Summary: The status of emerging issues in financial reporting is discussed. These include the National Association of Insurance Commissioners (NAIC) codification project, other NAIC issues, and new developments at the Securities and Exchange Commission (SEC) and Financial Accounting Standards Board (FASB).

Mr. Frank J. Buck: We have two guest speakers with us. I think you will be very pleased that they are both accountants, although we don’t hold that against them. The first one is Steve Butters of Deloitte and Touche. He is a member of the NAIC Codification Advisory Team, and he is going to talk about the codification process—where it is, how the process works, and what that is going to achieve. Steve has been in the profession for 20 years. He joined Deloitte and Touche in 1975, but also has ten years experience in the financial services industry as chief executive officer (CEO) and chief financial officer (CFO) of a savings and loan organization. He’s a graduate of Ankora State University.

The other speaker is Tracey Barber, who is a Professional Accounting Fellow at the SEC. Tracey’s responsibilities are to deal with accounting issues and the financial instruments in the financial institutions industry. She is also a liaison with various standards setting boards—the FASB, the Emerging Issues Task Force, and the
Mr. Steven Butters: The topic I’d like to address with you is the codification of statutory accounting project that is currently occurring. I want to talk to you about the codification process, what the nature of the project is, what the role of Deloitte and Touche is in assisting with the project, why the project is necessary, and what created the need for the project and its objectives.

Later in the presentation I want to talk about the industry reaction and also give you an update on the current status of the project.

The codification project is being undertaken by the regulatory community. It is being facilitated by the NAIC. The purpose of the project is to create a comprehensive basis for statutory accounting principles. Currently statutory accounting principles, as you are aware, are established in a number of different ways, including through state statutes and regulations, NAIC publications, as well as other documentation that is many times sparse. There is a need to create a comprehensive statutory basis of accounting for use by insurance departments, the industry itself, and auditors for the industry.

The role that Deloitte and Touche is playing in the project is to serve as the primary consultant to the NAIC working group that is creating the statutory accounting principle codification. We provide support to the NAIC staff, as well as the working group members, to research current statutory accounting from its various sources and current generally accepted accounting principles (GAAP) that deal with the various issues to provide them with the background from which to develop the working papers.

At the end of the project, we will also assist in the final codification and provide continuing support to the working group after issuance of all the issue papers.

The reason for the perceived need for the project is to provide regulators with uniformity among all the states. Currently each state establishes statutory accounting for insurers domiciled in that state and regulators from other states are not always certain how to measure or how to judge that company. The determination was also made to form the codification around a well-defined statement of concepts. The first step in the project was to develop a statement of concepts of accounting principles, framework around which to build the codification.
Auditors also had a similar problem in defining statutory accounting principles because not only was there diversity among the various state regulatory agencies but there is also a lack of documentation in many cases on exactly what statutory accounting principles were. The auditors, because of a statement issued in 1995, are also required to disclose or assure that the companies have disclosed the differences between prescribed statutory accounting principles and permitted practices that the state of domicile may allow a particular company to use. The industry also will benefit from a comprehensive statutory basis because the current NAIC accounting guides are not adequate and do not provide sufficient guidance.

The project really began in early 1994 with the appointment of a working group to develop a work plan for the codification project. In April 1994 the initial draft of the statement of concepts was developed along with the work plan, which was finally approved in September 1994.

The statement of concept provides a broad framework for the development of the codification and is based generally on three principles: those of conservatism, consistency, and recognition. These provide the basis for development of the subsequent issue papers. It is also supported by the hierarchy of GAAP, with the highest hierarchy in this project being the NAIC practices and procedures, followed by GAAP, FASB statements, technical bulletins, and so on.

The objective again is to develop a single, comprehensive basis of statutory accounting principles that is built around a sustainable statement of concepts and framework to provide a theoretical basis for the codification. Additionally, it pulls the statutory accounting practices and principles into a single source rather than all the various state statutes and various sources from the NAIC. This will be a comprehensive guide for all statutory accounting principles in a single process.

The other issue is to develop a process to continue to keep this project current, so that the codification stays relevant and keeps up with industry or attempts to keep up with industry.

I would like to give you a framework of how the issue papers are being developed, which will then be followed by the codification. There are four primary participants in the development process. The initiation of the project is led by the working group, which consists of various state regulatory department representatives, the staff of the NAIC, and ourselves as consultants.

The members of the working group represent eleven states and all have been appointed by the insurance departments of these various states. Generally they will be at the assistant commissioner level, although there are at least one or two commissioners on the working group.
The principal staff members at the NAIC who are leading this project are: Darrin Cook, who is the director of financial services; Barbara Dehaemers for property and casualty (P&C) accounting; Jane Kipper, life and accident and health; and Joe Sieverling, financial services. I might also mention that you should contact Barbara Dehaemers if you wish to obtain the issue papers that have been released for public exposure. They can also provide you with a website address, so you can pull up the exposed issue papers on the Internet, if you wish.

The project really began after the statement of concepts was developed. The working group developed the list of issue papers that would need to be addressed to develop the codification. The NAIC staff and Deloitte and Touche were assigned to go out and research the existing documentation that dealt with the various issues in the papers, to provide the working group with the current statutory accounting and any diversity among the states, as well as what GAAP would provide. The papers, after direction from the working group, were then developed. The NAIC staff would then complete their review, revise the working papers, which were then presented to the working group for further editing and review.

After the working group has reached consensus on a particular issue paper, it goes through a public exposure period for industry and public comment, and then goes again through another revision process following the comment period, during which comments are reflected. The issue papers provide a very good outline for the particular issues and incorporate existing documentation for statutory accounting (as it currently stands) and GAAP. These issue papers will then be drawn together in the final codification and will provide a continuing source of background material as the codification later becomes available.

