1973

A Study of Selected Accounting and Reporting Practices Used by Stock Life Insurance Companies.

Lloyd Brandt Jr

Louisiana State University and Agricultural & Mechanical College

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LIFE INSURANCE COMPANIES

A Dissertation

Submitted to the Graduate Faculty of the
Louisiana State University and
Agricultural and Mechanical College
in partial fulfillment of the
requirements for the degree of
Doctor of Philosophy

in

The Department of Accounting

by

Lloyd Brandt, Jr.
B.A., Southeastern Louisiana University, 1955
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Abstract

The accounting and financial reporting practices used by life insurance companies have been influenced by state regulation. States regulate such operational aspects of the company as controlling investment practices, enacting reserve requirements, prescribing the form and content of financial and operating reports and establishing auditing requirements. The intent of state regulation is to promote the solvency of a life insurance company and thus assures that contractual obligations with the policyholders will be fulfilled by the insurer.

Annually, life insurance companies are required to submit to the states in which they are licensed to operate a report called the NAIC Statement Blank. This report contains basic financial and operating statistics compiled by the life insurance company and prepared according to a set of detailed instructions which accompany the report.

Life insurance companies are organized as mutual or stock companies. In a stock life insurance company, the shareholders advance the funds to organize the insurer and receive dividends on their investment. In addition to state regulation, stock life insurance companies are subject to regulation by federal agencies such as the Securities and Exchange Commission. The SEC requires stock life insurance companies to file annual reports, Form 10-K, and to submit a registration statement prior to the sale of additional stock.
The intent of SEC regulation is to protect the shareholders and to require adequate disclosure of all significant financial information.

Besides state regulation and the SEC, accounting and reporting practices of stock life insurance companies are influenced by Certified Public Accountants. CPAs render a report on the financial statements of stock life insurance companies. The report is included in the Form 10-K and becomes a part of the annual report presented to the shareholders. The report contains expression of an opinion on the fairness of the financial statements in accordance with generally accepted accounting principles or, as in the case of most stock life insurance companies, in accordance with practices prescribed or permitted by regulatory authority, which vary from generally accepted accounting principles.

The accounting practices included in this study were selected by applying the following criteria: practices which have a material effect on the determination of net income and practices which affect the appearance of the published financial statements. The study includes an investigation of the following practices used by stock life insurance companies: recognition of revenue and expenses, computation of deferred federal income taxes, accounting for investments, reporting nonadmitted assets and determination of the form and content of the annual financial statements used in reporting to shareholders.

This study compares the statutory methods of accounting and reporting with those methods that would be applied under traditional financial accounting. Certain schedules and computations included in
the NAIC Statement Blank are incorporated into this paper to demonstrate the various statutory techniques used by stock life insurance companies. The pronouncements of the AICPA and especially the Opinions of the Accounting Principles Board are used to establish generally accepted accounting principles as they apply to life insurance accounting.

The financial statements included in the NAIC Statement Blank are presented and contrasted to financial statements prepared under conventional accounting methods. AICPA publications, including *Accounting Trends and Techniques, 1971*, were used to establish conventional reporting methods.

A comprehensive set of financial statements to be presented by stock life insurance companies was recommended. These financial statements are to be used for reporting to shareholders and are not intended for regulatory purposes or for determination of federal income tax liability. The recommended financial statements include treatment of revenue and expense recognition, deferred federal income taxes, accounting for investments and nonadmitted assets in the most relevant manner. The recommended method of reporting would allow greater comparability of stock life insurance companies with other industries and would promote meaningful financial reporting by stock life insurance companies.
CHAPTER I

Introduction

Financial statements are reports prepared by or for the management of economic entities and are designed to give vital financial information to various interested parties. The statements are prepared under certain assumptions relating to the business environment. A knowledge and understanding of these assumptions are essential in order to understand and interpret the data reported in the financial statements.

Over a period of time, accountants have developed two basic financial statements. The purpose of these statements has been to reflect the financial position of a company at a point in time (Balance Sheet) and to report the results of a company's operations for a period of time (Income Statement). The questions of the specific information to be presented and how that information should be reported are continually reviewed by accountants and by professional accounting organizations. During May 1971, the American Institute of Certified Public Accountants (AICPA) authorized the formation of two committees—one to deal with the establishment of accounting principles and one to determine the objectives of financial statements. Marshall S. Armstrong, President of the AICPA, stated that the study groups "Are a creative response—not a defense stratagem to silence critics or to
protect the status quo, but a genuine attempt to accelerate progress in financial reporting."\(^1\)

The evolution of financial statements for a given industry or enterprise is subject to pressures both from within that industry and from outside groups. Each industry has the primary responsibility of developing financial reporting practices suitable to the needs of that industry. The financial statements of an industry should not be considered as an end in itself, but as a means to an end, and thus are subject to various requirements of outside groups. Stockholders, governmental agencies, creditors and professional groups exert considerable influence over financial reporting practices. It is difficult to determine which faction, management or outsiders, or which group within the outsiders (stockholder, governmental agencies, creditors or professional groups) should exert the greatest influence on financial reporting practices. Obviously, within this framework a degree of compromise must exist, and some consideration for each special interest group must be given to improve the overall quality of financial reporting.

The assumptions under which traditional financial statements are prepared differ from those assumptions underlying life insurance financial statements. An understanding of these differences is needed to examine the existing accounting and reporting practices used by stock life insurance companies in preparing published financial statements.

Accounting and reporting practices within the life insurance industry are complicated by a number of factors. The industry is subject to state regulation in all activities, including operating procedures, terms of contracts and financial reporting practices. The intent of state regulation is to provide maximum protection to the policyholders. Accordingly, the operations of a company are regulated in an effort to assure, to the extent possible, the fulfillment of the long-term contractual obligations of the company. Specific examples of state regulation include establishing policy reserve requirements, requiring the use of certain unique forms for financial reporting, imposing auditing requirements and regulating investment practices.

The most significant effect of state regulation on the financial statements of life insurance companies is an emphasis on the liquidating value rather than the going concern value of the company. As a result, the financial statements of life insurance companies reflect a greater degree of conservatism than conventional financial statements. Specific examples of how conservatism is applied are discussed in later chapters.

Life insurance companies are required to submit annual reports to the insurance commissioners\(^2\) in the states in which the insurers are licensed to operate. The form and content of these annual reports, entitled the NAIC Statement Blank, are recommended by the National Association of Insurance Commissioners (NAIC). The Balance Sheet,

\(^2\)The insurance regulatory official of the different states is variously designated as the Commissioner, Superintendent or Director of Insurance. For purposes of this study, the states' insurance regulatory official will be referred to as the "Commissioner of Insurance" or "Insurance Commissioner."
Summary of Operations, and Surplus Account dominate the NAIC Statement Blank. Although these titles appear similar to the titles of conventional financial statements, there are some major differences in both form and content of life insurance and conventional financial statements.

