

RECORD, Volume 24, No. 3*

New York Annual Meeting

October 18–21, 1998

Session 46SM/L

Organizations That Impact The Financial Reporting World of Life Insurance Actuaries

Track: Financial Reporting

Key Words: Financial Reporting

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Summary: After a presentation of a primer on the organizations that affect the lives of financial reporting actuaries, Mr. Shouvlin presents an update on the American Institute of Certified Public Accountants and Financial Accounting Standards Board activities. Mr. Shouvlin is the current chairperson of the American Institute of Certified Public Accountants insurance companies committee.

Mr. R. Thomas Herget: We are going to have two types of presentations. The first part of this meeting is a primer on the nature and the players of the organizations that affect our work. When I entered the profession, I had a few good ideas and wondered how we could implement them. Some of my colleagues said that we would have to get the approvals and the endorsements of various organizations. Those organizations are numerous, intertwined, and represented by a series of mnemonics and acronyms that never seem to end.

I have asked Bill Carroll and Dan Kunesh to talk about the nature of organizations that have an impact on the financial reporting world of life insurance company actuaries. Bill has been with the American Council of Life Insurance (ACLI) as a staff actuary for 20 years. He is prominent in actuarial circles and has been a speaker and presenter in many past meetings.

Mr. William Carroll: I am here today as an individual, not as a representative for the Academy. My subject is a primer called “Alphabet Soup,” because many of the

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organizations and their subparts are known by their initials. Many of you have been involved in regulatory matters during long careers and spend much of your working lives there. Others may be less acquainted with these organizations. Nevertheless, I think we can all get something out of this.

I will talk about the organizations that either establish or influence the environment for life insurance statutory financial reporting in the United States. My subtitle is "Inside the Insurance and Regulatory Beltway." The ACLI is located inside the District of Columbia beltway because the federal government is there. But the environment is the state "beltway." It is a virtual beltway, but it is real. Inside that beltway are three kinds of organizations: Government organizations at the top make the rules, professional organizations enforce these rules, and industry organizations represent those who are regulated.

The bonds between these organizations indicate the relationships that exist. There are strong bonds between the profession and the regulators, and between the industry and the regulators. But there are weak bonds between the profession and the industry. The profession does not attempt as an organization to directly influence the industry, nor does the industry attempt to directly influence the profession. It is a weak bond, because many of us work in more than one environment and keep each other informed of current developments. Government organizations make the rules, professional organizations give unbiased professional advice, and industry organizations put the rules into practice.

Government organizations arise from state legislatures. That is the source of the world of statutory accounting. The states control this world and tell us in their laws that we must have financial statements and do them in accordance with the rules published by the National Association of Insurance Commissioners (NAIC). The state insurance departments are key to this effort. They make regulations that implement these laws and oversee the regulation of the insurance companies in their respective states. The NAIC is an association of the state insurance commissioners.

The National Council of Insurance Legislators (NCOIL) is an organization of state legislators who are interested in insurance regulation. They have hardly any impact on statutory financial rules or scope, but can have an enormous impact on their acceptance. For example, if state regulators decide that the NAIC and the state commissioners are interfering with the states' sovereign prerogatives, they could make changes. During the codification process, some influential state legislators were talking to each other.

Professional organizations include the AAA, SOA, the American Institute of Certified Public Accountants (AICPA), and others. The SOA does not attempt to influence governments or rules, but it does have a long-range influence. It is an educational, research, and member service organization. Its work provides the foundations for financial statement values.

Another key organization is the AICPA's Insurance Companies Committee. It does not publicly influence individual statutory accounting decisions on specific matters, but has had an enormous impact in the last 10 years on the issues addressed by the NAIC. The AICPA is the primary force that pushed for codification. When the NAIC adopted the requirements for statutory audits, it worked very closely with the AICPA to develop the scope of the audits and the appropriate kind of statements.

During that work the state regulators asked, "Could this be in accordance with NAIC standards instead of in accordance with state standards?" The AICPA replied that there is no such thing as an NAIC standard. There is no comprehensive set of accounting guidance. Statutory accounting could not be used as a basis of an audit. That led to the codification project with its goal (which may fall short of being achieved) of having a single national standard that could be the basis of audits.