What has been industry’s reaction to this process? I think generally one would have to say that the industry has been supportive of the project. It does provide industry with greater guidance in defining the statutory accounting principles and what measurements are going to be used for the industry. It is a single comprehensive basis.

There was concern expressed early on by the industry. The working group meets privately to develop and discuss the issue papers initially, prior to the public exposure period. There was a concern by industry due to the closed nature of those meetings early on in the project because, at that point, there wasn’t anything released for public exposure and industry had a concern about the input they would have into the project.

The NAIC and the working group attempted to respond to that concern by having a public forum in July 1995. Though that process now has public meetings at each of
the quarterly NAIC sessions, it also schedules open meetings for discussion of the public comments to give industry a public forum to share their comments on the various issue papers.

Right now there are 82 issue papers on the agenda. Eighteen of those issue papers have been released for public exposure and have then been revised and reworked following the public comment period and are currently in the second public exposure period. There’s an additional 35 papers that are in the initial exposure period, many of which are the reserve papers that have just been released in the last couple of weeks. The majority of those have a comment period that ends toward or at the end of July.

I thought we might brush on some of the issues that are impacting current statutory accounting. The first issue is pensions and postretirement benefits. I think this is a good example of the working group’s sensitivity to industry comments in certain respects. There’s also the electronic data processing (EDP) equipment and software and the accounting for that.

One of the early issue papers, Issue Paper 4 provides a definition of liabilities and loss contingencies for statutory accounting purposes.

The issue paper on investments continues the asset valuation reserve (AVR) and interest maintenance reserve (IMR) concept for life insurance accounting.

I also wanted to touch briefly on guarantee fund assessments.

On pensions and postemployment benefits, the initial release of the issue paper basically adopted GAAP. The key issue there is that GAAP will generally require you to accrue a liability not only for vested benefits under these plans, but also for nonvested benefits to accrue those over the life of the employment period. That was a change generally from current statutory accounting, and industry comments reflected that. Following the public comment period, the working group did in fact revise its issue paper, and as it is currently being re-exposed it does exclude nonvested benefits under these plans.

Under the issue paper, as currently exposed, electronic data processing equipment and software are treated as a nonadmitted asset. Depreciation will flow through the statement of operations; however, the undepreciated portion is excluded from statutory surplus.

The definition of liabilities and loss contingencies is provided in the issue papers and under the statement of concepts. It provides that liabilities will be recorded as
incurred and provides a basis for definition of loss contingencies and impairment of assets. It requires that a liability be recorded or an impairment be recorded when it is both probable and estimable that a liability has been incurred or an impairment has taken place. If it is either not probable or a liability cannot be estimated (and therefore is not recorded because it doesn’t meet both of those criteria), then disclosure is required. The issue papers, as currently exposed, do retain the AVR and IMR concepts, and I think the working group generally felt that they had been addressed recently in the statutory community and continued that valuation process.

Guarantee fund assessments are required to be charged to expenses. The liability is recorded at the point in time when it is probable that an assessment will be made and it is also reasonably estimable. In those cases where you have premium tax offsets, they are treated as admitted assets, if it is probable that you will be able to realize that asset.

The project right now is in the latter stage of development of the issue papers. Within the next several weeks, the remaining issue papers are expected to be completed by the working group and released for public exposure. The public exposure period is 90 days following the release of the papers. After completion of the public exposure period for all the papers, the guidance will be pulled together and summarized to gather all the issue papers into a single document that will provide the base of the codification.

Once the codification is addressed, it will again be released for public comment and review and then the final guidance will be released.

Currently about 54 of the 82 papers have been released or have been re-released for public comment. Other papers are currently being revised for industry comment. Other papers are nearing completion. The majority of the reserve issue papers have been released just within the last couple of weeks and are currently available. So I would encourage you to contact the NAIC to obtain those issue papers of interest. That will summarize my comments.

Mr. Buck: I think we should break with tradition and take questions. Steve, I am interested to know what sort of major, contentious issues you have come across in this process, issues where you have significant differences in practice.

Mr. Butters: Yes. There are significant differences among the states and it has been interesting within the working group. Industry reaction has also been interesting. While industry, I think, is supportive of the project and the concept of a codification, there certainly are always going to be issues with the regulatory side versus industry. I think the public exposure period seems to be working well; there are
industry groups formed to address the codification and hopefully that process will continue.

Mr. R. Thomas Herget: When the project is complete, let’s say we will have all 80 issues papers addressed and resolved, and we create a final document. What happens to that document? Does that go back to each state, and does each state have to adopt it, or does it just exist by itself and that’s the end of the project?

Mr. Butters: That’s a very good question. The codification will provide the basis of what is considered statutory accounting principles. When companies are required to present statements in accordance with statutory accounting principles, that will be the principal guidance. However, it does not usurp each individual state’s right to establish accounting principles different from those required by the codification. What it does require, though, is disclosure where those principles would differ from the NAIC guidance.

Mr. Herget: So this will be an additional source, or an additional document that an opining actuary would need to be aware of in order to complete his reserve calculations.

Mr. Butters: Yes, that’s correct. You will need to be aware of the codification, as the various states adopt it or adopt it with certain exceptions. Generally I would say the codification is your guidance unless states have made an exception to it.

Mr. Herget: Right, it seems like the codification of, say, cash-flow testing reserves wouldn’t be necessary, because they’re not exactly determinable. You can’t really put your finger on them as an event that’s likely to happen. But it seems to me that we still need to hold those reserves because they’ll be in the Standard Valuation Law (SVL) and the Actuarial Opinion Memorandum.

Mr. Butters: Yes. The issue papers, as they currently have been released, do incorporate the model investment law.