Some states prohibit the publication of life insurance financial statements on any basis other than that reflected in the NAIC Statement Blank. States applying this rule feel that the policyholders are given maximum protection through the accounting and reporting practices reflected in the NAIC Statement Blank. Any deviation from the statutory statements, they reason, would cause confusion and weaken the ability of the insurance company to meet its contractual obligations to the policyholders.

The most significant influence in the development of life insurance financial statements has been legal principles as developed and applied by life insurance commissioners. The basic objective of life insurance financial statements is protection of the policyholders which is contrary to the accountability objective of conventional financial statements.

Conventional financial statements are intended for reporting the results of management's stewardship to the stockholders. The financial statements generally are included as part of the published annual report and include the Balance Sheet, Results of Operations, Statement of Retained Earnings and Changes in Financial Position.

The accounting principles that are applied in the preparation of financial statements are generally applicable to all industries. Each
industry has certain accounting and reporting problems peculiar to that industry but it is the feeling of accountants that exceptions should be kept to a minimum and certain accounting principles should be applicable to all industries. The position of the American Institute of Certified Public Accountants is reflected in the statement that "the basic postulates and broad principles of accounting comprehended in the term 'generally accepted accounting principles' which pertain to business enterprises in general apply also to companies whose accounting practices are prescribed by governmental authorities or commissions."³ Without acceptance of this concept, users of financial statements would have to develop considerable expertise in interpreting individual industry financial statements.

One of the most basic and underlying accounting principles applicable in conventional financial statements is the matching concept. This concept requires recognition of revenues in the period in which they are earned and recognition of expenses incurred in earning such revenue. The matching of revenues and expenses for the same period results in the determination of the net result from operations for that period. The comparison of net results from operations from period to period allows the stockholder to evaluate the effectiveness of management and to take appropriate action based upon the reported results.

The accounting principles underlying financial reporting have developed over a period of time. The American Institute of Certified Public Accountants has been instrumental in the development and promulgation of accounting principles. During the 1930's, the AICPA—in conjunction with the Securities and Exchange Commission (SEC)—began to develop standards of financial reporting. The results of the efforts of the Institute are reflected in various publications. The intent of these publications is to develop, define and establish methods of financial reporting and accounting that can be identified as generally accepted.

The Institute believes that existing methods of financial reporting can be improved. In October 1970, the Institute published Statement Number 4 of the Accounting Principles Board, Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises. The purpose of this Statement is "... to provide a basis for enhanced understanding of the broad fundamentals of financial accounting. It is also intended to provide a basis for guiding the future development of financial accounting."

Many members of the accounting profession are not fully satisfied with existing accounting and reporting practices. This

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4 Some of the major publications of the AICPA include the following: Opinions of the Accounting Principles Board, Accounting Trends and Techniques, Accounting Research Studies, Statements on Auditing Procedures and Statements of the Accounting Principles Board.

disenchantment is good for the profession to the extent that it encourages continuous re-examination of basic purposes and intent.

Need for the Study

Stock life insurance companies publish annual financial statements. These financial statements, many of which have been audited by Certified Public Accountants, are made available to the stockholders, potential stockholders and all other interested groups. Also, the financial information included in the annual statements is sometimes reported in the financial press.  6

Individuals using the financial statements of stock life insurance companies must be informed of the differences between life insurance financial statements and conventional financial statements. By including a series of footnotes, most companies attempt to make the reader aware of the idiosyncrasies of life insurance accounting. The footnotes are a brief general comment of the treatment afforded an

6 The following information was reported in The Wall Street Journal for the dates indicated:

February 21, 1973—Connecticut General Insurance Corp., after several years of bad experience on group accident and health lines, reported consolidated operating net of $108.4 million, or $6.03 a share, up 40.5% from $77.6 million, or $4.31 a share, last year. Excluded are capital gains of $11.6 million in 1972 and $5.2 million in 1971.

November 14, 1972--CL Financial Corp., the parent company of California Life Insurance Co., expects to post operating earnings of about $400,000, or 41 cents a share, for the first quarter ended September 30, up sharply from $194,000 or 19 cents a share, a year before, Harry Mitchell, chairman and president, said in an interview.

June 2, 1972--Life Investors Inc., a financial services concern specializing in selling life insurance and mutual fund packages expects a better than 30% increase in 1972 operating earnings from $3.9 million, or $1.17 a share in 1971, Ronald L. Jensen, president, said in an interview.
item under life insurance accounting compared to the treatment of such item under conventional financial accounting. For the most part, such footnotes do not include identification of the absolute amount of the differences but merely a discussion of the nature of the differences.

The owners of stock life insurance companies use the published financial statements to arrive at an investment decision: buy, sell or hold. Financial analysts and investment advisors must also use the same information to recommend investment decisions to their clients. The published financial statements of life insurance companies are not intended to present financial data on which to base investment decisions, but stockholders and investment advisors have no alternative but to use the information that is presented.

Investment advisors have been aware of certain limitations of published financial statements of stock life insurance companies and have applied various rule-of-thumb adjustments in an attempt to restate life insurance earnings. One method of restating earnings takes into effect the annual increase of insurance in force. The amount added to earnings is calculated per $1,000 of policy value and the following scale applied: $15 per $1,000 for whole life, $8 per $1,000 for term and $5 per $1,000 for group. 7 An increase in whole life of $25,000,000, would result in an increase in statutory earnings of $375,000.

Numerous studies have been conducted by financial analysts and other groups to establish a standard method of adjusting life insurance

reported earnings. In 1969, the Insurance Investors Advisory Division of Standard Analytical Service, Inc., published a research report titled, Adjusting Life Insurance Company Earnings. The report was written to meet the needs of investors interested in life insurance companies. The publication "explains the technical factors involved in attempting to develop an accurate and reliable method of adjusting earnings to offset the reported loss from high first-year acquisition costs, traditional in the sale of life insurance policies."8

Also in December 1969, the Committee on Life Insurance Earnings Adjustments of the Association of Insurance and Financial Analysts completed a four-year study recommending a method of adjusting life insurance company earnings to make them conform more closely to generally accepted accounting principles.

The method of adjusting life company earnings set forth in the Committee's report addresses itself to three major areas:

1. The adjustment for, and amortization of, acquisition expenses. 2. The adjustment to reserves for (a) conservative mortality and reserve interest assumptions, and (b) different reserving methods. 3. The adjustment for accident and health insurance.9

The major concern in adjusting the financial statements is to adjust the statutory net income to conform with net income computed under GAAP.

