

SESSION 8

CANADIAN GAAP AND THE POLICY PREMIUM METHOD

MR. KENNETH T. CLARK: Nothing has aroused such lively discussion between actuaries and accountants as the gargantuan struggle to remove the footnote from the CICA Handbook that says that its recommendations do not necessarily apply to insurance companies. A central issue in that discussion is the policy premium valuation method. Today we have an actuary, Don Keith, and an accountant, Hank Howarth, to present that issue to you.

We have discussed this issue at general meetings; we have discussed it at length in the Committee on Financial Reporting; and the Council had two major discussions of it and endorsed it last year. The method now lies before the CICA.

The policy premium method has recently come under attack by some actuaries who profess to support it. They brandish a potent weapon: moral outrage at "profit anticipation." "By all means use the policy premium valuation method," they say, "but if its use would result in net income being reported at point of sale, then beef up the margins for adverse deviations in the assumptions so that our profession's clean hands are not sullied by the disgusting act of profit anticipation." What does the stipulation of no net income at point of sale do to the policy premium method? At the very least, it makes the result short of what one wants.

I wish that some of the promoters of our moral purity were less respectable and less likable members of the profession. Their support unfortunately gives

credence to a proposal that, if left to survive on its own intrinsic merits, would soon perish. I think that the proposal is a theoretical monstrosity; never mind the practical problems of poking around for assumptions that "use up" the policy premium, no more and no less. With the proposal, the margin for adverse deviations will depend on the fatness or thinness of the policy premium. I believe that the margin for adverse deviations should depend on risk and on nothing else—the risk of running a life insurance business and the risk that the probable assumptions are not realized. Why should a soundly priced policy have bigger margins than an unsoundly priced policy?

I don't know how the proponents of the proposal will manage revisions of valuation assumptions. I find it a can of worms. Let me illustrate my point with a simplified example. Consider the mortality assumption. Let's say that I have a table of probable mortality rates. After assessing the risks, I decide on a scaling factor of 1.2 and I use that for some of the policies. For a particular policy, however, I find that net income is reported at point of sale, so I have to increase the scaling factor to 1.3 to avoid that net income. Time goes by, the mortality risk outlook clarifies, and I now think that a scaling factor of 1.1 in place of 1.2 is appropriate. What do I do with the policy whose scaling factor has been the artificial 1.3? Do I say that its scaling factor has to be 10 points above the straightforward scaling factor? That is, do I move it from 1.3 to 1.2? That, at any rate, preserves the artificiality established at the point of sale. But I don't relish the idea of keeping track of all that artificiality. Alternatively, do I use the straightforward scaling factor of 1.1, thereby then reporting the profits I did not report at point of sale because it was morally outrageous to do so? What if a revision in assumptions takes place in the year following the year of sale?

I was a member of the joint task force that in 1982 did not recommend the policy premium valuation method. I have since changed my mind because of the theoretical arguments, both actuarial and accounting, in favor of the method, which will be well summarized by Don Keith and Hank Horwarth. Because of those arguments, I recommend the policy premium valuation method.

There are, however, other arguments—practical arguments—in favor of the policy premium valuation method that in themselves do not justify its adoption, but that are a welcome frosting on the cake. As president of the CIA, leading the Institute's attempt to get this matter settled, I especially welcome these arguments. It may be helpful to list them.

First, the transition is easy, because under current conditions, the calculated valuation premium is often constrained by the policy premium. It will become even more constrained when we put our professional house in order on the margin for adverse deviations, which is something we have to do before we can recommend implementation of the policy premium valuation method.

Second, the policy premium valuation method is natural and simple. I can explain to a layman why a valuation takes account of expected future premiums. I can't explain why it takes account of only some of the future premiums.

Third, the adoption of the policy premium method is easy to administer and will improve compliance with our Standards of Practice. There's no need to calculate a valuation premium. The actuary has to make an explicit assumption about policy administration expense; today, with implicit methods, inadequate provision is often made.