Mr. Herget: Does this obviate the need for mutual company GAAP, now that there is a statutory codification that you could opine on? Would Financial Accounting Standard (FAS) 120 and American Institute of Certified Public Accountants (AICPA) 94-5 still be relevant?

Mr. Butters: Yes, there will continue to be differences between statutory accounting principles and generally accepted accounting principles, so both will continue.
Mr. Bruce R. Darling: I’d just like a little bit more clarification on the timetable for all of this. You say the rest of the papers will be released in early 1996, but it’s already mid-1996. Could you be a little clearer on when we’ll see the last of them? Are there only 82? I had originally heard there were 100.

Mr. Butters: Currently there are 82, I believe. They’re numbered one through ninety nine, but there are some blanks in there. The other question is, how long do we expect the exposure period to last?

The initial exposure period on a paper is 90 days from the date of release. It is then re-exposed. After the issue papers individually complete the exposure period and they’re pulled into the codification itself as a single comprehensive basis, there’s a six-month public comment period planned. Right now, I think the working group is anticipating releasing the last of the issue papers within the next four to eight weeks. Originally, it was anticipated for early 1996 but that process has taken longer than anticipated. I would expect that in late 1996 or early 1997 the codification itself will be released for public exposure. That public exposure period should end in the fall of 1997, for implementation in 1998. That’s the current timetable.

Mr. Darling: Would that be for year-end 1998 or year-end 1997? Do you think it would be available by the audit of the 1997 statements?

Mr. Butters: I personally think it is most likely to be effective for year-end 1998 statements.

Mr. Darling: And will this replace the current volume of NAIC accounting practices and procedures at that time?

Mr. Butters: Yes, that’s correct.

From the Floor: I didn’t notice the issue of tax accounting addressed in any of the issue papers. Could you comment on whether or not the tax accounting was addressed, and will it stay different than GAAP accounting?

Mr. Butters: Yes. Accounting for income taxes is one of the issue papers that is currently in process and has not been released for public exposure yet. Because it hasn’t been released for public exposure, I can’t discuss it in great detail, but I would say definitely that there will continue to be statutory and GAAP differences for accounting for income taxes. I would say there’s a diversity of opinion right now at the working group as to the final form that the issue paper is going to take, but I would anticipate it be released sometime during the next month.
Mr. Buck: Most of the people here are involved in financial reporting for life insurance companies. What would you think is going to be the biggest impact on them, once this process is complete?

Mr. Butters: I think that varies by the state that you’re in. Certainly the P&C reserves will have some changes in terms of discounting and the elimination of scheduled penalties as the papers are currently drafted. I guess the reserve issues certainly will be significant. Other issues will vary by state. Admitted assets and, I think, EDP equipment were initially a large concern to the industry. The working group, as an objective, is anticipating that the codification, once it’s completed overall, will be somewhat surplus neutral. Individual issues may not be surplus neutral, but I think their objective is on the overall project to get close to that.

From the Floor: I follow the issues for the American Council of Life Insurance (ACLI), and I think you did a very good job of tracing all the steps. I did want to comment on one point that you somewhat glossed over, and that is the fact that the industry, actually the combinations of companies, trade groups, and the ACLI, have run a survey on the first 40 papers with the thrust being to try to quantify what the bottom line hit will be. I cannot go into the results. They are likely to be released at the NAIC meeting coming up in New York very soon. I would like to encourage the folks here, particularly those from the life companies, which is what I care about the most, if and when we get around to doing the second half of what’s likely a two-part survey process, they should do whatever they can to make sure that they complete and return the survey forms. The accounting firm that helped us with this had a tough time getting survey forms back. In the end, when the game was over, they finally received enough, so I think they could say there’s probably a 90% confidence level in the results that they have. I just wanted to make that comment for the statutory accountants in the audience.

Mr. Butters: I would second that. Do not only return the survey, but participate in the public exposure process and submit comments, either individually or through your various industry groups. I think it’s an excellent opportunity for the industry to participate in that process, and now is the time to do it, rather than attempting to change the fundamentals of the codification, once it’s released. I think industry’s ability to have their suggestions reflected in the codification will be reflected if you participate early in the process.

Mr. Darling: My understanding of the surplus neutral is that it doesn’t mean that there will be no surplus effect on the industry; it just means that you didn’t set out to have a particular surplus effect when you were designing the codification of the principles. It might, in fact, have a significant surplus effect.
Mr. Butters: I will try to give my view of the working group’s opinion, because that’s who really is driving this process. You’re correct; I don’t believe they set out to drive surplus up or down. I think their objective, at least the current feeling by the working group, is that once the codification is completed in total, they are anticipating that it’s going to be more or less surplus neutral. Naturally, there is a fear in the industry. I think the survey that Stan mentioned is reflective of that because you are certainly sensitive to what statutory surplus is. The working group’s response, at this point, is I think they are looking forward to working with the trade groups to try to measure that impact. Again, they are anticipating that it will be more or less surplus neutral.

Mr. Darling: Yes, I brought up the issue, partly as an incentive to all the company people here to do exactly what Stan and you are recommending, which is to examine the effect on your own companies, because even if the industry effect turns out to be neutral, the effect on your company may not be and you may have an ax to grind.

Mr. Butters: Right, agreed.

Mr. Buck: Our next speaker is Tracey Barber of the SEC. We will have time for more questions at the end.

Ms. Tracey Barber: I have to start out with a standard disclaimer because I work for the SEC, and the commission does not take responsibility for what its employees say in public forums like this. The views that I express will be my own and may not necessarily reflect the views of the commission or my colleagues on its staff. That being said, I will talk about a few issues that have been very much in the forefront at the SEC for the last two years that I have been there.

One in particular is derivatives and the impact of financial reporting and derivatives accounting, both the actual accounting and the disclosures for derivatives. I will do that briefly for you, so you can know where we are right now with respect to derivatives because it could have an impact on several of the companies that you work for and because of the current scope of the disclosure requirements that the SEC will have. I’ll also talk about some other life insurance issues that came up.