Regarding trade associations, I am most familiar with the ACLI, but other organizations worthy of mention are the Health Insurance Association of America (HIAA), and the National Association of Life Companies (NALC). These organizations exist because the ACLI cannot be everything to everyone.

Because there are special interest needs, we have small company associations—credit, reinsurance, fraternal, company, and credit union associations—that add flavor to the "alphabet soup" of associations.

I will cover two aspects of organizations: mission and organizational structure.

Missions, in general, are noble statements. The leadership works very hard to capture the essence of the organization's *raison d'être*. They are worth reading. Consider part of the NAIC's mission, "Promote the reliability, solvency, and financial solidity of insurance institutions." These are the aims of financial reporting. Of importance is one statement that is not there. It is not part of the NAIC's mission to create uniform state rules and regulations. It is part of the mission to be supportive of states. We tend to think that the NAIC ought to make things uniform, but that is not its job.

How does the NAIC do it? It puts out products, model laws, model rules, codified statutory accounting, a (not quite final) life accounting manual, annual statement

instructions, and actuarial guidelines. Its authority arises from the state laws and regulations that require the statutory blank, which, in turn, directs that methods and procedures be done in accordance with the accounting manual and annual statement instructions. For most of the states, putting the codification inside the accounting manual will create authority within those states. There are a number of states where you will have to make statutory changes.

Let us move to the ACLI's mission. The original wording gave the ACLI one job: to represent the common interest. However, the new wording creates two jobs. The first is to foster and create the common interest (and to discover what it is), and second is to work on its behalf. The ACLI tries to capture the essence in one sentence, "To create a unified association, to cause there to be a group of insurance companies with a common purpose, and then to advance that purpose."

The Academy's mission focuses on its first point: to provide "the independent expertise of the actuarial profession in the formulation of public policy." The second part has to do with professional standards, which is not within the scope of today's discussion. Today's discussion focuses on the Academy as the group that is speaking to the regulators and giving disinterested professional advice about matters at hand.

Now I will describe the organizational structures of these organizations. The NAIC has a pyramid-shaped structure. The Committee of the Whole includes all 50 state commissioners. There is an Executive Committee with seven Executive Subcommittees (Ex1-Ex7). The latter are functional committees with small memberships, made up of Executive Committee members and at-large members on each one.

Every one of our organizations has the problem of choosing between being a functional organization versus product organization. The Executive Committee has the same problem, so we find financial condition as one of the Functional Executive Subcommittees. With the Standing Committees, we find that the A Committee (Life) has domain over life insurance company matters, B Committee over health care organizations, and so forth. They all have Executive Subcommittee Task Forces. The A, B, C committees also have Standing Committee Task Forces. One of these is the Life and Health Actuarial (Technical) Task Force (LHATF).

Let's look at the Ex4 Subcommittee, Financial Condition. Its Accounting Practices & Procedures Task Force is responsible for the accounting manuals and statement blanks. The Blanks Task Force writes the annual statement instructions. The Examination Oversight Task Force sets rules for examinations and establishes practices for monitoring the financial condition of companies. The Risk-Based

Capital (RBC) Task Force sets the risk-based capital formulas. And the Valuation of Securities Task Force is responsible for the values placed on invested assets.

Up through LHATF to the A Committee come all the rules pertaining to valuing liabilities. LHATF consists of actuaries in state insurance departments.

Now let's look at the ACLI structure. It is not as well laid out for the purposes of financial reporting because the scope of the ACLI is much broader, so it is hard to see where financial reporting fits. We have a Board of Directors with an Executive Committee. We have five Functional Steering Committees: Financial Services, Regulation, Taxation, Retirement Security, and Public/Consumer Issues. Inside the Regulation Committee you find most matters pertaining to accounting. Each of these Steering Committees is made up of board-level members (CEOs of member companies) and has committees reporting to it.

Some of our committees focus primarily on financial reporting. The Actuarial Committee, which is part of the Regulation Steering Committee, concentrates on issues arising from the LHATF, such as valuation laws. The Statutory Reporting Principles Committee, which is primarily made up of accountants (although there can be some actuaries), concentrates on issues that arise from the Ex4 Committee. The Asset Valuation Issues Committee, a subcommittee of Financial Reporting, focuses on values placed on invested assets.

Because of our functional organization, other committees that may get involved in financial reporting from time to time include Annuities, Taxation, Company, Product, Life, Accelerated Death Benefits, Long-Term Care, Disability, and Pensions.