Certified Public Accountants have demonstrated a sustained interest in life insurance accounting techniques. The interest of CPAs


is manifested in the publications of individual firms and the efforts of the AICPA Committee on Insurance Accounting and Auditing.

In 1969, Arthur Andersen & Co. released a publication entitled *Accounting and Reporting Problems of the Accounting Profession*. The publication listed twenty-five areas which Arthur Andersen identified as the prominent accounting and reporting problems facing the accounting profession at the time the publication was issued. One of the areas included in the publication was insurance accounting with particular emphasis on life insurance and fire and liability insurance.

Ernst & Ernst has demonstrated, through research efforts and publications, its interest in the area of life insurance reporting practices. The Ernst & Ernst publication, *Financial Reporting Trends, Life Insurance 1972*, reflects the financial reporting practices used by 200 stock companies and 50 mutual companies as disclosed in 1971 published annual reports. As stated in the general comments of the publication, "the survey is descriptive, not analytical; no recommendations are made with respect to the form and content of annual reports." ¹⁰

In addition to individual CPA firms, the AICPA has demonstrated an interest in life insurance accounting and reporting practices. The AICPA Committee on Insurance Accounting has been studying the differences between generally accepted accounting practices and life insurance accounting practices prescribed by state insurance commissioners. In

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In December 1970, after four and one-half years of preparation, the AICPA published an exposure draft titled Audits of Life Insurance Companies. The draft was distributed to all interested parties for comment. The comments were to be forwarded to the Committee on Insurance Accounting and Auditing by no later than May 1971. As a direct consequence of the reaction of the first exposure draft, a second draft of the Audit Guide was released in August 1972.

One of the major differences in the second exposure draft was the exclusion of mutual companies from the Audit Guide. In order to avoid the confusion of simultaneous consideration of both stock and mutual companies, the August 72 exposure draft was titled Audits of Stock Life Insurance Companies. The AICPA Committee on Insurance Accounting and Auditing stated in the preface of the Audit Guide "that at this time mutual life insurance companies should not be made subject to an audit guide applicable to stock companies." 11

Audits of Stock Life Insurance Companies was approved by the Accounting Principles Board of the AICPA in December 1972. 12 The Board recommended that life insurance companies adopt to GAAP for year ended


1972 and established year ended 1973 as the required date of conversion to GAAP.

Articles appearing in the major life insurance trade publications such as Best's Review (Life/Health Edition and Property/Liability Edition), and The National Underwriter (Life and Health Insurance Edition and Property and Casualty Insurance Edition) present arguments pro and con involving life insurance accounting and reporting. In an address before the Society of Actuaries in Toronto, Joseph C. Noback, a consulting actuary, was somewhat critical of the AICPAs involvement in life insurance accounting and reporting practices. In his address, Mr. Noback stated that:

"During the past year (1971) the National Association of Insurance Commissioners and the American Institute of Certified Public Accountants influenced the financial statements of stock life insurance companies. The NAIC made 15 minor changes in the association blank; an AICPA committee completely revised the statement. The NAIC changes are evolutionary, elementary, progressive and mandatory. The AICPA changes are revolutionary, perplexing, provisional and dramatic. The AICPA is challenging the NAIC establishment." 13

One article that opposed the Audit Guide asserted that life insurance financial reporting should not have to conform to generally accepted accounting principles because of the differences between the objectives of an insurance company and that of a conventional company. The author concluded that if the earnings per share figure as reported, was not meaningful, it would be better to simply recompute earnings per

share on some other basis rather than revising the methods of reporting now being used. The author thus implies that existing methods are not completely meeting the reporting needs of the stockholders but compliance with AICPA Audit Guide would compound rather than improve existing deficiencies.

The emphasis placed on the financial statements represents a major difference between statutory reporting and reporting to stockholders. For statutory reporting purposes, where the objective of the financial statements is to establish the solvency of the company, the primary emphasis is placed on the Balance Sheet. In fact, the Gain or Loss Statement (Summary of Operations) was not included in the NAIC Statement Blank until 1939.

For conventional accounting purposes, primary emphasis is placed on the Income Statement and the determination of earnings per share. The net income determined in conventional accounting is considered as acceptable information on which to base an investment decision.

Stock life insurance companies present audited financial statements to stockholders and other interested parties. The financial statements report the earnings of the company and the earnings per share computed under statutory reporting requirements. However, the information as presented in the financial statements is used to arrive at investment decisions.

The adoption of the Audit Guide has not solved all existing accounting and reporting problems of stock life insurance companies. In addition, considerable confusion will result when the financial statements of stock life insurance companies are converted to GAAP. As life insurance companies convert their financial statements, the stockholders must be informed of the consequence of such conversion. CPAs and insurance executives will be required to explain and defend the application of GAAP in presenting the financial statements and determining net income. Thus, there is a continuing need for research and study of the existing methods and the effects of converting from statutory accounting to GAAP.

The audit guide itself reflects the need for additional study and research in life insurance accounting and reporting practices. In Appendix A of the audit guide, a series of recommended financial statements formats are presented. However, the guide states that the format presented might be used and that "further experience in the implementation of this guide may result in new and improved presentations."^16

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15 Evidence of the concern that CPAs have to inform the investing public of the implications of the Audit Guide is reflected by an Arthur Young & Co., February 1973, publication, Questions & Answers About the Audit Guide for Stock Life Insurance Companies. The author of the booklet is Randolph H. Waterfield, Jr., Chairman of the Arthur Young Life Insurance Industry Committee. Mr. Waterfield has also served on the AICPA Committee on Insurance Accounting and Auditing. The publication consists of a series of thirty-seven questions and answers relating to the following major topics: Common Criticisms, Financial Statements, Reserve Methods, Yield Rate, Acquisition Expense, "Lock-In" Concept, Loss Recognition and Deferred Taxes.

The responsibility for developing, perfecting and publicizing the accounting and reporting practices to be used by stock life insurance companies rests with the organizations representing the life insurance and accounting professions. As with most complex problems, the adoption of the audit guide has not solved all of the old problems and probably has created some new problems that heretofore have not existed.

**Objectives**

The objective of this study is to compare the accounting and reporting practices used by stock life insurance companies with accounting and reporting practices derived from application of Generally Accepted Accounting Principles (GAAP). Current accounting practices used by stock life insurance companies are intended to generate the necessary information to allow the company to annually prepare the NAIC Statement Blank. In addition to the NAIC Statement Blank, stock life insurance companies must present an annual report to their stockholders. The financial statements included in the annual report do not take the same form as the NAIC Statement Blank, but the financial information reported to the stockholders is identical to the information reflected in the NAIC Statement Blank.