We have a group that works on insurance company filings. In preparing for this, we sat down and talked about some of the big issues that have come up over the last six to ten months with respect to insurance company filings. It’s interesting that the most prevalent insurance company issue has been environmental liabilities. I have addressed that in a number of places, but this isn’t exactly the place that you would do that.
On the life side, there has only been one issue because it relates to form filings and not U.S. filings. I’ll give you some overall issues that affect the accounting and financial reporting for all companies, because that will have an impact on the life filings, where there are assets that are held. I’ll talk a little about some of our current positions with respect to those issues as well.

Then, to give you some sense of how the SEC works, because not everybody has a good sense of what we do, I’ll talk briefly about the process and how people go about getting in contact and talking with us about accounting issues. That’s how a lot of the stuff that I’ll tell you about evolves. We get involved with various registrants and various accounting firms and discuss various accounting issues and come to conclusions. There is a process that we go through to get there and there’s a way we do things, like issue derivatives releases and so forth.

The first thing I’ll cover briefly for you is the current status of the derivatives release, which was undertaken about two years ago in response to some of the concerns expressed in the press about derivatives and their impact on various companies that started reporting these huge losses that were, prior to that, unannounced or unknown. The SEC has long taken the view that companies should be disclosing the risks that they’re involved in, and, if they’re involved in derivative activities or derivative instruments, then those have some risks that aren’t apparent in the financial statements. They’re not transparent. The SEC staff undertook a long project to work on coming up with what derivative disclosures should be.

During that time, FASB issued FAS 119, which also covers disclosures. However, the FASB in that process chose to only encourage, but not require certain disclosures about derivatives. Those are disclosures that the SEC commissioners have said that they believe are very important. Then what happens is, they get into this rule proposal process and the current derivatives release includes those as required disclosures.

The derivatives release covers four primary areas. The first is accounting policies about derivatives and for derivatives; the second is quantitative disclosures about market risks and about derivatives and other financial instruments. This covers not just derivative financial instruments, but all financial instruments. There is a third section on qualitative disclosures about the risks that a registrant faces. The final section is a brief reminder to registrants about what’s already required that maybe people haven’t been focusing on in the past. They need to do that in order to make the financial statements under Regulation SX, not misleading.
The SEC recognizes that this is simply additional guidance. There are already requirements in GAAP to disclose your accounting policies. This just gives an idea of what the commission staff is looking for when they’re reviewing filings.

What it does is set forth the fact that you must disclose each method that you use to account for derivatives. Most companies have more than one, and maybe more than four methods to account for derivatives, and they’ve only been disclosing that derivatives are accounted for using hedge accounting and that’s too general. This particular release gives you some idea of what the commission staff expects to see, with respect to that. In accounting policies, you also have to describe the criteria that you have to meet in order to use hedge accounting.

Some of the things that’ll be interesting from an insurance company perspective are that there are many new products that are on the horizon because of the changing competition in the industry. This release, as it stands now, covers insurance contracts as financial instruments. It sets forth some disclosure requirements that are related to some of these products that are financial instruments. Are the liabilities on balance sheet, off balance sheet or assets? The disclosures that are required here could have an impact on what people are doing in setting up new products and developing new products and so forth.

The quantitative disclosures are probably the single most important, from the perspective of the commission, because that’s the only one that the FASB chose to encourage, but not require. Quantitative disclosures would be allowed to be prepared in one of three ways. One is a tabular presentation of cash flows, another is a sensitivity analysis, and another is the value-at-risk method. Different companies use these different methods on an ongoing basis. We try to make it as accessible as possible for everybody so if there’s somebody that has only a few derivatives he or she could just use a cash-flow-table type of presentation; whereas the people who have some risk management activities going on are probably already doing sensitivity analyses or value-at-risk type calculations. We said, “Here are the three alternatives that you can use. You only have to use one of them, but you must choose to use one and do all of that for all of your financial instruments and all of your derivative instruments.” Essentially they’re described as market-risk-sensitive instruments—anything that’s subject to interest rate risk, foreign currency or price risk, or anything like that.

Qualitative disclosures are going to address the risk management practices of the company. How does management enter into hedging or speculative activities with respect to risks? This requirement, both the quantitative and the qualitative, will be outside of MD and A and outside of the financial statements.
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This is a new section within Regulation SX. These two things would go hand in hand. You need to have the disclosures that matched up so that people would know what you were doing. You also have to put into context what it is that your risk is, with respect to derivative activities. How does it impact the rest of your business? Is it something that is very integral to the whole of your business, which could be in a financial institution, for example, and may not at all be in a manufacturing entity.

The final thing is a reminder to registrants. It is to remind people that when you have a footnote that describes long-term debt maturities and other requirements that the SEC has set forth with respect to Regulation SX for financial statement reporting, you must include information about derivatives that impact that footnote or the information that’s disclosed. Basically what it’s getting at is you can’t just hang it out there and then have off-balance-sheet items that really impact what you’re doing and not disclose them together. If you don’t do that, it would be deemed to be a deficient filing with respect to the SEC staff, and comment letters will be issued.

That’s really an overview of the derivatives release and what we’re expecting. The comment period just ended on this release in the middle of May, and we have started analyzing the comments. As of the day before the comment period ended I think we had approximately 12 letters and as of the day after the comment period, we had hundreds. That’s usually how it works in accounting standard setting; unfortunately everything comes in the week after the final due date.

You really do still have time if you want to make some comments. I would expect that there’s somebody out there in your industry that has commented on the fact that insurance contracts are covered by this release because they’re not covered anywhere else in any of the FASB standards. It should be interesting to see if anybody picked up on that. As we give speeches, we have been telling groups that this is the case. I hope somebody out there has been listening and sent in a comment letter. I haven’t seen them yet, so I’ll be interested to get back into the office and see what’s included in those.