The Academy is more simply organized with regard to financial reporting. It has a Board of Directors at the top. Below that are the Practice Area Councils (Life, Health, Retirement, and Property/Casualty) reporting to the Board, with Practice Area Task Forces under them. Two key task forces are the Valuation Law Task Force and the RBC Task Force. They have inherited their jobs from what used to be called "Interested Parties," an ad hoc group of actuaries, responsible to no one, that advised the NAIC. The NAIC, from time to time, reorganizes the way that it is willing to receive advice. This has greatly enhanced the advisory role of the Academy to the NAIC.

Under the task forces are the Practice Area Committees. The Committee on State Life Insurance issues speaks primarily to the LHATF at the NAIC. The Committee on Life Insurance Financial Reporting has charges in financial reporting, both statutory and GAAP. The Committee on Federal Life Insurance Issues also addresses GAAP issues.

Mr. Herget: Dan Kunesh, a principal with Tillinghast-Towers Perrin in Chicago, will speak on GAAP authorities.

Mr. Daniel J. Kunesh: I am going to cover two areas on GAAP authorities. First, I will introduce you to the names behind the acronyms. Then I am going to compare how standards are set in the United States versus internationally. And, finally, I will walk you through how a GAAP standard comes into being in the United States.

The godfather with the biggest clout is the Securities and Exchange Commission (SEC). The SEC has the statutory authority to establish all accounting standards for publicly traded organizations in the United States. In reality, it delegates that responsibility to the Financial Accounting Standards Board (FASB). The SEC has five commissioners, appointed by the President of the United States, who report to the U.S. Congress. The SEC is responsible for the administration of all federal securities laws. It regulates all the trading firms, the investment advisers, and the investment companies. It is very heavily involved in enforcement. Like everything else in the United States, it has its own general counsel and an audit division.

The Accounting Principles Board is an organization you may not even remember anymore. It was the primary accounting standards-setting group from the late 1950s through 1973.

The Financial Accounting Foundation (FAF) is an organization that oversees the FASB and the Government Accounting Standards Board (GASB). Its primary duties are to appoint members of the FASB, the Financial Accounting Standards Advisory Council (FASAC), and the GASB. It approves the budgets, arranges financing, and takes care of all operational matters. The FAF resolves jurisdictional matters between the various organizations. Its role primarily is to advance and contribute to the education in accounting standards and accounting in the United States. It is made up of 16 trustees from eight different organizational sponsors. These are associations that represent public accounting, finance, industry, education, and government, so it has a good cross-section in terms of the underpinnings of the accounting standards-setting process.

Then there is the FASB, perhaps the best known agency next to the SEC and the AICPA. It is the primary U.S. accounting standards setter for public companies. The FASB comprises seven full-time members, each with five-year terms, so they have ample time to pursue issues in depth. Generally, three of them, are from public accounting firms, two from industry, one from education, and one is a financial analyst, to give depth and breadth in terms of financial markets and accounting. This very busy group meets every week, working through technical staff, project task forces, and the Emerging Issues Task Force (EITF).

The FASAC is the key adviser to the FASB. It helps select agenda projects and determine priorities and makes decisions on technical issues and policy matters. However, it does not have any direct responsibility for establishing standards. It is a 30-member group appointed by the FAF trustees. FASAC members serve for a relatively short term (one year) and meet quarterly.

The EITF was established in 1984. High-level accounting professionals know this is a very important group of the FASB. Its role is to study and resolve some of the narrow practice issues that come up from time to time. It helps identify, discuss, and seek consensus on these issues. The task force's work is not to conflict in any way with any of the existing standards, but merely to interpret or help implement practical issues related to the standards themselves. This group has a very active agenda. It is made up of 13 voting members appointed by the FASB Chair. It meets at least six times a year, but is usually much more active than that.

The AICPA is the equivalent of the SOA for accountants. It is the national professional organization for CPAs. With 358,000 members, it is slightly bigger than the SOA. It provides certification, licensing, professional standards and other member services, similar to those provided by the SOA and AAA. The AICPA provides technical support and guidelines to the FASB standards-setting process as well, a very important role.

