respect to *FAS Statement 133*; this should also become an issue.

There is another issue that seems quite uncomfortable for actuaries, but it is very significant in the accounting community. If a fair-value-based system is adopted, should an insurer's credit position be reflected in its own liabilities? For example, FASB and many other accountants feel that if you want to recognize fair value as reflected in the market, by definition, you have to recognize the credit position of a carrier. That is because the market would reflect it if the liability were tradable. Some people have observed that this is illogical. The worse off you are, the better the financial statement appears because the liabilities will be decreased, and, therefore, the capital will be increased. This seems like an inconsistent position and is an extremely controversial one which is far too complicated to get into in depth in this session. However, it will be an issue of increasing importance as the IASC discusses insurance and the liability-related issues.

As of now, deferred tax assets and liabilities cannot be discounted. Actuaries have made the point, that to not discount taxes when discounting liabilities is inconsistent and potentially misleading. So far in the insurance discussions, there has been some acceptance that the accounting treatment of deferred taxes may have to be totally revisited in view of its long-term insurance assets and liabilities. This may prove to be an interesting discussion in the accounting community.

Another relevant issue includes disclosure; this has not been fully explored by the IAA so far. That may include the cost or value of regulatory constraints, as well as the general objective of trying to make insurance reporting more transparent.

The International Association of Insurance Supervisors (IAIS) is relatively new being ten years old. It has become involved in this discussion, as observers to the IASC insurance discussions. They have so far expressed significant concerns with the direction that has been taken in these discussions. I believe that involving regulators in these discussions has a number of opportunities that may be of benefit to insurers and actuaries. There is an upcoming meeting in Berlin of actuaries, including myself, who will represent the IAA.

I will briefly discuss the role of the actuarial organizations. The key leader right now is the IAA. Paul McCrossan, a former board member of the SOA, formerly president of the CIA, and former parliamentarian in the Canadian Parliament, is the IAA representative to the IASC committee. The IAA Committee, which I currently chair, has 21 members from 18 different countries plus 60 other interested parties on the Committee's list server. The AAA has formed an International Accounting Task Force that is discussing some of these issues. I am sure that Dan's AAA Financial Reporting Committee will become involved in these issues as the FASB starts discussions on these same issues. The CIA has formed a joint CIA task force to discuss these issues several times a year. As a result of these meetings, Paul McCrossan is also providing input from the Canadian perspective. Accountants and actuaries are discussing these issues in several other countries as well.

Prior to the last meeting of the IAA in March of 1999, our committee prepared five draft papers. The titles are:

- "The Meaningful Financial Statements," which I will summarize briefly, is the overarching one covering fundamental principles.
- "Fair Value of Liabilities" discusses an approach to determine the fair value of an institution.
- "P&C Issues" is issues as they relate to property /casualty.
- "Deferred Acquisition Cost" discusses the relevance of "the amortization of acquisition costs.
- "Catastrophic Resources" discusses conditions under which it may be appropriate to hold a position for future catastrophes.

These are all currently being updated and may continue to be over the course of the IASC project. These pages are currently in draft form, and they have not yet been adopted by the IAA. They have been communicated to the IASC as being discussion drafts. Even they have made a significant impact on the IASC deliberations and have been used by some as basic principles for further discussion.

Now a brief discussion of some of the principles we have discussed so far. Insurance accounting should be on a prospective basis, independent of actual assets, except in the case that benefits are explicitly dependent upon them, such as in variable life insurance. They should be based on best estimates for all material contingencies and based on company-specific experience, not insurance industry averages. The use of company-specific expectations is a very significant issue as market assessments or fair values may be based on aggregate industry values, or maybe even best possible values (assuming outsourcing could occur at that price). The assumption is that a company could be sold and then stripped or outsourced in

terms of its administrative expenses. The bottom-line question is: what set of expenses is appropriate?

The papers conclude that these best estimates would be appropriately made by an insurance specialist, normally an actuary. However, the papers use the phrase "normally as an actuary." We took this approach specifically because there are many countries in which there are very few, if any, actuaries. A lack of this "option" would be an impediment to the implementation of any such system internationally.