Fourth, and most important, adoption of the policy premium valuation method provides a healthy and badly needed incentive to marketing management to increase the financial soundness of their companies through higher profit margins on currently sold policies. The present method provides no credit at point of sale for healthy profit margins. Far from provoking moral outrage, I hope that the policy premium valuation method does result in reported net income at point of sale. Nothing could possibly be better for the financial soundness of the insurance industry.

MR. DONALD M. KEITH: When Mike Rosenfelder invited me to take part in this panel, he suggested that I talk about two things: first, how the policy premium method fits into the current proposal for GAAP accounting; and second, the application of this method to a few of the practical problems faced by the actuary in performing a valuation.

Before I get into my assignment, I would like to review very briefly the key events leading up to the confluence of the life insurance financial reporting tributary with the river of generally accepted accounting principles.

1977: Amendment to CBIC Act.

- o Called for the appointment of a valuation actuary.
- o Prescribed a minimum method of valuation (now known as the 1978 Canadian method).
- o Required a report to the superintendent by the valuation actuary.

- 1979: Recommendations for life insurance company financial reporting (developed under the leadership of Ken Clark as chairman of the Financial Reporting Committee). These covered everything worth knowing about valuations.
- o Verification of data.
 - o Setting of assumptions.
 - o Valuation method (1978 Canadian method).
 - o What the valuation actuary should say in reports to management and the Department of Insurance.
- 1982: Report of the joint task force on GAAP for life insurance companies (3 years).
- o To study differences between life insurance company financial reporting and GAAP and try to reconcile them.
 - o Valuation of investments, valuation of PLs, income tax, currency translation, statement presentation, etc.
 - o Recommended some refinements to 1978 Canadian method.
- 1985: Canadian Institute of Actuaries (CIA) response to GAAP report (after much debate by the Financial Reporting Committee).
- o Substantial agreement.
 - o Refinements to 1978 Canadian method a step in the right direction.
 - o But proposed the use of the policy premium method for valuation of PLs.
- 1986: CICA Accounting Standards Committee.
- o Joint task force report and all responses are dealt with.
 - o Hank will report on the progress of this body to date.

For some time I have been struck by the fact that Canadians and Americans, after taking similar approaches to policy valuation for more than a hundred years, seem to have interpreted "GAAP reporting" in two very different ways. I think the reason for this is the different order that GAAP problems were addressed in the two countries. In the United States, GAAP was first established (for stock companies) with emphasis being placed on reporting net income, and now they are moving toward establishing the valuation actuary and standardizing his work. In Canada, we standardized the actuary's work first, placing the emphasis on consistency and appropriateness, and now we are trying to agree on what GAAP is.

Because the Canadian and American solutions are so different, I felt that a critical look at both approaches would provide the perspective needed to examine the valuation question in its broadest terms. If any American actuaries have wandered into the room by mistake, all is not lost; you will at least get one outsider's view as to why GAAP reporting has not lived up to expectations in your country. I think it boils down to an incompatibility between two ideas: one that prevails in Canada to the effect that provisions for future risk should be standardized; the other, which has prevailed so far in the United States, that sales normally should have a neutral effect on income. More about that later.

In discussing "net income from a policy," let's first recognize that there will be experience gains and losses each year and that these gains and losses are by their nature recognized as they occur. What we want to talk about are the net gains over expected experience—the gains that are built into the pricing. These gains are the company's compensation for taking risks.

NEED FOR STANDARDIZATION

The timing of policy gains entering the company's income statement is determined by the choice of assumptions used in the policy valuation. That's why the assumptions and their margins are such a vital part of GAAP for life insurance companies. To resolve the question of timing, and hence what assumptions are appropriate, either in the United States or Canada, we might well ask ourselves what GAAP financial statements are supposed to do.

I submit that they are intended to measure the performance of the company's management. The income statement should show how management did in the year reported on, and the balance sheet should show the financial condition of the company as a going concern. When an insurance policy is sold, a risk is created that continues for many years. It is future managements that must live with the risk, and, in fairness to them, an appropriate amount of income should be deferred to later years. Conversely, if current management does things very well, it shouldn't blindly defer income in excess of the fair amount.