The Accounting Standards Executive Committee (AcSEC) is part of the AICPA and has a very serious role. It is the senior technical committee of the AICPA responsible for developing standards of practice, industry guides, and other publications. A 15-member group appointed by the AICPA chair for three-year terms, it meets eight times a year.

GASB is the governmental equivalent of FASB and very similar in structure. GASB was formed by the FAF in 1984 to establish standards for state and local government entities. It has seven full-time members appointed by the FAF trustees.

Let me cross over the big pond to the London-based International Accounting Standards Committee (IASB). You will hear more about this over time. The IASB is in many ways like the FASB except with an international scope. Its objectives are to develop and promote worldwide accounting standards and currently represents 116 accounting organizations from 86 countries around the world, all major financial markets. It has a 17-member board, a large advisory council, a consultative group, and other support. The IASB works mainly through steering committees. With 38 international standards in place to date, it is recognized in all countries except the United States, Canada, and Japan.

The International Organization of Securities Commissions is the equivalent of the NAIC for securities exchanges around the world. It represents all major exchanges, including our three, in more than 80 countries. It is an informal group intended to promote consistency and discipline in the world securities markets. The International Organization of Securities Commissions has recently commissioned the IASC to develop a complete set of standards for cross-border filings. You are going to hear more about this over time.

And the final group to watch is the International Federation of Accountants.

Let's compare some of the key characteristics of how standards are set in the United States and internationally. The primary standards setter in the United States is the FASB on behalf of the SEC. Internationally, it is the IASC. The supplemental standards setters in the United States include the SEC, EITF, and the AcSEC. There are no supplemental standards setters internationally of which I am aware. Regarding mission and focus, in the United States, it is domestic and overseas it is international. We have formal oversight in the United States from the SEC and FAF. If you feel overregulated, you may be justified. The regulators take their mission very seriously. Internationally, oversight is an informal process by an advisory council to the IASC.

U.S. commitment to standards setting is a full-time job, whereas international commitment is part-time. On frequency of meetings, the FASB meets weekly and, believe me, it has a full agenda all the time. The IASC Advisory Council meets three times a year for one week each. The last meeting was earlier this month in Munich, Germany. An insurance standard is coming into place, but the council barely talked about it.

With respect to public oversight, all meetings in the United States are open to the public, whereas most international meetings are closed-door. And, finally, in comparing enforcement authority, the United State has a big club, the SEC, whereas internationally, there is no such function. Enforcement probably will be the responsibility of the country in which the standard is being implemented, but that has not yet been resolved.

For the standards/pronouncements themselves, the United States has three levels, A, B, and C. Level A includes the FASB statements and interpretations; SEC rules and interpretative releases; Accounting Practices Bulletin (APB) opinions, which are now dated but still very important, and the AICPA's Accounting Research Bulletins.

Level B includes FASB Technical Bulletins and the very important AICPA Standards of Practice and Industry Guides. Level C is the AcSEC bulletins and the EITF consensus.

There is a single set of international accounting standards, to date, and no industry-specific guidance coming from the IASC, although there is an insurance standard in process.

Finally, I want to comment on the process of a standard going through in the United States. Generally, a project is determined in one of two ways. If an item of great importance comes up, the SEC forces it. Alternatively, the FASAC has an active role in forming the project. An advisory task force of outside experts works with this group to help flesh out what the project should be. A dedicated task force of about 15 people meets with the FASB to help define the scope of the project. The task force members work on the nature and extent of the research that is needed to prepare a discussion document and related matters. A discussion document is prepared by a staff technical group of the FASB. Then there is a public hearing, which is announced at least 60 days in advance. Here, questions and comments come from the general public and various points of view are shared. The FASB takes under advisement very seriously the oral and written comments.

The hearing is followed by a series of as many meetings as needed to determine what has to be done to finalize a standard, or at least a draft. An exposure draft is issued setting forth the standards of accounting and reporting. There is at least a 60-day exposure period during which more comments are made and deliberated on by the board. It can address these comments in a revised exposure draft, which may or may not be reexposed. Finally, there is a vote. At least five of the seven members have to approve the standard before it is enacted.

Mr. Herget: Our next speaker is Pat Shoumlin, a Partner with Pricewaterhouse Coopers in New York. Pat is the leader of the audit practice within the insurance group, both in the U.S. and globally. He also is the chair of the AICPA Insurance Companies Committee.