Let’s discuss a few of the life insurance issues that have come up over the past year or so that are really only specific to life insurance companies. The first is the GAAP-to-statutory differences for mutual life companies and other enterprises that file with the commission that have, in the past, used statutory accounting principles. The commission has decided to continue to allow that exception on forms N3, N4 and S6. These are the forms that are used when you have variable products, when you’re not registering under the 33 Act, which is for registrants that are raising debt or raising equity capital. This is only the parties that have products that need to be
registered through the investment management division. Those people that, in the past, have been using statutory accounting can continue to do so, even though there is GAAP for mutuals now. The problem is, if GAAP has been done for any other purpose, that will preclude you from using the exception. It’s the same exception that existed prior to the 120 and 95-4. The reason for that is, it still seems to be that if there is a GAAP set of financial statements, the commission wants one filed as opposed to any of these other financial statements.

One of the expectations that we have is that people understand that the auditor’s opinions are not standard auditor’s opinions anymore; they are adverse opinions with respect to GAAP. They do go ahead and say that the financial statements are in accordance with statutory accounting principles, which may lead people to need to use GAAP in their financial statements. The reason is, the market places some emphasis on having a standard auditor’s opinion. If you don’t have a standard auditor’s opinion, there can be problems that arise in selling your products. We do believe that many people will move to GAAP statements and that will be good for us, but we’re not precluding people from continuing to use statutory accounting principles.

Surplus notes accounting is an area where mutual life enterprises have a great deal of need to raise capital. In the past, they’ve been accounted for as debt. There’s a project ongoing right now that’s starting up at the insurance companies committee of the AICPA, and it will address the accounting issues. We believe they’ve been talking about trying to make these surplus notes into some sort of a hybrid between equity and debt. The staff has not, in the past, been responsive to that kind of reporting. We’ve been saying that surplus notes are debt. They are notes and they reflect interest.

We will watch what the insurance companies committee comes up with and see where that goes within the Accounting Standard Executive Committee, which is the standard-setting body that will be responsible for the standard of practice (SOP) that might come out of that project. So far there hasn’t been a real flushing out of that issue, but it is something that’s on the horizon, and it’s something that we will be taking part in as our liaison function between the accounting standard setters and the industry.

Another issue that impacts this group is Guide Three, which is the information with respect to certain assets and liabilities for financial institutions. People have to report information that’s required in Guide Three if they have any of the assets or liabilities that are of the same nature that banks have. It’s a bank-reporting requirement for the most part; however, insurance companies are one of the other industries that use the Guide Three information for things like mortgage loans.
Guide Three is going through a substantial revision and it will not look like it does now when it is done. We anticipate that it will be streamlined. The last time it was done was in 1983. These other accounting pronouncements that have come out—105, 107, 114, 115, 118, 119—have an impact on what’s disclosed in Guide Three. In the past we’ve just been answering questions on a registrant-by-registrant basis about what they should include in their Guide Three disclosures. Well this version will take into account all of those accounting pronouncements and try to get rid of duplicated information while maintaining the information that the staff has thought was important over the years, with respect to some of these assets and liabilities that are reported and net interest margins. I think we’ll probably also try to address more people under Guide Three because it will be different information. It will be information that’s more relevant now because it’s not included in other places in financial statements. That’s where that’s at. I would anticipate that will be issued for public comment sometime later this year. It’s getting much closer than it has been in the past.

The area of deferred acquisition costs was a hot topic at the time when the FAS 115 announcement was made. Deferred acquisition costs (DAC) should be changed as a result of unrealized gains and losses under FAS 115. We anticipated that we might get some questions regarding that; however, since we haven’t really seen any significant unrealized losses, we haven’t had to deal with many issues in that area because it has resulted in primarily an acceleration of DAC being written off, with some reinstatement, but nothing to the extent that might be material yet.

In that regard, there are two reminders with respect to deferred acquisition costs. One is that there are only certain things that can be included in DAC. We have had a number of companies try to include some marketing cost that should not be in there. It was rather interesting when they made the argument, but we said, “No, that’s not deferred acquisition cost, that’s something that should be expended in the period in which you incur it and should not be put into a deferral at all.” They were trying to make some sort of an analogy to direct response advertising, and it really didn’t have any bearing. It was not what we would anticipate being DAC. That’s one reminder—don’t try to put things in that aren’t specifically DAC.

Second is the process of FAS 115 having an effect on how DAC gets amortized and on the valuation allowance that goes against DAC. If the market changes and there are losses, one of the things that we’ve been pointing out on the fringe is that we would not anticipate anybody restoring DAC beyond its initial value. Let’s say you had deferred acquisition costs of 100 that were at day one when you first set them up, that were related to certain policies. We wouldn’t anticipate that there would be a valuation allowance that would make that number 110, because that’s not the asset. The valuation allowance should only permit you to go between the 100 and
zero to the amortization in total. We haven’t seen any of that yet because there hasn’t been a real problem in that area.

We get several questions each day on financial instruments. They might be different products that people are coming up with or different transactions that people are coming up with to enter into for the purpose of hedging, for the purpose of managing risk, or for the purpose of finding a new way to do a tax strategy. We highly recommend that if you’re considering new products, and you’re not sure of how to account for them because there are gray areas, that you talk to the staff before they show up in accounting and financial statements. The reason for that is because you don’t want to be restating your financial statements if you think you have securitized something or you think you’ve done something with respect to a financial instrument. You may not have, and it may require mark to market or fair-value-type accounting, especially if there are risks that are off-balance sheet items.