Once it is recognized that financial statements serve as a tool for measuring something, it becomes evident that we must have standards by which to do the measuring. In the present case, the standards apply to the margins in the assumptions used in the valuation. The more clearly the standards are defined and the more clearly the techniques used by the actuary are laid down, the more consistent the measurement of performance will be from one year to the next and the more comparable it will be from one company to the next.

Failure in the United States to recognize this fundamental need to standardize, and the resulting decision to depend instead on the pricing basis, bears with it a

serious shortcoming, this being the inappropriateness of the pricing basis as a statement provision for future risk. Pricing, as we all know, is influenced by all sorts of factors unrelated to financial reporting, not the least of which are the whims of a president who is trying to keep his board of directors happy until the day he retires. Actually, U.S. GAAP does envisage departure from pricing assumptions when they are known to be inadequate, but this option is far too arbitrary and too seldom applied.

Standardization has been the way of life in Canada since 1979, when the Institute adopted its financial reporting Recommendations. Standardization was also endorsed in 1982 by the joint task force on GAAJP with the recommendation "that the CIA provide more precise guidance to the actuary in the determination of an appropriate provision for adverse deviations." Both the CIA and CICA concurred with this recommendation.

What provision there should be in the policy liability for future profits depends on what a company does in those future years to earn profits. It is evident that the company does two things: it services the policy as long as it remains in force, and it bears the risk associated with any benefits claimed. In a generic sense, these two functions are exactly the same: in each case, expenses and claims, future costs are unknown and must be estimated and provided for. In each case, the function performed by the company is one of risk taking and there is no reason to treat expenses any differently than claims. In each case, future managements have a right to fair compensation for risks being taken on by today's management.

What constitutes "fair compensation"? The accounting profession has a clearly stated qualitative answer to this question, but so far not a very good quantitative answer. It says that any future uncertainty associated with an accounting estimate should be properly provided for, and the provision should be released into income when it is no longer required. What actuaries call "release from risk" is exactly the same thing. The accountants go further to say that there is no other justification for conservatism. And so do we actuaries, for that matter, with our requirement that assumptions be "appropriate."

What accounting theory doesn't tell us is how to go about determining such a provision, and there is a legitimate concern among some accountants that the provision could too easily be subject to manipulation. The Financial Reporting Committee is working with the CICA on this very question, and I think it would be safe to say that valuation actuaries everywhere will welcome any help they can get.

AN EFFECT OF SALES ON INCOME

Let's now examine what happens when the actuary does come up with assumptions independent of those used in the pricing. Usually, the valuation assumptions are more conservative, and the initial reserve, combined with sales and issue costs, tends to create a net loss at time of sale. I know that some will say I am back-ending profits. I stand guilty as charged, but let me say to my accusers that, with diligent search, I'm sure I could come up with someone in Canada who feels otherwise.

Supporters of U.S. GAAP would object to the appearance of this loss before anything has really happened. But something has happened. The new policy has

exposed the company to a risk that, for reporting purposes, at least, is not adequately covered in the pricing. If this vital fact is ignored in the financial statements, there will be no distinction in the statements between companies doing sound business and those that are cutting corners with their pricing. In other industries, price cutting shows up in the financial statements very quickly, but insurance policies stay on the books for a long time, and the effects of price cutting are not revealed unless valuations are standardized.

If income is to be deferred to cover risks assumed, the effect must be borne when the risk is taken on. When that is done, the net income follows a pattern somewhat different from U.S. GAAP: negative in the first year and positive in subsequent years in amounts designed to reflect the risk borne by the company in each accounting period. The net income still adds up algebraically to what is provided for in the pricing, but is now deferred somewhat. This treatment is absolutely essential if financial statements are to reflect current pricing decisions and if future financial statements are to reflect properly the risks being assumed today.