Preparation of the NAIC Statement Blank is a complex and involved procedure. The form is accompanied by a set of instructions which details the information to be reported in the various exhibits and schedules. Additional description of the accounting practices to be used to prepare the NAIC Statement Blank are included in various manuals and textbooks.
The objective of the NAIC Statement Blank is to allow effective state regulation of life insurance companies resulting in the maximum protection of the policyholder's interest. To this extent, the NAIC Statement Blank has been an effective tool and accomplishes its objective. The adequacy of the NAIC Statement Blank for regulatory purposes is not being questioned. However, a question is being raised concerning the desirability of allowing the NAIC Statement Blank to influence the content of the financial statements included in the published annual report of stock life insurance companies.

A 1970 AICPA publication, *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises*, states that "the basic purpose of financial accounting and financial statements is to provide financial information about business enterprises that is useful in making economic decisions."\(^{17}\) Also included in the publication were seven qualitative objectives of financial statements. The primary qualitative objective is relevance and the other objectives are as follows: understandability, verifiability, neutrality, timeliness, comparability and completeness.\(^{18}\)

Published financial statements are normally prepared in accordance with Generally Accepted Accounting Principles (GAAP). These principles are broad guidelines that have been established by the accounting profession in order to accomplish the objectives of financial reporting. Application of GAAP to a particular situation or problem

\(^{17}\)Accounting Principles Board, *op. cit.*, p. 9.

\(^{18}\)Ibid., pp. 36-38.
involves a degree of judgment and subjectivity. Accountants have often been criticized for the numerous alternative ways that an item can be treated and still conform to GAAP.

The AICPA is aware of the need for flexibility and judgment in financial accounting. In a landmark decision the Council of the AICPA promulgated the following position on GAAP:

1. "Generally accepted accounting principles" are those principles which have substantial authoritative support.

2. Opinions of the Accounting Principles Board constitute "substantial authoritative support."

3. "Substantial authoritative support" can exist for accounting principles that differ from Opinions of the Accounting Principles Board.19

In its 1964 Bulletin, the Council unequivocally established that Opinions of the APB are to be considered as generally accepted but also provided for possible exceptions to the general guidelines expressed in the opinions.

It is possible to identify life insurance accounting and reporting practices used for statutory reporting purposes. GAAP, as they apply to stock life insurance companies, are not easily identified and application of GAAP to a particular life insurance practice involves the exercise of judgment. This study will attempt to compare those statutory practices used to prepare the NAIC Statement Blank with accounting and reporting practices that conform to GAAP.

Scope of the Study

There are two principal types of life insurance companies, stock companies and mutual companies. In a mutual company the policyholders own the company. Mutual companies hold annual meetings where the policyholders are invited and the annual report, including the financial statements, is presented. Policyholders elect the management and dividends are paid to policyholders based on the individual premium paid, type of policy and net income of the company.

In a stock life insurance company stockholders own the company. In some instances, the stockholders are also policyholders but they represent two distinct groups with different objectives. A stockholder is concerned with a return on his investment, whereas a policyholder is concerned with obtaining insurance coverage at reasonable rates. Obviously, stockholders would like to maximize the return on their investment and policyholders would like to obtain the necessary insurance coverage at the lowest possible cost.

The scope of this study will be limited to the accounting and reporting practices used by stock life insurance companies. This limitation is justified because of the conflict of objectives between the stockholders and policyholders of a stock life insurance company.

As indicated earlier, life insurance accounting and conventional financial accounting have different objectives. Because of such differences, the accounting and reporting practices used by stock life insurance companies do not coincide with generally accepted accounting principles. A second limitation to the scope of this study concerns the
basis of selecting the specific accounting and reporting practices to be examined in the study.

The following criteria were used to select those accounting and reporting practices to be examined: (1) The treatment of the item must have a material effect on the determination of net income. (2) The item must have an effect on the physical appearance of the published financial statements.

A composite list of the differences between life insurance accounting practices and GAAP were included in the August 1972 AICPA exposure draft of the Audits of Stock Life Insurance Companies:

Recognition of premium revenues
Recognition of costs
Deferred income taxes
Valuation of investments and recognition of realized and unrealized gains (losses) thereon
Investments in subsidiaries
Special reinsurance agreements
Stockholders' equity
Mandatory Securities Valuation Reserve (MSVR)
Nonadmitted assets
Other variances
  (1) charging reserve "strengthening" directly to surplus rather than against income
  (2) charging surplus rather than income with prior service costs of pension plans
  (3) netting encumbrances against related assets
  (4) transferring only the par value of stock to capital for certain stock dividends.

The areas to be examined in this study, selected by application of the two criteria previously listed, include the following:

1. Recognition of Revenue and Expenses
2. Deferred Federal Income Taxes

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3. Accounting for Investments
4. Nonadmitted assets
5. Annual Report of the Stockholders

The areas included in this study are also included in the AICPA's list of differences between life insurance accounting and GAAP. Some of the areas listed by the AICPA are not included in this study as they do not have a material effect on net income determination nor do they affect the appearance of the published financial statements.

In addition to the differences between life insurance accounting and GAAP, some consideration will be given to a discussion of the mechanics of the accounting cycle and the information included in the NAIC Statement Blank. The mechanics of the accounting cycle for life insurance companies is influenced by the following classifications: ledger, non-ledger, admitted, and non-admitted. These terms are used in the discussion of the accounting treatment of the items included in this study and it is necessary to be aware of their meaning and significance.

The schedules and exhibits included in the NAIC Statement Blank reflect detail computations of the amounts included in the financial statements. In order to relate life insurance accounting and GAAP it is necessary to understand both the mechanics of the accounting cycle and have a knowledge of the exhibits and schedules included in the NAIC Statement Blank.

Research Methodology

The primary research material that will be used in this study include the following sources: (1) text books and manuals on life-
insurance accounting, (2) pronouncements of the AICPA, (3) publications of Ernst & Ernst, (4) annual published reports of stock life insurance companies and (5) published NAIC Statement Blanks.

The study will involve establishing the accounting and reporting practices used by stock life insurance companies. A comprehensive explanation of accounting practices is presented by Joseph C. Noback in his book, *Life Insurance Accounting, A Study of the Financial Statements of Life Insurance Companies in the United States and Canada*. The author states that his text is intended to "... describe the generally accepted principles, practices, and procedures applied by U.S. and Canadian life insurance companies in preparing the comprehensive financial statements required by the supervisory authorities."\(^{21}\)

Publications of the S. S. Huebner Foundation for Insurance Education represent another major source of text material related to life insurance accounting and reporting practices. The primary purpose of the Foundation is to encourage insurance education at the college level. To accomplish its objectives, the Foundation has published "... research theses and other studies which constitute a distinct contribution directly or indirectly to insurance knowledge."\(^{22}\)

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Pronouncements and publications of the AICPA will be used to establish and identify GAAP. The AICPA publications to be used in the study include Opinions of the Accounting Principles Board, Statements on Auditing Procedure, Statements of the Accounting Principles Board and Accounting Research Studies.