We have made some comments about fair value of liabilities. A fair value of liabilities should be a goal of an accounting environment if assets are at fair value. In other words, the IAA has been pushing for consistent valuation of assets and liabilities. I don't think these issues have been explored in an explicitly detailed manner so that we can be sure of what it does imply. I am sure that this understanding will come in the next round of discussions. Thus, fair value of liabilities will use present value.

For those in the audience involved with a property/casualty insurance company, those discussions may result in the IAA coming out in favor of discounted loss reserves. They will exceed the best estimate by an adjustment for risk, which will be a reward for risk taking, and we in the IAA have indicated it to be a narrow range developed judgmentally. Further discussion will be held on this issue.

A key assumption underlying some of these suggested principles is that the IAA will be prepared to develop appropriate standards for actuaries to practice under. This is an aggressive statement because the IAA does not have a process in place for developing actuarial standards of practice. As a result, I began the process of having the IAA address this issue through the formation of a professionalism committee that may be adopted by the IAA in August in Tokyo. Hopefully we will then be able to lend some credibility to this principle. Best estimates and adjustments for risk should be re-measured at each valuation date, based on the most credible, recent, and relevant information, that is, with no lock-in of assumptions. DAC is not appropriate under a fully prospective system, although it may be implicitly derived based on the details of the prospective accounting system put in place.

Several principles relate to disclosure requirements in a financial statement. Potentially one appropriate disclosure would include the effect of regulatory constraints or something similar in an embedded value-based system, which would focus on distributable profits. Second, the actual embedded value of the insurer, potentially including the level of risk of unhedged exposure, implies more disclosure of the degree of risk. It is reflected in actuarial liabilities, along with the impact of industry experience that differs from company experience. This level of disclosure may become controversial. It relates to options, what has been called real or embedded options inherent in insurance contracts.

The two last items that have been used in Europe and Japan are applicable to P&C insurance. They are equalization and catastrophic provisions. The use of equalization reserves in Europe is a method to establish conservative financial

statements and may result in smooth earnings. Some actuaries have come out in favor of the continuation of equalization reserves, but, in fact, there are some reasons why they are being pushed. In some countries, they are tax deductible. Also, the papers indicate that provisions providing for future catastrophes might be okay if certain long-term contracts are involved. This is also controversial. An early vote in the insurance steering committee was not in favor of catastrophe reserves (provisions), which are currently required by regulators in Japan (this reflects Japan's earthquake exposures). So far it has been indicated that catastrophe provisions do not meet the definition of a liability because, as I defined earlier, it would be a provision for future, not past events.

The last issue that I'll mention is that more meaningful financial general purpose statements could result if regulatory calculations, including risk-based capital value disclosures, would be harmonized with those of general purpose accounting. This would constitute a revolution in regulatory accounting. The U.S. just went through a codification project of accounting practices for regulatory purposes. Some people tried to push GAAP standards, but clearly it has been unsuccessful so far. This will be a topic that should be discussed. If it results in a reduction of overall requirements, it will make a lot of actuaries' work easier.

Mr. Kunesh: We thought we would end our presentation with some perspectives about what to expect in respect of IAS. What is likely to happen? It seems to me that if state regulation of insurance continues in the U.S., market value accounting will not impact statutory accounting. However, if the federal government is successful in taking over solvency matters within the insurance industry, then, in my view, it is quite likely that we could go to a full market-value-based accounting system in the U.S., for both statutory and U.S. GAAP. Statutory would undoubtedly have some requirement for risk-based capital, perhaps along the lines that Sam was talking. Maybe the IASC can gain some consensus among the regulators in some of the countries with major capital markets toward a single common accounting basis that applies to both statutory (solvency) accounting and GAAP (in the major capital markets). However, I think it is going to be real tough to accomplish this in all jurisdictions, particularly throughout Europe.

If the IASC had its way, it would like to see international standards applied not only in the major capital markets, but in all countries. In a recent speech, the IASC chairman has made it quite clear that this is his intention and hope.

Many countries have already adopted these standards. In terms of a current score card, there has been a rapid movement towards the adoption of the IAS, particularly for reporting financial performance in the capital markets. In some countries it is also an option for local reporting.