Now that the United States is moving toward establishing the position of valuation actuary, and especially if it requires that person to follow standards in setting valuation margins, U.S. accountants are soon going to face a dilemma. If they retain the pricing basis for GAAP valuations, they will have to continue to live with the confusion of two different financial statements. Then, if the standards followed by the valuation actuary are also endorsed by the accounting profession, as we are moving toward in Canada, someone will have to explain why these two statements both conform to accounting principles. I hope I am around to see the footwork!

The Canadian answer to this dilemma is to be found in the superintendent's requirement that a certain part of retained earnings be earmarked as unavailable for distribution. This requirement, in effect, places a minimum on a company's retained earnings due to specific balance sheet items with different values, depending on whether we are reporting on a going concern or testing solvency. We heard in Session 2 from Wayne Bergquist the work currently going on to improve the basis for this solvency restriction.

I said earlier that usually the valuation assumptions will be more conservative than the pricing assumptions. Under very favorable circumstances, we could have the opposite situation, where the valuation assumptions, although in full compliance with standards, are less conservative than the pricing basis. In this case, we will have an extra source of income: namely, what is left over after fully providing for the risk-bearing function, which, of course, includes the risk of not receiving your premiums. How is this residual income earned, and when should it enter the income statement? This brings us to the question of method.

It is here—and only here—that the policy premium method departs from traditional valuation technique and it is very important that we keep this departure in perspective. It is only in this situation that net methods actually hold back any part of the policy premium. But, since the valuation margins already defer income to match all future risk taking, there is no reason to hold back part of the premiums. To do so, for whatever reason, would duplicate the margin in an assumption we've already determined to be appropriate (most likely our withdrawal assumption) and thereby render it inappropriate. On the contrary, there is very clear justification for recognizing this residual profit at time of sale. It is the success in selling policies under these favorable conditions

that enables the company to earn the extra income. If the extra income is deferred, future managements would get the credit for the good job being done by current management. Thus, the income statement loses its efficacy as a measure of management performance.

Accounting principles support this approach. Accountants tell us that income should be recognized as soon as it is earned. The words "as soon as" make it clear, once it is decided when income can be considered earned, that only one valuation method will do so at the correct moment—no earlier, no later. Accounting principles also require that the residual gain be handled the same way the loss would be—which, if the Canadian approach I've been describing is correct, is in the first year. Moreover, holding this gain back and adding its value to the policy liability constitutes what accountants would call a "secret reserve," which has been taboo for most of this century. It is interesting to watch proponents of net methods cling to the extra fat those methods conceal, and then drop it like hot grease later on if they need the money to conceal the cost of a strengthening!

The policy premium method has the support of actuarial theory, as well. In 1979, when the transition from a purely solvency standard to a financial reporting basis began, the standard for valuations became a two-edged sword: "good and sufficient" gave way to "appropriate," and an excessive estimate became just as wrong as an insufficient one. Those who objected to this change did so because they wanted to continue to hide surplus under the umbrella of ultraconservative valuations. The invisible surplus made managements look good by generating

very visible profits. Objections to removal of the cash value floor and to adoption of the policy premium method, I dare say, are motivated by the same desires.

PRACTICAL CONSIDERATIONS

The advantages of the policy premium method from the viewpoint of the person actually doing the valuation are in the practical application. There isn't very much to talk about here, because many of the familiar problems simply go away. Calculation of that dreadful artificiality, the "net valuation premium"; so-called deferral of acquisition expenses; premium deficiency tests; and the omnipresent arbitrary limitations associated with net methods all disappear.

The entire family of net premium methods has kept us pretty much in the dark for what seems like eons, and suddenly, now, we can see what we're doing. So can accountants, auditors, regulators, stockholders, and anyone else who reads our financial statements. Strangely enough, the light seems to fall according to some company-by-company phenomena.

The darkness is amply illustrated by the difficulties experienced by the term insurance task force under Charles McLeod in trying to test the term policy liability's sensitivities to the various assumptions. The task force tried to do this test work using first the 1978 Canadian method and then the net level premium method, but it found in each case that the distortions in the method itself made the task impossible. It was only when the task force adopted the policy premium method for its testing that it became clear how the assumptions interacted with one another.