Mr. Patrick J. Shoumlin: Dan did a great job of describing the standards-setting process, so I can focus on the AICPA Insurance Companies Committee. One can be a CPA and not be a member of the AICPA. The licensing is done at the state level by each state's Society of CPAs. At least half of the CPAs in the country are members of the AICPA. The AICPA sets professional standards for CPAs, but you can also think of it as a trade organization because it has various industry committees within its structure, including a Banking Committee, an Investment Company Committee, and an Insurance Companies Committee, for example.

The Insurance Companies Committee deals with auditing and accounting matters. We might deal with how auditors report on a statutory accounting set of financial statements. Those matters are sent to the AICPA's Auditing Standards Board, whose meetings are open to the public. It can directly issue statements on auditing standards.

Accounting matters, with which we deal, are sent to AcSEC, which has the authority to issue statements of position. AcSEC cannot issue guidance without approval of the FASB, which has the final say on whether standards, statements of position, and interpretations can be issued. However, a lot of the projects do come out of these industry committees.

Our committee comprises six members from the public accounting profession, five from what we call the "big five" firms and the sixth from another firm, because we want a smaller firm represented on the committee. We also have six or seven members from industry on the committee. They represent life insurance, property and casualty (P&C) insurance, life reinsurance, and P&C reinsurance companies. We also have a regulator on the committee. It used to have an NAIC representative, but currently a State of Virginia regulator is serving on the committee. Members typically serve a three-year term.

We have an active agenda at the AICPA Insurance Companies Committee, especially related to accounting matters, which is a relatively new development. In the past, the committee focused primarily on auditing issues, but we shifted our attention in the last year.

Before we go further, I must issue a disclaimer. What I will talk about today and the opinions that I give today are my own opinions, not those of the AICPA and not necessarily those of PricewaterhouseCoopers.

We try to focus on relevant issues based on current industry trends. The three major trends are convergence, consolidation, and globalization. Some of the projects I will cover deal with those trends, some are more narrow, and some are just a matter of updating accounting standards.

I will describe some of the current projects in detail, such as accounting and reporting for certain nontraditional long-duration contracts and for separate accounts. Then, I'll report on accounting and reporting of mass tort exposures of insurance enterprises. Finally, I will touch on a long-running project on accounting for certain managed care arrangements.

Future projects that plan to address include accounting in mutual holding company and demutualization situations, accounting for purchase business combinations, internal replacement costs (how to handle deferred acquisition cost [DAC] rollover on internal replacements) and risk transfer for direct insurance contracts. These are GAAP financial reporting, not statutory, matters.

The project of accounting for mass tort exposures of insurance enterprises arose because additional guidance was needed to apply *FAS No.5*, which is our standard for dealing with contingencies. It actually began because of environmental hazards and asbestos, but we realized that the scope should be expanded to mass torts in general.

Suppose an insurance company, XYZ, receives a few claims due to prolonged exposure to latex gloves because it had provided cover to either pharmacies or manufacturers of latex. Suddenly newspaper articles appear about the damages caused by exposure to latex rubber. The company conducts a study to see what kind of coverage it may have provided, what policies may apply, how policyholders might respond, and if XYZ wants to dispute the reports. Then preliminary industry exposure estimates start to come out, ranging from \$25 million–1 billion.

XYZ's estimates of its market share of 15% for manufacturers of latex and 10% for pharmacies lead to some interesting accounting questions. Should XYZ give separate accounting considerations to this specific exposure and, if so, when should it do that? How should the liability be measured and should that liability be discounted if it has an extremely long payoff period, such as those for some of the environmental exposures? What disclosures should XYZ make and when should it make disclosures about this exposure? That is the framework for this project.

In trying to identify what a mass tort exposure is, we defined it as exposures having a relatively large volume of current or potential claims involving multiple policy years and purportedly caused by one common harmful condition. Examples include environmental contamination, asbestos, HIV-tainted clotting factors for hemophiliacs, and silicone-gel breast implants. Items that would not be included are what we call mass economic torts, such as class action litigation arising from security fraud.

With respect to possible exposure, when available information indicates that it is reasonably possible that additional claims will be filed, disclosure is required. In addition, unless the possibility of coverage disputes is removed at that time, recognition of an estimate of expected declaratory judgment costs should not be delayed.

