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ADJUSTED EARNINGS—ANOTHER VIEW

Editor's Note: The following contribution is a continuation of a series of articles which began in the October issue of The Actuary *on the subject, "Accountants and Adjusted Earnings."*

by William J. November

The projected use of natural reserves for adjusting life insurance company earnings is an interesting phenomenon. The idea is moving along with dazzling speed even though there may be some important actuarial questions about the use of the method and there certainly will be many practical problems associated with the application of the method. Surprisingly, there seems to have been a minimum of discussion in actuarial circles of this new development.

Natural reserves make two important adjustments to statutory earnings: acquisition costs are in effect amortized over the premium paying period (although strong support has developed for limiting the period of adjustment to 20 years) and policy reserves are recomputed by means of mortality and interest assumptions that differ from the factors that enter into the statutory reserves.

The amortization of acquisition costs has long been discussed. The issues involved are not particularly actuarial. The accountants regard the practice of charging acquisition costs when they are incurred as violating a basic accounting principle that revenues and the expenses which produce them should be matched in time. Stumbling blocks in the way of implementing this principle, as a supplement to the statutory basis, have been lack of agreement on the definition of acquisition expenses that qualify for deferral, concern that non-recoverable expenses will get into the deferral process (this might be a particular problem for new companies), and the difficulty of defining the recovery period on a company-to-company basis. The natural reserve method seems to be making an end run around some of these problems. Clarification of the effectiveness of the method in the areas mentioned would be helpful.

The second adjustment, having to do with changing the mortality and interest factors, is the one I would like to concentrate on. I believe something important is happening when managements, anxious to report higher earnings to their stockholders, are encouraged by the accountants to slice off a part of their policy reserve liabilities as excessive.

I have heard an accountant who has been close to the adjusted earnings problem say that if policyholders did not have the protection of the statutory basis, he did not believe the accountants would be sponsoring natural reserves as a method of adjusting earnings. What this seems to mean is that it is a good thing for the protection of policyholders that life insurance companies have to hold the reserves they do; but when it comes to making reports to stockholders we can forget all that and proceed on the basis that lower reserves are sufficient as of now.

Not How, but Why?

To put this point in a somewhat different way, one of the charges against current operations is the amount that is taken out of premium and investment income for the additional policy reserves that need to be established. Nobody is suggesting that something less should *actually* be put aside. The natural reserve method changes the stockholders' earnings by in effect assuming that some other amount *might have been* added to policy reserves. In general, stockholders' earnings will be higher under the natural reserve method at the early policy durations and lower at the later policy durations. At the present time the "higher" result would for the most part prevail, and undoubtedly that accounts for the interest of stock company managements in the method. Because of the growth of new business, this situation may continue for some time to come, even though earnings over the policy lifetime would have the same value.

I have trouble understanding what generally accepted accounting principle this change of reserve factors satisfies. The maintenance of policy reserves is a means of keeping out of current earnings premiums and investment income that will be needed for benefits that will be incurred at a future date. The principle of matching revenues and costs is thus at work, but it would seem the *degree* of matching is being criticized. Are the accountants getting into deep water on this technical aspect of life insurance operations when they insist on a different rate of matching?

If the use of natural reserves should be recognized by accountants as an acceptable *optional* method of making a supplementary analysis of financial results by those companies that want to make such an analysis for their stockholders, the impact on the business would be quite different from the situation that is developing. At the present stage of the accountants' deliberations, it appears that, unless a company uses the method, it will not get an unqualified opinion. This position is highly questionable for the mutual companies, as was ably brought out in the article by Paul Knies and Ed Colton in *The Actuary* in December. As to the stock companies, it would force them into the added expense of a second valuation and (currently) into a less conservative earnings report, whether they like it or not. Why should this happen? Why should a system of accounting which has served so well in assuring the public of the fulfillment of the long-range obligations undertaken by life insurance companies no longer be generally acceptable to the accountants? Must there be one set of generally accepted accounting principles when the objectives served by the financial reports obviously do not fit into a single mold?

Instead of so much discussion of the "how's" of adjusting earnings, let's make sure of the "why's"!! □

Letters

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Sir:

At our annual meeting in Denver I was most impressed by Jack Moorhead's *Presidential Address* and by the talk given by Professor Boulding.

I suggest that a printed leaflet containing the texts of these two presentations be distributed to the same groups of people, and perhaps others as well, to whom the booklet, *So You are Good at Math,* was sent. It seems to me that the light thrown by these talks on some of the concerns of our profession could help dispel some of the foggy notions about actuaries which probably deter a substantial number of individuals from attempting an actuarial career.

John C. Wooddy