At the same time, the policy premium method demands of the actuary a greater discipline than is evident at present. Because margins have a function in the income statement as well as the balance sheet, it is not satisfactory to come up with a correct total provision for adverse deviations and ignore the policy year pattern. And it certainly isn't satisfactory to cut corners, as net methods do, in the hope that the padding built into the method will cover our sins.

Examples of how this method will produce valuation reports of better quality might well be offered by someone from the Department of Insurance rather than by me. It is well known that valuations have not been of consistently high quality, and some of the fault certainly lies with the complexities inherent in the method currently used.

One thing the new method will force us to do is look objectively at all future administration costs. If these costs are on the increase, we had better provide for them. If there are special costs in certain future years, such as term renewal dates, we had better provide for them too. We can't just assume that expense allowances held back out of future premiums will cover these costs; the pattern is nowhere near the same, and many policies don't have any future premiums.

The disappearance of the need to test for premium deficiencies will be a blessing. Some policies are so complicated these days that it is hard to tell whether the valuation premium is recoverable or not. The fear today is that some actuaries are assuming it is recoverable without really testing it. That seems to have been one of the problems underlying the recent term to 100 and renewable term difficulties.

Nontraditional policies are the big problem these days, with so little data on which to base the valuation. Yet the valuation actuary has at least as much to go on as the pricing actuary. He can look at future claim patterns, future administration expenses, and premium payment patterns, and make judgments similar to those the pricing actuary made—and from a better vantage point. The key difference is that the valuation actuary is expected to make those judgments independently, following valuation standards rather than market considerations.

Another current problem is reinsured business. A company that sells a policy and then insures it is essentially off the hook for the claims risk, although it still must administer the business and keep it on the books. Yet present methods force that company to spread the profits over the full term of the policy. Hence, unless the valuation is based on premiums actually charged, the financial statements make no distinction between two companies selling similar products with different premiums, even though the claims risk and withdrawal rates have been fully covered.

It will be infinitely easier in the future to understand and handle a change in valuation assumptions. I recently looked back at the mass of correspondence from the time this testy question was being debated by the Financial Reporting Committee. You wouldn't believe the complexities we got ourselves into, all having to do with treatment of the difference between the policy premium and the net valuation premium: whether to preserve this difference or let it change; whether it should be permissible to increase the difference as well as decrease it; whether to amortize all of the change, part of it, or none of it; and if so, why, how, and over what period. There must have been at least a dozen proposals on the table at one time or another, every one of them displaying sophisticated

reasoning from a premise that ultimately proved to be unsound. In fact, it was this very problem that brought to the surface the folly in letting the valuation premium be anything but the policy premium. Now we will be able simply to change our assumptions, do another valuation, and take our profit or our lumps, as the case may be.

Regulation certainly becomes a more direct and reliable process. The Department of Insurance can focus on the appropriateness of the assumptions, which are the judgmental part of a valuation. In the case of renewable term, and to some extent term to 100, the Department of Insurance was happy with the assumptions but had to admit it couldn't really tell why the reserves came out so low. It took a very close look at this problem by Charles McLeod's task force to sort out what was actually going on.

Another regulatory problem is that of trying to describe in law the valuation method that should be used. What we have at present is a prescribed method for level premium policies and a requirement that liabilities for all other policies be modified in a manner the superintendent considers appropriate. In effect, the Department of Insurance has thrown its hands up trying to tell us exactly how the current method would have to be adapted to the many possible situations. Not surprisingly, this leads to problems of interpretation. The actuary must think through what the real premiums are and their probability of collection, how the 1978 Canadian method would arrive at the net valuation premium in the level premium case, and then what the analogous calculation should be for the policy at hand. Using the policy premium method, we simply drop the last two steps and avoid the inconsistencies arising from a variety of interpretations.