Generally if there’s not a specific application of hedge accounting, the staff is not extending hedge accounting to a great deal of analogies. That’s one of the things that we’ve been dealing with. Hopefully, the accounting standard that the FASB is working on will address this issue, but we’ll see how fast that happens. Until that does happen, we do take questions in the office of the chief accountant and deal with them. Then we’re sure that companies, as they start adding these things to their balance sheets or to their portfolios, are recording off-balance-sheet stuff and on-balance-sheet stuff appropriately in the financial statements.

Maybe you’ve read in the paper about what are called indexed debt instruments. The Times Mirror had an issue with respect to what they were doing with some debt that they wanted to issue, in order to permit them to, in essence, forward sell a stock that they owned. What happens in that case is that they issue a debt instrument, receive proceeds, and that debt instrument will be paid back based on the value of the shares that they own.

Let’s say Company A owns 100 shares of Company B, and they do not want to be subject to the risk of market value changes in Company B any longer. Company A issues a debt instrument so there’s no tax ramification because they haven’t sold the Company B stock. They index that debt instrument so that it’s paid back based on the fair value of the 100 shares. In essence they would agree to sell the 100 shares in the future or deliver the 100 shares in exchange for the debt instrument. Those things must be accounted for as index debt instruments. If you are the company that has entered into a transaction like that and you have received proceeds, those must be recorded at settlement value, which is, in essence, fair value. It is the value of the stock that you’re going to have to pay back.
The question came up, what if I have that stock and I own the 100 shares and that’s not an equity account but merely a FAS 115 asset? It’s recorded and available for sale, and I mark it to market through the equity section. Can’t I apply hedge accounting in that case, for that debt instrument? Can I offset the debt instrument changes in equity instead of putting it through income? The staff dealt with that and addressed that question. It said that, in that case, it would permit you to recognize, through stockholders’ equity, the changes in the debt instrument. Normally they would go through income. If you do not own the shares that were subject to the indexing, you’d have to charge it through income.

In addition, if a company owns an investment and let’s say that 100 shares is 25% of Company B, then the company accounts for it on an equity method accounting basis. In that case you would not be permitted to use hedge accounting. The staff does not permit hedge accounting of equity method investees or of subsidiaries. You can’t enter into hedges of values of things that are not recorded at fair value on your financial statements.

The issue was, what do you do with these FAS 115 securities that do not allow you to record something through earnings? We were sympathetic to that. If you had just the forward sale of the stock without the debt, we would allow you to record that in the equity section as a hedge. We said, just because it’s embedded in a debt instrument, it doesn’t mean that we wouldn’t allow you to get the same treatment. That’s the kind of thing that, as companies started doing this, became an issue because of the way the asset was accounted for. The equity method investee people wanted to do the same thing. They wanted to be able to run something through stockholders’ equity or not change the value of the debt instrument. We said, “No way.” The debt instrument is currently accounted for under indexed-debt-instrument accounting, and we were not swayed by the fact that you owned the investment because you essentially consolidate it on a one-line item, if you’re an equity-method investee.

Another issue in this kind of area is commercial paper. There are companies that had commercial paper programs where you just keep rolling short-term debt and you attach interest rate swaps to it. We had companies that, when they terminated the commercial program and it was no longer outstanding, wanted to put that as debt extinguishment and record it as an extraordinary item. It doesn’t work. It’s a hedge of an anticipated transaction in that case, and so there’s no accounting for a debt extinguishment. It’s not an extinguishment of debt, it is the termination of the swap that is on an anticipated transaction. It should be recorded through earnings and through ordinary income. Those are the kinds of things that we deal with, and those are two relatively new ones.
Of course, you’ve probably heard about our hard-line stance on FAS 115 and held-to-maturity. That has been kind of a folklore, if you will, but it resulted in the FASB giving the holiday in November in order for people to really get their act back together and understand that FAS 115 was a serious issue. They don’t usually issue accounting standards that they do not mean to be followed, but they did provide an out for a limited time. We have seen some fairly good disclosures in that area, and we hope to continue to see good disclosures in the area of applying the adoption of the transition guidance. We don’t anticipate having any problem with that. Hopefully people moved a lot of their stuff out of held-to-maturity so we don’t have to come back and say, don’t sell your held-to-maturity securities, that’s not appropriate. If you do, you’ve got no more held-to-maturity, and you can’t use it for a period that extends at least a year. Those issues are still out there.

I would like to conclude with some ideas about the process at the SEC. I work in the office of the chief accountant. You’ve probably heard of the Division of Corporation Finance, and you’ve probably heard of the Enforcement Division. The Enforcement Division is the one you don’t want to see at your door. You’ll regularly encounter the Division of Corporation Finance. You will rarely hear from the office of the chief accountant and hopefully you won’t hear from Enforcement at all. The Chief Accountant himself is almost a direct advisor to the Commissioners with respect to accounting matters and reporting matters. Our office helps him support that. Because we’re the primary office within the commission, with respect to accounting matters, we do all of the liaison activities with the Auditing Standards Board, the FASB, Accounting Standard Executive Committee, and all of the various standard-setting bodies. We do have direct oversight with respect to them and we go to their meetings, observe, and take part.

Mike Sutton, the chief accountant, has a voice on the Emerging Issues Task Force (EITF). I don’t think he votes, although, if he did vote, or if he says something with respect to certain accounting issues, it’s probably taken much like a vote would be.

The Division of Corporation Finance really is primarily responsible for looking at all the filings that you put together. If any filings are sent in—10Ks, S4s, S3s,—this department ensures companies are filing to either raise new equity or filing under the 1933 Act in order to keep current in their filings. They select a number of them to review. Every registration statement that’s new also will get reviewed, but 10Ks will only get reviewed on about a rolling three- or four-year basis. When that happens, you’ll get contacted by the Division of Corporation Finance, and you may be asked a great deal of questions. There are usually a great deal of questions about reserves in the insurance area. There’s a great deal of questions about products, or about how disclosures look for various liabilities and various assets that are owned by the insurance companies, or how reserves are set, or what kinds of things are
included in the actuarial opinions. There are many different things that could come up in that process.

