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THE IMPORTANCE OF BEING ERNST

by W. H. Odell

Robert Posnak, *Ernst & Ernst GAAP—Stock Life Companies*, 653 pages, Ernst & Ernst, 1974.

Many individuals working with GAAP over the years found much of value in the Memorandum *Natural Reserves and Life Insurance Accounting* published by Ernst & Ernst in August 1970. They have been eagerly awaiting a sequel — a book which they hoped would be a comprehensive, well considered, and well illustrated exposition of a complex subject. This is the book and expectations have been more than fulfilled.

This volume will be sought after by every individual connected with GAAP work as a guide, as an explanatory text, and as a book of reference. This reviewer suggests that the Introduction be required reading for all actuaries whether or not they are actively at work in GAAP. To encourage them it should be mentioned that a most pleasurable aspect of the text is a visible sense of humor which starts in the Preface and is continued throughout. The light touch of Mr. Posnak is more than welcome in a volume of 653 pages on such an involved and onerous subject.

The success of the book is due in no small part to clarity of diagnosis of problems and objectives by those who initiated and managed the project. In the introduction, it is stated "the problem giving rise to this research project is the fact that the application of generally accepted accounting principles to life insurance companies has not definitely been determined. Underlying this general problem is the problem that the nature and practices of the life insurance business are not adequately understood from the accounting point of view." This text will surely go a long way toward promoting such an understanding.

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THE 1975 TRUSTEES REPORTS

by Robert J. Myers

The Social Security Act provides that, on or before April 1 of each year, the Board of Trustees of the OASDI trust funds and the two Medicare trust funds should submit to Congress reports presenting statistical operational data, future cost estimates, other actuarial analyses, and financing recommendations. Actually, there are three reports, for OASDI, for HI, and for SMI. The Board of Trustees consists of three cabinet officers (the Secretaries of HEW, Labor, and Treasury).

Of foremost interest in the 1975 reports is the one dealing with OASDI, because the financial plight of this program has been so much in the news in recent months. The 1974 report showed a very serious long-range financing situation in that there was a lack of actuarial balance of 2.98% of taxable payroll, or a cost over-run of about 25% relative to the tax income. This year's report shows an even worse situation — namely, an actuarial deficiency of 5.32% of taxable payroll, or almost 50% of the average value of future taxes. This is certainly a far cry from the situation that prevailed before the 1972 Amendments, when the "acceptable limit" on the actuarial imbalance was 0.1% of taxable payroll, or about 1% relatively, and this limit was almost always maintained (or else prompt corrective action was taken by Congress).

The increase in the OASDI actuarial deficiency under OASDI results primarily from a change in the long-range economic assumptions. The 1974 report assumed annual rates of increase in earnings in the ultimate situation of 5% per year, as against 3% increases in the CPI. The 1975 report uses 6%/4% assumptions. Some 83% of the increase

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ACTUARIES AND ASSETS

by Irwin T. Vanderhoof

Over the past five years, an increasing number of actuaries have become concerned with the asset side of the balance sheet. Many papers on investment topics have been presented and several actuarial consulting firms have begun including investment advisory work in the services they offer to clients. Clearly, an area of actuarial responsibility exists here which so far has not been well-defined.

The following definition of the responsibilities of the actuary in investment matters has no formal endorsement by any actuarial body or company, but has been discussed with other actuaries who have offered no serious disagreement. Once stated, these responsibilities should seem obvious to everyone. All comments and criticisms are welcome, since I feel the profession must decide upon a course of action or allow this matter to escape us as has the question of adjusted earnings.

In this article, I will be referring to those responsibilities that we have automatically because we are actuaries, not those which individual actuaries may have because of non-actuarial expertise. Choice of specific investments is *not* one of these responsibilities. Some actuaries may be proficient in this area, but it is not an integral part of the material of the profession.

What is the basic responsibility of the actuary? I think it is the determination of the surplus of a fund (or the determination of the adequacy of implicit margins in the assumptions, which is inherently the same). Surplus has traditionally been the difference between the liabilities the actuaries have been concerned with and the assets they have merely accepted. This unilateral concern

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Importance of Ernst

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real life situations. GAAP, along with the illustrations in this text, has shattered this rather peaceful state of affairs. The illustrations show that with respect to intermediate reserves as well as in connection with many other practical matters concerning GAAP, it is necessary to rethink things through from first principles as opposed to adopting methods which prior to GAAP might have been labeled "traditional." (A minor off-key note is reference at one point to a reserve as a "fund.") Detailed formulas for the actuarial calculations underlying the examples used throughout the text are presented.