SUMMARY

Where does all this leave us? I believe, as we move forward with the task of coordinating policy valuations with GAAP, that our primary concern is understanding better what we are doing and improving how we do it. Toward this end, the train of thought I have followed, which should be equally applicable in the United States and Canada, goes something like this:

1. Financial statements should provide a useful and meaningful measurement of management performance that is consistent from year to year and comparable to other companies.
2. Any measurement calls for standards and what needs to be standardized here are the margins in the valuation assumptions.
(These first two points I address to our American colleagues.)
3. Use of valuation margins causes a deferral of income that is justified by the uncertainty created when a policy is sold. (The case for this must be made to a handful of accountants who argue against any deferral of income.)
4. The effect of standardizing the deferral of income, whatever that effect may be, is necessarily incurred in the year of sale.
5. The effect is usually a cost, but under circumstances very favorable to the company, it can be a gain. This depends on the relationship between valuation standards and pricing margins.

6. Any deferral of such a gain that is implicit in the valuation method distorts the standard of measurement that we have taken so much trouble to establish. (This point is aimed at those actuaries who would rather be safe than right).
7. The directness and simplicity of the policy premium method offer many practical advantages, both for the valuation actuary and for regulators, and are better understood by accountants and others who read our financial statements.
8. If the valuation method and the rationale behind it are properly understood, the quality of valuations and likelihood of conformance cannot fail to improve. (This fact and the preceding one should certainly win the notice of the Department of Insurance.)

MR. H. D. HOWARTH: In 1985 the Accounting Standards Committee of the CICA approved a project that would remove the exemption of life insurance companies from the recommendations of the Handbook. This final step in the evolution of GAAP for life insurers is the culmination of a long, and for some a frustrating, process.

As early as 1973, a CICA research study entitled "Financial Reporting for Life Insurance Companies" was published, seeking to promote comment and discussion toward more consistent treatment within the industry. Its chairman, Gord Johnson of Imperial Life, has come full circle—now serving, 13 years later, as an advisor to the current committee.

In 1982 a joint task force of the CICA and the CIA attempted to develop financial reporting and disclosure principles that would become generally accepted as both accounting and actuarial principles. Mike Rosenfelder and Ken Clark both served on that task force.

The Accounting Standards Committee is indebted to all those volunteers who devoted their time and talents to provide such important research into a difficult, seemingly insurmountable objective. It is obvious that mutual concern among both professional bodies has been a driving force behind a resolution on the current exclusion of life companies from the Handbook.

For all our progress to date, the jury is still not in. Although the committee will be issuing an exposure draft late this year containing its approved positions, we cannot gauge the reaction that may come from the industry, regulators, or our professional members. Our greatest detractors may originate within the accounting profession itself—in particular, acceptance of the concept of the actuarial liability calculation within the historical cost model. I won't dwell on this, other than to indicate that the prospect of one balance sheet account that, just for starters, nets future revenues and expenses, contains contingencies with an acronym PAD, incorporates some dividends, and summarily discounts to present values, may bring tears to the eyes of even the most progressive of accounting purists.

Let us turn our attention, then, directly to this actuarial liability account and review some of the major principles involved that ultimately lead us to a choice of the appropriate method for its calculation.

The first of these principles is consistency—consistency of accounting treatment that underlies both the necessity for, and the usefulness of, a professional handbook. To bring life insurance companies within the Handbook, and thereby accept the rationale of consolidated financial statements, requires insurers to conform, where applicable, to accounting conventions previously established. One factor within the actuarial liability equation that is in contravention of established GAAP is the concept of provisions for solvency. Our position is clear that such provisions (defined as the cash value floor method or some other term), which may be very necessary to satisfy concerns of regulators or management, should be reflected as appropriations of retained earnings. Such treatment correctly divorces solvency concerns from proper recognition of income or liability disclosure.

The second principle relates to income recognition, more commonly known as the "matching principle." Much has been written on this topic, and arguments abound for and against any position one wishes to take. In the interest of time, let me boil it all down to the essential ingredients and process that led to our proposed position for matching of costs and revenues of life insurance contracts.