The preliminary guidance that is coming out indicates that once you identify that you have an exposure and that there are coverage disputes, you at least ought to record a liability for the costs of defending those coverage disputes. Once judicial decisions come out about coverage, there is a presumption that a liability for a mass tort exposure exists, although the presumption is rebuttable. Although the overall liability may be difficult to estimate, recognition of the costs to defend the policyholder against the liability should not be delayed beyond this point. Once cases get successfully aggregated in the court system, the advice is to recognize an estimate of the overall liability at that time.

Thus, there is some specific guidance on when to recognize liability. We also have some guidance for the measurement in disclosures. What costs should you include? We concluded that declaratory judgment costs should be included in the measurement of the liability because *FAS No.60* says that you should not only record claim expense, but also the cost to adjudicate or pay the claims. That is why companies set up loss adjustment expenses and unpaid loss adjustment expenses. What measurement methods are best? There is a hierarchy of estimation methods. There are some that we do not believe are sufficient to warrant recognition of a liability. One is the market share method, in which the company determines that it has 15% of the market and estimates total market exposure as \$1 billion, making its share of liability \$150 million. We do not think that meets the requirement of *FAS No. 5*. Survival ratios definitely do not meet the requirement. We think these methods are useful indicators, but recommend that, in cases of mass tort exposures, relying on ground-up methodology using detailed information. Some very large models have been developed for superfund sites, for example, in the environmental area.

With respect to discounting, we concluded that giving any advice at this time is inappropriate, in light of some of the other things FASB is doing with fair value of liabilities.

We currently have two levels of disclosures: (1) private company disclosures, which you would find by reading various FASBs, and (2) the SEC requirements for public companies. We are trying to integrate these disclosure requirements to create uniformity.

The other project that I will discuss in detail is the project on nontraditional products. I believe this is one of the most important projects that the Insurance Companies Committee will take on in the next few years. Let me give you the background. Accounting for the insurance industry has evolved around products. *SFAS No. 60* was developed in response to traditional life contracts and traditional P&C covers. When insurance companies developed universal life products and

annuities, the FASB responded with *SFAS No. 97*. When mutual life companies concluded that they needed GAAP financial statements, the FASB responded by issuing *FAS No. 120*, which codifies one of the statements of position that came out of the Insurance Companies Committee. *FAS No. 61* is another example that deals solely with title insurance.

Our standards-setting process has been product-driven. We see the proliferation of new annuity and life insurance products that do not fit the mold of these standards. In addition, international companies that try to convert to U.S. GAAP are having a very difficult time, especially companies in the U.K., for instance, that sell unit-linked products that do not fit into a *FAS No. 60* or *FAS No. 97* model. As a result, we have diversity in accounting practice.

The FASB approved our prospectus on this project and we expect to get an exposure draft out in 1999. In the year 2000, we expect to issue a final standard. When this item is released, the exposure period allows for public comment.

Let's look at traditional annuity and life insurance contracts. We see traditional fixed deferred annuities offered through the general account, but we also have traditional annuity and variable life insurance offered through separate accounts.

In addition, we have nontraditional annuity and life insurance contracts, which we believe are hybrid instruments—some with fixed features, some with variable features, and some with both. Variable annuities with guaranteed returns of principal and/or interest at specified dates, or fixed annuities with guaranteed returns plus contingent returns based on an external index such as the S&P 500 are two types of annuities that contain embedded derivatives. Therefore, they fall out of the scope of our paper and are being picked up by the FASB as part of implementation guidance on *FAS No. 133*, the derivatives product. An equity-indexed annuity, for instance, is a basic annuity with an embedded derivative.

Annuities that provide fixed returns if held until maturity, but a market adjusted value if surrendered early, are covered by our statement of position. Fixed annuities with high teaser rates at the front end or bonus interest at the back end also are covered. As are variable annuities that have a minimum guaranteed death benefit.

We are trying to provide interpretive guidance on the valuation and presentation of nontraditional annuity and life products that do not fit into *FAS No. 133*. We will also discuss the valuation and presentation of separate account assets and disclosure for products in separate account investments. Finally, we will assist the FASB staff in developing interpretive guidance on those nontraditional products that fall within the scope of 133.

For example, for an equity-indexed annuity, how is the contract valued and how is it accounted for at inception and subsequently? One position is that there must be a separate value for the embedded derivative in those contracts. We will be working with the FASB to get some guidance on how that should be done.