As previously noted, CPA firms have demonstrated an interest in life insurance accounting and reporting practices. Ernst & Ernst recognized the lack of empirical data in the area of the actual reporting practices used by life insurance companies and accordingly has conducted a number of surveys of reporting practices. In 1969, Ernst & Ernst published a Survey of Life Insurance Company Reports to Stockholders and Policyholders. The 1970 edition was entitled, Insurance Financial Reporting Trends, and in 1971, Ernst & Ernst published Insurance Financial Reporting Trends. The three editions of the Ernst & Ernst survey established the reporting trends of stock life insurance companies from 1964 to 1970.

The 1971 edition of Insurance Financial Reporting Trends reflects the extent of the survey. The insurance in force for the companies included in the survey is listed as follows:

<table>
<thead>
<tr>
<th>Insurance in Force (In millions of Dollars)</th>
<th>As of December 31, 1970</th>
</tr>
</thead>
<tbody>
<tr>
<td>200 Stock Companies</td>
<td>$490,439</td>
</tr>
<tr>
<td>50 Mutual Companies</td>
<td>761,354</td>
</tr>
<tr>
<td>Total Survey Companies</td>
<td>$1,251,793</td>
</tr>
<tr>
<td>Life Insurance Industry</td>
<td>$1,402,758</td>
</tr>
</tbody>
</table>

Stock life insurance companies publish annual reports. These annual reports, including the financial statements and the auditor's opinion on the financial statements, are mailed to all stockholders with the notice of the annual stockholder meeting. Life insurance companies will also provide copies of their annual report to anyone requesting a copy.

In addition to the annual report, stock life insurance companies file a NAIC Statement Blank in all states in which the company is licensed to operate. Most companies will provide a copy of the NAIC Statement Blank upon request but do not provide a copy, as a matter of practice, to all stockholders.

Most of the research data reported in this study will be of a secondary nature. However, some information will be obtained directly from copies of the annual report and the NAIC Statement Blank submitted by stock life insurance companies.

Outline of Subsequent Chapters

This study is organized into the following chapter presentations. Chapter II presents a discussion of the influence of various regulatory agencies on stock life insurance accounting and reporting practices. Life insurance operations are influenced by both state and federal agencies. Traditionally, states have regulated the operational aspects of life insurance companies. The federal government, through the SEC, regulates, financial reporting practices and dealings with the stockholders.
Chapter III involves the determination of existing accounting practices in the following areas: accounting for investments, recognition of revenues and expenses, nonadmitted assets and deferred federal income taxes. The establishment and application of accounting practices in these areas have a material effect on the determination of net results from operations.

Chapter IV presents the existing reporting practices as reflected in the NAIC Statement Blank, the financial statements included in the annual report and the CPA's opinion on the financial statements. A copy of the major financial statements included in the NAIC Statement Blank are presented to provide a better understanding of statutory financial statements. The form and content of the financial statements required for statutory reporting purposes are then compared to the financial statements included in the annual report. Finally, the standard short opinion rendered by CPAs is compared to the opinion rendered for stock life insurance companies.

Chapter V includes a series of recommendations intended to make the net income computation of a stock life insurance conform to accounting practices determined in accordance with GAAP. The specific accounting recommendations pertain to those areas that were described in Chapter III.

Chapter VI proposes a set of financial statements that would allow stock life insurance companies to report in accordance with GAAP. The recommended methods are based on improving the overall quality of
financial statements and directing the published financial statements to satisfy the needs of stockholders.
CHAPTER II

Influence of Regulatory Agencies on Life Insurance

Stock life insurance companies are subject to both state and federal regulations. Annual financial reports furnished to the state insurance departments are in the form of the NAIC Statement Blank and are prepared in accordance with state insurance regulations. The financial reports required by the SEC can be prepared in accordance with GAAP as defined in the AICPA publication, Audits of Stock Life Insurance Companies.

The state insurance department represents the primary regulatory agency with jurisdiction over the operations of stock life insurance companies. The primary objectives of state regulation is protection of the policyholder. Effective state regulation is enhanced through the efforts of the NAIC, a voluntary organization of state insurance commissioners, whose job it is to promote uniform and effective insurance regulation.

Stock life insurance companies are also subject to the securities regulations administered by the SEC. The objectives of the SEC include promoting responsible financial reporting and protecting the interest of the shareholders. Another federal agency, the FTC, has become involved in regulation of insurance mergers under the provisions of the McCarran-Ferguson Act. Finally, Congress has shown an interest
in insurance companies and has conducted a number of congressional hearings into insurance operations and regulations.

State Insurance Commissioners

Each state and the District of Columbia has a department responsible for regulation of insurance companies that operate within their respective jurisdiction. The state insurance departments are responsible for regulation of life insurance companies as well as all other types of insurance operations. The insurance departments are headed by a commissioner, superintendent-in-charge, or director. The individual in charge of the department may be elected or appointed. In addition to the director, the insurance departments have a staff of examiners, actuaries and attorneys.

Overall regulation of life insurance operations is justified because of the number of people that have a direct interest in life insurance policies and because of the potential duration of the policy period. The time difference between the issue of a policy may span many years. In order for the insurance company to meet its eventual contractual obligations it must accumulate, over time, ample policy reserves. Thus, an important part of state regulation of life insurance companies is concerned with the establishment of policy reserve requirements.1

The principal objectives of state regulation of life insurance companies involves solvency and equitable dealings with policyholders. It should be noted that state regulation is not primarily concerned with the interest of the stockholder, but in an indirect way affords protection to stockholders by establishing stringent solvency requirements. An exception to the lack of concern for stockholders can be noted in the operation of the insurance departments of a few states. For example, in Iowa, the administration of the securities laws is vested in the insurance commissioner. The securities and insurance departments share the same offices.  

The first state to have a department of insurance was New Hampshire in 1851. An 1856 New York proposal to establish a separate insurance department was defeated because the insurance companies believed it would infringe on their rights and liberties. However, the New York setback was only temporary and by 1860 New York had its insurance department.  

The beginning of effective state regulation of life insurance is attributed to Elizur Wright. It was Wright who compiled a series of valuation tables which could be applied to determine policy reserve requirements at the end of each policy year. In 1858, Wright lobbied his legal reserve principle through the Massachusetts legislature and

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in that year was appointed as head of the Massachusetts insurance department. Within the next ten years, thirty-five states established insurance departments and adopted various laws to regulate the operations of life insurance companies.