While the matching principle is normally applied to the allocation of costs in relation to revenues derived, in this instance the existence of a liability that is composed of future revenues net of future expenses and obligations adds an extra degree of complexity. The change in this liability within a fiscal period represents an adjustment to the actual revenues derived and expenses incurred, forcing the normal application of GAAP principles upon the individual components of the liability.

The first of these components is revenue. Recognition of future revenues is appropriate under current GAAJP if significant uncertainty about the amount that will be realized is removed. Where a valuation actuary uses reasonable assumptions and tempers those with a margin for adverse deviations, a methodology generally accepted in the industry, this should constitute such removal of uncertainty. No other arbitrary restrictions, such as valuation premium maximums, would be appropriate in the determination of the present value of future revenues.

The other component, of course, is cost. I use the term cost to denote a combination of various types of expenditures:

- o The allocation of past acquisition expenditures.
- o The future administrative expenses.
- o The future policy obligations, including benefits and policyholder dividends.

The objective of the matching principle is to determine income in a manner that best reflects the cause-and-effect relationship between costs and revenues. The allocation of policy acquisition expenses to the full term of contract revenue would represent appropriate treatment under this principle. Since the amount and timing of future policy expenses and obligations must be estimated, concordant reasonable assumptions and margins for adverse deviations used by the valuation actuary for these components would reduce the uncertainty of payment and provide a proper match with future revenues.

Having defined the treatment of both revenues and expenses within the actuarial liability calculation, we are left, then, with a future income stream and an

immediate income or loss at point of sale. This income stream, which assumes, through perfect foresight, that reasonable assumptions will be experienced, will reflect the release to income of all margins for adverse deviations. Is such a methodology of income deferral and recognition appropriate under normal GAAP?

The committee engaged in considerable debate on this issue. It concluded that future income from life insurance contracts represents that portion of total policy income that is attributed to the risk assumed by policy issue and that ultimate release from risk in future periods should be recognized as income in those periods. This pattern of recognition would reflect a rational and systematic manner of income allocation over the life of the contract.

Any income or loss generated by initial valuation at sale, experience differing from reasonable assumptions, or changes in future estimates should logically be reflected in the current period. The logic of this statement is not predicated specifically on a principle of accounting, but rather relates to the accounting profession's constant debate over the hierarchy of financial statements. Since financial statements must articulate, income measurement issues often result in somewhat dubious account balances on the Balance Sheet. Such items include unamortized financing expenses, deferred foreign exchange gains or losses, and deferred tax.

The reverse is also true. Where issues are resolved in favor of more appropriate balance sheet treatment, resulting income becomes nothing more than a residual calculation. Examples include treatment of inventory values and receivables balances.

The committee realizes that if the income measurement issue takes precedence over balance sheet liability determination, then actuarial liability valuations would become meaningless, retaining a host of residuals that lack credibility in relation to the portfolio of assets held. Consequently, the committee has opted for appropriate balance sheet liability presentation with residual incomes or losses flowing through on an annual basis.

The practical effect of all this theorizing comes down to the following: First, of the present or potential methods of calculation of actuarial liabilities reviewed by the committee, which include the current method, the current method without limitation of acquisition expense deferral, and the policy premium method, the policy premium method best exemplified the principles I have just outlined. Our exposure draft should reflect this recommendation. Second, since a future income stream will be established upon the sale of new policies, and that stream of income will be founded on the size of margins for adverse deviations, I would implore the actuarial profession to finalize measurement standards for the industry in this area. Although the competitive nature of the industry currently may not offer scope for actual premiums to exceed valuation premiums on new policy sales and therefore generate residual profitability at point of sale, the committee is definitely concerned about valuation premiums on new product sales that may significantly exceed gross premiums.

If these residual losses were to continue to be excessive, financial reporting might ultimately lead to the inevitable credibility gap between life insurance management and readers of financial statements, when management must publicly state that "the strong growth in earnings is the result of excellent investment performance, reduced mortality in individual and group insurance,

and a slower rate of individual life insurance sales." Such a statement sends a clear message that selling insurance in the current market is a negative business decision. I do not believe this is the case, nor should methodologies dictate that management must be forced to offer such explanations.