What about the valuation of non-FAS No. 133 nontraditional contracts? For investment contracts, FAS No. 97 says to account for those in a manner consistent with other interest-bearing or financial instruments. However, for universal life contracts, it mentions account balance accounting. How do you apply this guidance to market value adjusted contracts with variable terms, front-end teaser interest rates, back-end bonus interest rates, or guaranteed minimum death benefits?

Should separate account assets and liabilities be included in the financial statements of insurance companies? Separate account presentation in GAAP financial statements has evolved out of statutory accounting presentation of separate account assets and liabilities. That is not necessarily bad, but we are challenged to fit it into an appropriate GAAP model. Who owns the separate account assets? Bank trust funds or mutual funds managed by investment managers do not appear on insurance company financial statements, so should we even recognize separate account assets and liabilities? I think the answer is "yes" and that is where we are headed.

However, we must refine that and determine which separate account assets and liabilities should be included in the general account and which should be separately presented as separate account assets and liabilities. Single capitation treatment may be appropriate if the assets are legally isolated, there is no significant general account guarantee, and the policyholder directs the investment choice and the separate account represents a pass-through from the insurance company directly to the policyholder.

We are not sure that all assets currently being placed into a separate account should properly be put into a separate account. FAS No. 60 could be amended to consolidate all separate accounts, but I do not think we will recommend that. What distinguishes whether something should be put into a separate account is a significant guaranteed investment return. We are struggling with what represents a guaranteed investment return and when it is significant. One view is that any investment guarantee, no matter how insignificant or remote, would result in general account valuation. If there is a guarantee that the insurance company is providing, why shouldn't the assets supporting that guarantee be in the general account rather than in a separate account? Paragraph 54 in FAS No. 60 mentions the term "significant," but does not define it.

Another issue is seed money. A lot of insurance companies that set up separate accounts use seed capital, which represents an investment in the separate account. Why is that investment in a separate account and not carried as a general account asset of the insurance company? Thus, we are challenging some of those practices to see what solutions we can devise.

Let's move on to the project on purchase business combinations. Currently, we have conflicting guidance between *FAS No. 60/FAS No. 97* versus APB 16, which is the overriding guidance on purchase business combinations. With the P&C valuation, deferred policy acquisition costs typically are carried over. Loss adjustment expense reserves are carried over at historical costs, not fair value. The same is true for reinsurance. Under APB 16, one should carry those assets and liabilities at fair value.

Some of the other items are quite technical. On the life side, there are differing actuarial methods for future policy benefits and present value of future profits (PVFP). The SEC has asked what discount rate is used to set up the PVFP. Also, separate account valuation issues have not gotten off the ground yet, but we are forming a task force.

One of the projects we will put on a fast track concerns demutualizations and mutual holding companies. There has been a lot of recent conversion activity and, in most of these cases, a closed block is set up. The current GAAP accounting is that these transactions are considered reorganizations, therefore, the historical basis of the assets and liabilities carry over. There is no new basis of accounting. Closed-block assets and liabilities are classified into a single line on the balance sheet, and there is a very detailed closed-block footnote in the financial statements.

We are challenging the concept of putting the closed-block assets and liabilities on one line. These are still assets and liabilities of the insurance company. They are not separately held, legally, for the sole benefit of the closed-block policyholders in all cases. This accounting presentation seen in most of the existing demutualization financial statements went through SEC review. This is how the SEC required the early filers to do it and it has been carried over. We think that deserves a fresh look.

There are other closed-block accounting issues. Does one establish a liability for favorable experience in a closed block? Does one establish an asset for unfavorable experience? In other words, is there a deferred dividend liability if the closed-block returns are doing better than originally anticipated? In the presentation of the closed block, one may see closed-block accounting on the income statement and yet not see all expenses related to it in that line because the parent company has assumed

some of those expenses. The result is not very meaningful financial statement presentations.

I want to finish with codification issues. Codification was passed at the Plenary Session of the NAIC in March. In June, the effective date was pushed back to January 1, 2001. Will it be an accreditation standard? It looks like it is headed that way. States will be encouraged to adopt codification either in whole or in part. They can adopt it on a piecemeal basis. A state can choose not to adopt codification, but I do not know what will be done then in terms of filing statutory financial statements with the NAIC.