What then happens is, if there’s a major accounting issue that comes up in that whole process, it could come upstairs to the chief accountant’s office. That office will make a determination in corporate finance. It is sort of the appealing body, and when companies come into us and want to talk about it and want to give us their reasons, they bring their accountants or lawyers with them.

In the last year, we’ve had some insurance companies in that have been very interesting. They talked to us about reserve setting and how the new or different techniques in reserve setting have allowed different amounts to be recorded, billion-dollar environmental liabilities have come up. We do that on a frequent basis. We have many different issues that come in.

In addition, in the office of the chief accountant, we deal directly with questions from registrants. I recommended that if you were thinking about new products or ways to structure products and were worried about the accounting ramifications because you didn’t want to end up with certain financial reporting, but wanted to end up with a particular effect on the surplus or on the bottom line, then you could come in and talk to us anytime with either a written submission on a name or no-name basis. Obviously a no-name basis is a little more difficult because of fax machines and so forth, but we do take no-name questions. Usually the best way to do that is to do it through a law firm or an accounting firm because then they’re the only people that we have the name of. The law firm will write things on their own letterhead for you on a no-name basis.

With respect to those issues, when they come in, they come directly to our office and then we have meetings and discuss it internally. We may request a meeting with a company, and in that case, they’ll prepare things like slide presentations. It’s funny. The larger the company, the more complex the presentations will get.

Recently we had a company that came in and presented color graphs and slides, and we really didn’t think that necessary. We could have dealt with just a nice write-up of what the issue was. Then we discuss it internally. We get the chief accountant involved if it’s a significant enough issue and then we’ll come to an answer and get back to you. You’ll then have an idea of where the staff stands, with respect to whatever the financial instrument is or whatever type of insurance contract it is.

Some big ones that came up in the insurance area over the last couple years have been about the FAS 115 securities and how that impacts private-placement-type
securities that are owned. The other ones that have been insurance company related have been related to reserves or to risk-based-capital-type requirements.

We do encourage anybody to call us if they have questions. You hate to get a letter back that says—could you explain this accounting or could you explain what this instrument is? We don’t think it looks like it’s accounted for appropriately. That will happen if it is either a 10K review or a registration statement. The worse thing to have happen, when you’re trying to register new shares or register debt, is to have the staff ask questions and go back and forth because it adds time to that process.

If you know there’s something that may be a gray area, do it on a prefiling basis. Call us up. Our office is easily accessible, as is the division of corporation finance, through the branch accountants that you talk to. I just thought I’d give you an idea of how it works because not everybody understands the fact that it’s not just about filings. There are people there who actually work on these accounting issues. I’d be happy to answer any questions.

From the Floor: You made a comment earlier that the new release deals with insurance policy liabilities and disclosures related to them. I’m not really clear what is required by the release. Can you give me an illustration of the type of disclosure that you would ask for?

Ms. Barber: Sure. With respect to insurance contracts, let’s say that you have contracts that are of a guaranteed investment nature. For example, you have to pay somebody a set amount, but you have to invest the assets in order to obtain that return or greater return. The interest rate environment is changing; the risks that are associated with having that liability outstanding, and having to fund that with assets that may or may not have the exact same duration or maturity, rates and so forth, those are the kinds of risks that would be disclosed in that area. Now, as I said, this is the first time I think that it has not been taken from a document. I think it is from FAS 119 and FAS 107, although companies do prepare the FAS 107 disclosures, which are fair-value financial instruments, and we encourage all of that. I’m not sure if that will stay in the release or not, but it is in there now.

From the Floor: So is that more or less qualitative disclosure of these risks related to mismatches?

Ms. Barber: Yes, it’s qualitative and quantitative. Let’s say, quantitatively, you have assets that aren’t matched appropriately; for example, a value-at-risk disclosure could show you that the value-at-risk provides a loss that could happen. There’s the maximum loss that could happen given 95% confidence. It provides you with both
the information that says, qualitatively we’re not exactly matched and quantitatively here’s what that means to us or could mean to us. It doesn’t have to absolutely mean that, but it could happen. If you do a sensitivity-type analysis, and if interest rates go up or down 100 basis points, find out what the impact is.

**From the Floor:** The comment that I had was related to the DAC adjustment when you have an FAS 115 unrealized gain or loss. Over the last year or so I’ve become aware that at least one Big Six firm had a problem with allowing a company to write up DAC when they had an unrealized loss. The firm wouldn’t allow them, the company, to use negative margins in a real amortization for income. On the other hand, my point of view on that was just that you can have a loss that is contributing to diminish the gross profits stream, and you would still be able to take that offset.

So I don’t really believe that’s the right answer. Other Big Six firms that I’m aware of don’t have a problem at all with allowing the offset. I believe that is the original intent, isn’t it?

**Ms. Barber:** That is the intent, yes. It’s not an intent that says you can only go one way and accelerate DAC amortization.

**From the Floor:** Is there any intent that you should diminish the effect by, at some point, saying, this part of the loss we would not be taking through as a negative?

**Ms. Barber:** We think that ought to be a management decision in terms of whether or not you do that. There is going to be some judgment in that, because it’s an estimate. Even when you amortize that it’s an estimate based on future expectations and the current period information, there is going to be some judgment that goes into that. We’re aware of that. It may not have the exact same impact in an unrealized loss situation as it does in an unrealized gain situation. We’d be comfortable with that, but we would not be comfortable with just automatically saying that you couldn’t increase your valuation allowance so that it reinstates or adds to the DAC balance, as opposed to taking it away. It’s not just an accelerated amortization ploy or anything like that. It is meant to take into account the FAS 115 differences.