Part III — Expenses. This begins with a clear and detailed presentation of terminology of the subject. The discussion of the actuarial approach to cost accounting does not clearly spell out the practice, still followed by most companies, of assigning all costs of an insurance company to policy years. The concepts of variability and attribution are treated in some detail. The question of renewal acquisition costs is also discussed. Throughout this entire discussion the reader is continually reminded that the Audit Guide as adopted did not provide for complete matching of costs which in the pricing process are considered first policy year costs against revenues (which was the basis for one of the exceptions of the Joint Actuarial Committee to the Audit Guide) and that the Audit Guide does not use the concept of assigning all costs to policy years.

The material on amortization of acquisition costs includes detailed discussion of the "factor method" under which reserve factors are determined and the "sum-of-the-years' premiums method" and "related worksheet methods." It was the discussion of "sum-of-the-years' premiums method" contained in the memorandum which was the predecessor of this book that apparently led to the development of many of the types of amortization tables used in the industry today. The case for and against amortization with interest is discussed in depth. The American Academy Committee Recommendation No. 1 points out that, in accordance with the concepts of matching and an overall reserve, actuarial principles require the use of interest. The matter of persistency experience varying from that assumed is given special attention.

Part IV — Other Lines of Business. This deals with lines of business other than individual ordinary life in some detail. An example of the depth of the text is the discussion in Chapter 18 *Industrial Insurance* of the cost differential between the extended term and cash surrender non-forfeiture options. Subjects that are characteristic of the industrial way of doing business, such as times contracts, are analyzed in some detail and extensive numerical illustrations are presented to show how they may be accounted for on a GAAP basis.

The first topic treated in Chapter 19 *Individual Health Insurance* is the classification of policies between short term and long term. The conclusion is reached that "the nature of commercial health insurance is such that prorated gross unearned premiums should be held in respect of active lives in all cases and acquisition costs should be amortized to income in proportion to premiums earned." Later in the text it is clearly indicated that deferral of acquisition costs on commercial insurance may be entirely appropriate depending on persistency expectations. The nature and characteristics of individual health insurance are reviewed. The exposition of how GAAP accounting is applied to individual health insurance is again illustrated profusely with examples using for the most part noncancellable disability income coverages. Other insurance products that must be accounted for in the GAAP statement are given attention ranging from simple YRT reinsurance on the one hand to IPG group annuity contracts on the other.

Part V — Special Problems. This section covers a wide range of topics. The material in Chapter 23 *Deferred and Uncollected Premiums* is an extensive and well-illustrated exposition of this difficult subject. Most actuaries interested in GAAP accounting will probably find some time spent with this chapter particularly worthwhile. With respect to the controversial subject of the handling of deferred and uncollected premiums, the author reviews some of the practices that appear to be permitted under the Audit Guide and concludes that ". . . deferred and uncollected premiums represent reserve adjustments . . ."

The procedures for performing recoverability and loss recognition tests are described along with such special situations as participating business and experienced unit maintenance costs which are greater than the gross premium structure can support. The material on deferred taxes and business combinations will be helpful to those who have special interests in these subjects even though some of the material may be dated.

Some of the other considerations involved in GAAP statement work are discussed with particular attention to the role of the actuary. This subject is obviously of extreme interest to all actuaries. With respect to the publishing of the actuarial opinion, for the public, the author concludes ". . . such mention [of the actuaries' opinion] might take the form of discussion in the text [of the stockholder's report], publication of the actuaries' letter reporting the scope and results of his review, or a note to the financial statements . . . " which is in accord with Opinion A6 which in reference to the guides to professional conduct says ". . . the objective of Guide 2c will be more fully satisfied if the auditor's opinion identifies the actuary or if published financial statements include a formal actuarial opinion."

The author concludes that "accountants and actuaries were so exhausted by the traumas of 1973 that they didn't have the energy to count their riches and in fact would gladly have handed them back if only the agonies could have been reversed." Many life insurance company presidents and ex-presidents would have been glad to oblige if this were possible. □

Actuarial Meetings

Aug. 6, San Francisco Actuarial Club

Sept. 3, San Francisco Actuarial Club

Sept. 7, Seattle Actuarial Club

Oct. 15, Seattle Actuarial Club

Oct. 24, Middle Atlantic Actuarial Club

Death

Owen C. Lincoln