The implementation battles are not over. NCOIL still has problems with codification. The NALC has problems, most of which are caused by the NAIC's requested reconciliation between the financial results on a codified basis versus the financial results that a company may present on the basis of practices prescribed or permitted in its state of domicile.

Thus, if a state adopts codification with a few exceptions, or if a state has granted a company a few permitted practices, regulators in other states have asked to see a footnote reconciliation. At least one state and one trade association are fighting that. NCOIL is fighting it on principle, because it believes that requiring a reconciliation to NAIC codification gives codification more stature and legitimacy and creates a de facto standard, which it feels is a threat to state regulation. Codification updates appear on a regular basis on the NAIC's Web site, www.naic.org.

Mr. Herget: I have a question on codification. Do you think that this will mean the actuary must prepare more sets of financial statements and, perhaps, sign another opinion?

Mr. Shouvlin: I do not know what will come out of it. I think there is talk about putting that requirement in there, but I'm not sure where that will end up. I have not had time to talk to our actuaries about that one, so I'm not sure where it stands.

From the Floor: Pat, on the demutualization and mutual holding company issue, time is of the essence, as you recognize. How long does it normally take for your group to come to a conclusion and what would be the work process?

Mr. Shouvlin: We have put it on a fast track. We will have a paper to present to AcSEC by the end of the year. AcSEC has agreed to put it at the top of its agenda, which it normally does not do. Typically, one has to wait a few months to get it on the AcSEC agenda. I think that we can get it through AcSEC sometime this winter

and take it to the FASB in the spring. This would be extremely fast, compared with the normal standards-setting process. We considered taking it to the FASB's Emerging Issues Task Force, but it is too complex and narrow for that task force. For us, it affects a lot of companies. For the FASB, it affects a small segment of a segment of an industry, and, thus, it may not want to deal with it through the EITF.

Mr. Lawrence N. Segal: Could any of the panelists comment on what accounting or regulatory issues may arise from the passage of HR10?

Mr. Herget: We welcome anybody's opinion from the audience. Does anybody have any insights or predictions?

Mr. Shouvlin: I think one of the last items in HR10 that was stricken is the ability to redomesticate.

From the Floor: My question addresses codification. First of all, you said the states can adopt piecemeal or not at all. And if there is no need to reconcile the state of domicile accounting to codified statutory accounting, I wonder what has been accomplished. Would we still have the existence of codification sufficient to have statutory accounting considered a comprehensive basis of accounting?

Mr. Shouvlin: We can say that we have constructed a more robust accounting policies and procedures manual, which is something we did not have. With regard to the opinions, the NAIC indicated its view when this project started years ago, that the states would adopt codification and this would be the "law of the land." I think the NAIC realized about a year ago that NCOIL was not buying that. It became apparent that, while codification had enough support to get it passed at the NAIC, it might die on the vine in the states. This is because the state legislators did not like the fact that they were no longer in the hierarchy of statutory accounting principles.

Thus, the NAIC came to the AICPA in March and said, "We can not force the states to adopt codification. We can encourage uniform adoption of codification. We think this task force has done great work, it is a great work product, people worked very diligently on it, but we cannot force it. Therefore, it is political suicide for us to try to force you, the AICPA, to give an opinion on a codified basis of accounting, because (a) we cannot force a codified basis and, (b) the states will not accept it." We replied that we are a trade organization; we cannot force it either. If a state adopts codification, and that becomes part of the foundation of their practices prescribed or permitted, that will be the basis of the preparation of the financial statements going forward, and, therefore, that would be the basis for our opinion going forward.

Mr. William A. Zehner: Pat, what is the thinking of the AICPA regarding internal replacement DAC?

Mr. Shouplin: *FAS No. 97* states that when there is a replacement from whole life (*FAS No. 60*-type products) to universal life, the DAC gets written off. A question that has continually come up over the years is what about other types of internal replacements? Should the DAC be written off or not? Some people believe that it should be. If one has a replacement, DAC follows the contract. It does not necessarily follow the customer. There is another view that DAC should do that. Getting the customer relationship and then later converting it to a different form of a relationship should not necessarily warrant writing off the DAC. That is what we are trying to reconcile. It is a very interesting issue. At first glance, I did not think it was difficult. However, after consideration, it really is a difficult issue. I see good arguments on both sides.