The key opponents of the IAS initiative, and they will remain fairly strong opponents, are Canada, Japan, and the U.S., in alphabetic order. The greatest opposition has come from the SEC and FASB in the U.S. and from certain other business sectors. It is not clear whether or not that's beginning to change. In a recent scan of the Internet, I found at least four other jurisdictions where IAS still was not in favor in the capital markets: Israel, Korea, New Zealand, and Taiwan. I

would also say that I believe the current initiative is supported either actively or in concept by most, if not all, of the accounting firms on the New York Stock Exchange.

From the Floor: It seems to me that the SEC will have to join the others if the U.S. hopes to retain its market edge competitively in the world markets.

Mr. Kunesh: I'm not going to jump in and agree or disagree with you, simply because one could argue about this point for a long time. I tend to be on your side of the fence. However, the SEC has been very consistent in their message. Over three years ago in April 1996, the SEC chairman stated that the international standards need to contain three elements to gain the SEC's support. First, the standards have to comprise a core set of comprehensive accounting pronouncements that constitute generally accepted accounting principles for all reporting entities. I think they are close to achieving this objective. Second, the core set of standards must be of high quality, resulting in comparability, transparency, and full disclosure. The SEC is big on the disclosure issue, and they feel that the existing international standards do not even come close to the current disclosure requirements found in the U.S. under US GAAP. They feel that the international standards, as they currently exist, would put U.S. companies at a competitive disadvantage.

Third, the standards must be rigorously interpreted and applied. There appears to be some feeling among critics that there are too many options available under the current international standards. I don't know whether that's true. However, many of the loopholes have been closed. Yet when there are options that go one way or the other, companies can play games with the rules, to their advantage and the disadvantage of others.

Do I think the SEC is going to comply? If the IASC tightens the disclosure and interpretation standards, I think that eventually the SEC might comply. However, this is going to take some time. There is some question as to who will survive as the ultimate standard-setter in the world. I have heard rumors to the effect that the FASB is vying for this position.

Mr. Gutterman: I will briefly discuss my perspective on the future. I think that this issue will affect almost all insurance companies in the next five to seven years. It may affect them if they use IAS or if these concepts are applied to them through modified U.S. GAAP. Different companies will be affected in different ways, but general purpose accounting will change.

This is a very politically charged issue. There is a political struggle within the accounting community about who will be in charge of international insurance accounting. The IASC put out a position paper five months ago describing its proposal covering its strategic direction, including things like the degree of openness, transparency, and objectivity that should be involved. On the other hand, FASB has come out with a statement that indicates that if the IASC does not meet a minimum set of standards, they would be willing to set IAS for the rest of the world. The more people are aware of the discussions, the more input that the

international actuarial community will receive from various people, the better the final product will be.

The next two years or so may be very contentious as these standards develop. The issues will become more focused as the discussions between fair value, historical cost, and mixed attributes models develop. With the definition of risk adjustment, and fair value reshaped, I hope that actuaries will be well placed to play a significant role in that discussion. One thing I do know is there will be change.

From the Floor: Will fair value be forced on insurers?

Mr. Gutterman: As of now, I would say yes. Certainly, the U.S. FASB appears to be committed to putting all financial instruments on a fair-value basis. The FASB is currently investigating a whole range of asset and liability issues in terms of what fair value means in applications such as credit card receivables and bank deposits. Insurance should be addressed in the next four years.

From the Floor: Are regulators involved in these discussions? What are their views?

Mr. Gutterman: The regulators' initial reactions to this movement toward fair value have been skeptical. Regulators have traditionally focused on balance sheet issues as opposed to the income statement issues; this is similar to what has happened to accounting in general. I think it is at least not a foreign move to them. The issues surrounding fair values are not completely foreign to them. The IAIS representative on the IASC Insurance committee, who happens to be an actuary from France, has expressed significant reservations with developments to date. It is quite worthwhile that issues of joint concern are addressed, although I cannot foresee the outcome. The IAA and actuaries in general are trying to serve as facilitators between the accountants and the regulators by trying to at least get them to talk about the same issues. I hope that in the long term these accounting issues will be determined on their merits and not on political issues and not simply as a result of maintenance of the status quo. It should be an interesting discussion.