The first legal test of whether the states or the federal government had the right to regulate insurance operations was the 1868 case of Paul vs. Virginia. The case involved the arrest of an agent from a New York company, Mr. Paul, who was selling insurance in Virginia, but had not been licensed by Virginia. Paul appealed his case to the U.S. Supreme Court claiming that only the Federal Government had the power to regulate interstate commerce. The court ruled that insurance was not commerce and consequently was subject to state regulation. This Supreme Court decision remained as the law of the land for more than seventy-five years.

A significant development concerning the operation and regulation of life insurance companies took place in 1905 when the Armstrong Investigating Committee was organized to probe the operations of life insurance companies operating within the state of New York. The investigation resulting from the public's concern over the operation of life insurance companies and a feeling that more than a few companies engaged in shady practices. The Armstrong Investigation was not intended to

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5 Thores, op. cit., p. 1042, citing Wall, 75 US 168 (1869).

6 Mayerson, op. cit., pp. 36-37.

7 Norton, op. cit., p. 1130.
condemn life insurance companies but instead to provide more protection
to policyholders and improve the overall life insurance operations by
eliminating undesirable practices.

The recommendations of the Armstrong Committee included the
following proposals:

1. Setting requirements as to the organization of companies,
election of directors, and conversion of stock into mutual
companies.
2. Limiting the right to hold real estate, prohibiting
investment in stocks and forbidding syndicate participa-
tions in security transactions.
3. Limiting the amount of surplus and contingency funds that
may be accumulated.
4. Forbidding tontine dividend plans by requiring that mutual
life insurance companies must distribute surplus annually
and not otherwise.
5. Dealing with the contents of policy forms and the rights
of policyholders.
6. Prescribing the detail to be reported in annual statements.

Acting on the recommendations of the Armstrong Committee, New
York passed a new insurance code in 1906. Other states followed New
York's lead which resulted in a significant improvement in the insurance
laws throughout the country.

In 1944, the U. S. Supreme Court handed down another decision
that affected regulation of insurance companies. The case of U. S. v. South
East Underwriters Association involved fixing premiums and
commissions as a violation of the Sherman Anti-Trust Act. In this case,

8Thore, op. cit., p. 1077, citing Report of the Joint Committee
of the Senate and Assembly of the State of New York, Appointed to
Investigate the Affairs of Life Insurance Companies, in Exhibits, Reports
and Index of Legislative Insurance Investigating Committee (Albany, 1906),
Vol. VII.
"in a 4-3 decision, two justices excusing themselves from the case, the court held on June 5, 1944, that when the transaction of insurance business crosses state lines it is interstate commerce."\(^9\)

Following the SEUA decision, Congress in 1945 passed Public Law 15 which stated that regulation and taxation of insurance operations is in the public interest. "Congress, in effect, was inviting the states to continue regulating insurance, but was serving notice that it would be prepared to take over, if state regulation proved inadequate."\(^10\)

There are additional cases and decisions affecting the regulation of insurance operations, but the ones previously cited (Paul vs. Virginia, Armstrong Investigation, U. S. vs. South East Underwriters Association, and Public Law 15) represent landmark decisions in the area of insurance regulation. Additional cases will be cited in a subsequent discussion in this chapter involving other federal regulation of life insurance operations.

Much has been written concerning the merits of state vs. federal regulation of life insurance operations. However, the fact remains that under Public Law 15, insurance companies continue to be regulated by the various state insurance departments.

The existing insurance laws administered by the state insurance departments can be identified as relating to the following six major areas:

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\(^10\)Mayerson, op. cit., p. 38.
1. Laws governing the organization, powers and duties of the insurance departments.

2. Laws relating to the powers, limitations, and requirements of insurance companies, both those domiciled in the state and those chartered elsewhere but doing business in the state.

3. Laws with respect to qualification and licensing of agents.

4. Laws bearing on insurance contracts and the rights of policyholders and beneficiaries which arise from the contract.

5. Miscellaneous statutes which deal with such matters as rights of minors to contract for insurance, exemption of proceeds from claims of creditors, insurable interest and assignment of policies.

6. Tax laws. (States impose taxes on life insurance companies at rates which average about two per cent of the premiums paid by policyholders.)

The direct relationship between state insurance laws and accounting and reporting practices used by stock life insurance companies is:

(1) State insurance commissioner require the filling of the NAIC Statement Blank on an annual basis.

(2) The commissioner is required to conduct a triennial examination of all companies operating within the state. Special examinations into the financial or operating practices of a company can be conducted at any time, at the discretion of the commissioner.

(3) The commissioner is responsible for reviewing the determination of policy reserve requirements. State law "... requires that life insurance companies reserves must be those calculated from the 1958 Commissioners Standard Ordinary Mortality Table at 3½ per cent ... or a mortality table and interest rate giving, in the aggregate,

11Thore, op. cit., no. 1072-041.
higher reserves.\textsuperscript{12}

(4) Valuation of assets is another financial reporting area subject to the regulation of the commissioner. The designation of nonadmitted assets include assets owned by the company but not reported in the life insurance financial statements. Examples of nonadmitted assets include equipment, other than certain data processing equipment, agents' debit balances and furniture.

(5) Investments made by life insurance companies are regulated by the commissioner as to the type of security that can be acquired and the percentage of the portfolio that may be invested in any one security issue. The major objectives of the laws regulating investments include the following: to prevent management from making speculative investments, to prevent the insurance company from being vulnerable to fluctuations in market conditions, to prevent control of another company by acquisition of controlling interest, and to promote social objectives such as investments in housing.\textsuperscript{13}

State regulations of investments vary and specific examples of regulations include Wisconsin, which limits common stock investment to 15 per cent of admitted assets and New York, which limits common stock

\textsuperscript{12}Mehr and Osler, \textit{op. cit.}, p. 712.

to 5 per cent of admitted assets, or one half of surplus, which ever is smaller.\textsuperscript{14}

State insurance laws are under constant revision. Within recent decades, many states have adopted new insurance codes.\textsuperscript{15} Most revision of insurance regulation comes as a result of an orderly process and is directed toward improving the effectiveness of existing regulations. Occasionally, as a result of a specific incident, attention is focused on the regulation of insurance companies and the adequacy of such regulation is questioned. A recent case which has caused substantial attention to be directed toward life insurance companies and their regulation is the Equity Funding case.

In April, 1973, Equity Funding Corporation of America, the parent company of Equity Funding Life Insurance Company filed and was granted protection under Chapter 10 of the Federal Bankruptcy Act. The Equity Funding case involves reporting bogus policies by Equity Funding Life and the disappearance of 75 per cent of the $29 million assets reported by Equity Funding Life in its December 31, 1972 financial statements.\textsuperscript{16}

\textsuperscript{14}\textit{Ibid.}, p. 131.