**From the Floor:** But you don’t believe that interest accruals could have taken you up higher than the original deferred amount.

**Ms. Barber:** We haven’t dealt with that issue. That’s a possibility, but if you’re running up against that, I recommend you talk to the staff. That is just one of those things where if it ends up being material at all it would be worthwhile to talk to the staff, because generally we don’t look at assets as something that can go above their
initial value. However, interest accruals are something we haven’t discussed at any length so we’d like to see some rationale behind them.

Mr. Daniel J. Kunesh: I have two questions, one relates to FAS 115 and the second one is a bit different from the topics.

A couple years ago the EITF issued D41, which was supposedly an interpretation of comments made by the SEC and the SEC observer about certain aspects of FAS 115. I think this thing was hustled through and imposed on the industry without a lot of guidance, and this was an attempt to give some guidance. The guidance was in two areas and I would like to address only one. One was basically what we call in the industry shadow effects or offsets to DAC. The door was left open, although I think it was very poorly worded at D41, relative to liabilities. It seemed to imply that in the case of unrealized gains, you should look at unrealized gains and losses as if they were realized and see if there was a significant impact on the decision process of the insurance company. In other words, those liabilities would increase or decrease as a result of that, and there would be an opportunity for companies (although I have not seen companies in the U.S. take this approach). I’ve seen overseas companies take this approach in applying U.S. GAAP. Could you comment a bit about the intent of the SEC allowing companies to make liability adjustments under FAS 115?

Ms. Barber: What we were trying to do was not have people show stockholders’ equity at values that were not really available to stock equity holders. A good example of this happened to us within the utility area where we have nuclear decommissioning trusts. The trust had unrealized gains and losses on their assets and we said those shouldn’t be in stockholders equity of the utility company because they don’t accrue to the utility company. They only accrue to this trust. So they need to be shown as part of the trust only and not as a separate component of equity if they’re unrealized gains.

That’s basically where it’s based; so you don’t end up showing this equity effect. If it were realized, it doesn’t really go to the shareholders. If they were all realized gains, you would have had the offset in income at the same time, and this was a concern. That’s really where it all came out. It wasn’t meant to say, either now we can start fair valuing liabilities, or, now we can start recording liabilities at different amounts. However, if there is an impact from FAS 115, we have discussed other issues like the utility issue and allowed people to do that offset as well, wherever the unrealized gain actually goes.

One of the things that I didn’t cover was the foreign filing issue that’s out there. There’s a notion in some of the European countries where certain liabilities are
recorded. They’re hybrid products; they’re not products that are exactly the same as the U.S. products, and so they’re accounted for a little differently. Fair value is accounted for in the financial statements in Europe, and they’re not permitted to be fair valued in the U.S. under GAAP.

There’s a fairly significant difference in the amounts that would be reported under U.S. GAAP and under the foreign country GAAP. That’s an issue that we have been dealing with through disclosure. We’ve been allowing people to do some additional disclosures that maybe wouldn’t normally be presented in that area. Those are the kinds of things where there are differences because of the way that companies account for things at fair value and so forth, that we do get involved in by adding disclosures, for example. It makes what everybody is doing perfectly clear. If there is a need to change liabilities because there are certain factors where the unrealized gains go directly outside or some portion of the unrealized gains go directly outside, then we’re certainly interested in seeing and hearing about that. That was kind of where D41 was going. It was to try to make it a little more workable with respect to having shareholders understand what they really had as unrealized gains that were accruing to them.

Mr. Kunesh: I think there are many U.S. companies that would argue very strongly that for group pension writers that if you were to treat unrealized gains as realized, that money would have to go in the favor of their group pension holders and therefore should be a liability and not—

Ms. Barber: Right, we have not seen that in the U.S..

Mr. Kunesh: There’s not DAC.

Ms. Barber: Yes, we have not seen that in the U.S.

Mr. Kunesh: The second question is a fun question. From the perspective of a U.S. investor, a securities investor and perhaps from the perspective of fairness and competition of U.S. companies, it seems to me that the SEC has taken a much laxer attitude in accepting information from foreign entities from making initial filings in the U.S. and 20F and registration statements and the level of disclosure and the types of disclosure. Can you comment briefly as to why that is the case?

Ms. Barber: Sure. Foreign filings, which are bringing other sources of capital to our markets, have been long deemed to be a very positive thing for the U.S. They bring other opportunities for investors. What happens is, many of these other countries and companies in those other countries don’t have easy access to prepare GAAP financial statements. There are certain exclusions and exceptions; however, there is
always the intention to get enough disclosure so you understand what the differences are between U.S. accounting and that foreign company accounting.

It doesn’t always happen the first time, though, because there’s a process that’s ongoing, and if it’s done in a prefiling sense, we can get there, but if it’s not, then we do have some problems. I would say that while it is very important to the commission to allow foreign filers to come in, it’s also important for us to allow new small companies to come in and larger companies that already have all of this information so it’s not an additional burden for them. What happens is, once they’ve been in the country a few years, the disclosures start looking a lot more like the U.S. companies.

It’s just a matter of getting people in and getting them in the system so they can get in the comment process so that people can actually do these things to get them up to speed. I would say that if you looked at an initial filing, there’s going to be information in there that is probably, in many cases, better information because it’s not boilerplate to some of the U.S. companies that have had this stuff rolling forward for years and years. There’s a need to get the best information for investors. We don’t want investors not having enough information to make an adequately informed decision. We strive for that, even though it may seem like it’s lax. It’s more a way to get everything on an even playing field because the U.S. companies already have the benefit of having done all this stuff for years and years.