The Equity Funding case will influence future regulation of life
insurance companies. The case is very involved and some of the parties
implicated in the investigation include the Insurance Departments of
Illinois and California, the SEC, banks, other creditors, certified
public accounting firms, stock brokers, stockholders, the NYSE, and
other governmental agencies.

Although the SEC has no jurisdiction over the regulation of
life insurance companies,

... Chairman G. Bradford Cook of the Securities and
Exchange Commission disclosed ... that the SEC plans to
hold a conference of state insurance regulators and "representative" accounting firms, insurance companies and reinsurers
to determine whether there currently are "adequate safeguards"
to prevent a reoccurrence of the Equity Funding scandal in
other quarters of the industry.17

The potential effect of Equity Funding on state regulation of
life insurance companies was discussed by Fred A. Muck, Illinois
Director of Insurance. In a press conference, Mr. Muck stated "there
could and must be substantial improvement in the financial examination
and regulation of insurance companies."18 One of the specific
proposals mentioned by Mr. Muck was the measure that "states require
insurers to file annual financial statements that have been prepared
and certified by independent certified public accountants rather than
by the companies themselves as is now being done."19 If adopted by

17"Big Board Moves to Penalize Disks on Equity Funding," The

18"Equity Funding Case Prompts Regulator to Ask Tighter Controls,"
The National Underwriter, Life and Health Insurance Edition, 77th year,

19Ibid.
Illinois, this provision could have far reaching effects on the present structure of triannual examinations and NAIC Statement Blank reporting requirements.

Evidence of the concern that the state insurance departments have for the policyholder can also be demonstrated by the Equity Funding case. At first mention of the investigation, stockholders, creditors, and reinsurers were identified as the groups that would stand to lose the most financially. Then as the investigation unfolded and the materiality of the fraud was disclosed, the policyholders were included in the group of potential losers. The California Insurance Commissioner, Gleeson L. Payne, "called for the life insurance industry to assume the liabilities of any troubled life or disability company in the state."\textsuperscript{20} A bill to provide such protection was introduced into the California Assembly on April 5, 1973 and a similar bill is being drafted in Illinois.

Effective regulation of life insurance operations began in Massachusetts in 1858 and is still evolving today. Significant cases and events having an effect on regulation include: 1868 - \textit{Paul v. Virginia}; 1905 - Armstrong Investigation; 1944 - \textit{U. S. v. South East Underwriters Association}; 1945 - Public Law 15; and 1973 - Equity Funding. In addition to the ones cited, other cases and events have influenced insurance company regulation. It is the interest of the

\textsuperscript{20}"On the Coast-to-Coast Trail of Equity Funding," \textit{Business Week}, Number 2276, (April 21, 1973), p. 68.
policyholders that is of prime concern in the determination of the
measures adopted by states to regulate the operations of life
insurance companies.

National Association of Insurance

Commissioners

A discussion of life insurance regulation would not be con-
sidered complete without some consideration of the National Association
of Insurance Commissioners (NAIC). The objective of the NAIC is to
promote uniformity in state insurance laws.

The NAIC was formed as a voluntary organization in 1871 by the
Honorable George W. Miller, Superintendent of Insurance of New York. 21
The reason for calling the first meeting of insurance commissioners
was to establish uniform practices in the area of financial reporting,
examination, and regulation.

A listing of some of the achievements of the NAIC would include
the following:

1. Uniform rules have been adopted for the valuation of
   securities in the annual statement blank.
2. A standard mortality table for ordinary and industrial
   insurance has been developed.
3. New standard valuation and nonforfeiture laws have been
   drafted, and their enactment has produced a uniform
   pattern in these areas in virtually all the states.
4. The so-called "zone system" for the triennial examination
   of life insurance companies has been developed. Under this
   system, examiner teams from several state insurance

21 Mehr and Caster, op. cit., p. 695.
departments examine companies under the general direction of the insurance department of a company's home state.\textsuperscript{22}

The NAIC operates through a number of standing committees and special committees. Standing committees that have an important effect on financial matters include the Committee on Valuation of Securities, the Committee on Examinations and the Blanks Committee.

The Committee on Valuation of Securities determines the rules to be followed in reporting investments for financial statement purposes. At the end of each year the committee publishes a listing of the association values for all stocks and bonds owned by life insurance companies. This listing is arrived at by a staff of security analysts who decide on the appropriate values to be assigned to investments in stocks and bonds.\textsuperscript{23}

The Committee on Examinations is responsible for arranging examinations of all life insurance companies operating in two or more states. The examination is intended to verify the amounts reported in the NAIC Statement Blank and determine that the company is complying with existing state regulations.

For examination purposes, the United States is divided into six examination zones, each zone containing eight or more states. The company's home state usually initiates the examination with examiners from other states assisting in the examination. At the conclusion of

\textsuperscript{22}Thore, \textit{op. cit.}, p. 1076.

\textsuperscript{23}Mayerson, \textit{op. cit.}, p. 73.
the examination, a detailed report is provided including recommendations or criticisms noted by the examiners.  

The Committee on Blanks is responsible for the annual reporting form, the NAIC Statement Blank, used by life insurance companies in reporting to the state insurance departments. The committee is responsible for reviewing the format of the Blank and making suggestions for its improvement. In this regard, the NAIC bylaws state:

The Committee on Blanks shall hold one or more meetings annually at the call of the chairman for the purpose of considering amendments to the various Association annual statement blanks. Following such meetings the Committee shall submit its report with recommendations to the Executive Committee and the Executive Committee shall consider such report and refer the same with such recommendation as it deems necessary to the Association. It shall be the duty of the Committee on Blanks to prepare blanks in accord with the action taken by the Association and have them distributed to all members of the Association.  

The NAIC meets twice each year to consider the standing and special committee reports. The committee appointed to study the effect of the AICPA audit guide has made a number of progress reports to the NAIC. At the December 1971 winter meeting, the committee members recommended that "... the NAIC discourage life insurers from

24 Ibid.

adopter prematurely the principles of the exposure draft of the AICPA and instead endorse the development of modifications or supplements to the annual statement as the proper means of providing meaningful information to the investing public." The committee stated that it had reported to the SEC, that since life insurance financial statements are policyholder oriented any radical change in reporting could result in both added expense and confusion.

The AICPA audit guide was finally issued in December 1972, two weeks after the NAIC 1972 winter meeting. Previous mention of the NAIC's reaction to the audit guide was noted in Chapter I. Essentially the NAIC "... reiterated its position that statements prepared on other than a statutory basis have no legal standing ..." 27

Although the NAIC has no legal status it plays an important role in the regulation of life insurance companies. The semiannual meetings provide a means for the insurance commissioners to consider pertinent topics affecting insurance and keep informed as to the progress of the work of the special and standing committees. Through the efforts of the NAIC, uniformity of life insurance regulation is promoted and life insurance commissioners are better informed and thus more capable to fulfill their obligation to the public by protecting policyholders.


Securities and Exchange Commission

The Securities and Exchange Commission (SEC) was created in September 1934 following the adoption of the Securities Exchange Act of 1934. The origin of the SEC can be traced to the Senate investigations following the 1929 stock market crash. Although prior to the market crash many states had laws for the regulation of securities, their laws were ineffective and, furthermore, were not applicable in interstate commerce.\(^28\)

Provisions of the Securities Act of 1933 regulate the distribution of securities by requiring the registration of certain securities before they can be offered for sale. The Securities Exchange Act of 1934 is concerned with trading in securities and includes the following registration requirements:

1. National securities exchanges
2. National association of securities dealers
3. Securities listed on exchanges
4. Securities of most other (so-called over-the-counter) companies; except banks and insurance companies \(\ldots\) \(^29\)

Provisions of the Securities Exchange Act of 1934 require the following forms to be filed: (1) Form 10, the principal form for registration of securities; and (2) Form 10-K, the prescribed form for annual reports. Special relief is provided insurance companies by the


provision that "financial statements filed by . . . insurance
companies (other than title companies) need not be certified."\(^3\)

Regulation S-X, initially adopted in 1940, is the "principal
accounting regulation of the SEC in its administration of the
Securities Act of 1933, the Securities Exchange Act of 1934 . . . and
the Investment Company Act of 1940."\(^3\) In 1964 Article 7-A of regu-
lation S-X was adopted which required life insurance companies to use
the NAIC Statement Blank form, with some modifications, in reporting
to the SEC.

In Release No. 100, October 6, 1964, the SEC stated that it was
necessary to adopt Article 7-A " . . . because of the increasing
number of life insurance companies filing financial statements with
the Commission in registration statements and annual reports . . . ."\(^3\)
As previously indicated, Article 7-A requires the use of the basic
NAIC Statement Blank forms in filing Forms 10 and 10-K. SEC require-
ments differ in the area of presentation of the "Surplus Account" and
Article 7-A requires the following:

20. Surplus.—(a) Separate captions shall be shown for
(1) paid-in surplus, (2) surplus arising from revaluation of
assets, (3) other capital surplus, and (4) earned surplus
(1) appropriated and (ii) unappropriated. There shall be
included under earned surplus, appropriated, all special
surplus funds. That portion of the surplus allocable to
participating policies should be included in caption 21 below.

\(^3\)Ibid., pp. 13-6, 13-11 & 13-12.
\(^3\)Ibid., p. 14-1.
\(^3\)Securities and Exchange Commission, Accounting Series Release
//100, Adoption of Article 7-A and Rule 12-13 of Regulation S-X,
October 6, 1964.
(b) If undistributed earnings of subsidiaries are included, state the amount thereof parenthetically or otherwise.

(c) An analysis of each surplus account setting forth the information prescribed in Rule 11-02 shall be given for each period for which a profit and loss statement is filed, as a continuation of the related profit and loss statement or in the form of a separate statement of surplus, and shall be referred to here.33

Stock life insurance companies are required to comply with SBC requirements as a result of: (1) listing their stock on a national stock exchange or (2) operating as part of a parent holding company complex. The consequence of a company qualifying under either of these criteria requires that the company "must comply with annual and periodic reporting requirements and are subject to the proxy solicitation and inside trading rules."34

Of the 200 stock life insurance companies included in the Ernt & Ernst, Financial Reporting Trends, Life Insurance, 1972, the following information relating to listing of stock was reported:

Number of companies whose shares are traded on the:

<table>
<thead>
<tr>
<th>Exchange</th>
<th>Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>New York Stock Exchange</td>
<td>17</td>
</tr>
<tr>
<td>American Stock Exchange</td>
<td>2</td>
</tr>
<tr>
<td>Midwest Stock Exchange</td>
<td>1</td>
</tr>
<tr>
<td>Over the counter</td>
<td>180</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>200</strong></td>
</tr>
</tbody>
</table>

33Rappaport, op. cit., p. 1755.


The Ernst & Ernst survey also reported the following concerning holding companies: "seventy-one per cent of life insurance companies included in the survey were part of a congenic combination in 1971 . . . ." The trend that has developed over the past five years indicates an increase in insurance companies listed on national exchanges and an increase in the holding company form of organization.

Following the 1964 adoption of Article 7-A and until 1967, life insurance companies used NAIC Statement Blank methods in reporting to the SEC. In 1968 a large life insurance company, whose stock was traded on the NYSE, deferred acquisition costs in the financial statements filed with the SEC. In 1969, additional departure from regulatory techniques was reflected in SEC statements by the adjustment of reserves for interest and mortality.

Following the promulgation of the AICPA's, December 1970 Exposure Draft of Audits of Life Insurance Companies, a general trend to depart from the NAIC Statement Blank to GAAP was noted. Life insurance companies began to report in the financial and trade press their intentions to report using GAAF for year ended 1971.

The controversy involving the merits of life insurance companies reporting under GAAP and the question as to which method should be used in reporting to the SEC and shareholders was temporarily settled by a letter dated December 14, 1971, signed by the SEC's chief accountant,

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36 Ibid, p. 78.

37 Ernst & Ernst, Insurance Industry Committee, Natural Reserves and Life Insurance Accounting (Ernst & Ernst, 1970), p. 19.
A second exposure draft of the audit guide, *Audit of Stock Life Insurance Companies*, was issued by the AICPA in August 1972. Comments on the guide were to be forwarded to the AICPA Committee on Insurance Accounting and Auditing with a deadline of September 30, 1972.

Announcement of the approval of the audit guide was noted in the December 12, 1972 *Wall Street Journal*. The *Journal* reported that the Accounting Principles Board had "finally approved generally accepted accounting principles for life insurance companies." The audit guide recommended immediate implementation of GAAP for year ended 1972 and requires adoption of GAAP for year ended 1973. Some major life companies, including U. S. Life Corporation, Franklin Life Insurance Company, and Connecticut General Insurance Company, reported that they would not switch to GAAP for 1972. Other companies, including CNA, stated that they would restate earnings for 1972 according to GAAP.

Acceptance of the Audit Guide by the AICPA resulted in a change in the original position of the SEC on reporting life insurance financial statements under GAAP. In a January, 1973 ruling the SEC announced "... it will be acceptable in filing with the SEC for financial statements of life companies prepared in accordance with general accepted accounting principles (GAAP) as described in the audit guide."

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Andy Barr. The letter stated that companies which had reported "to the SEC and to their shareholders in accordance with accounting practices prescribed by state statutes must continue to do so until an industry audit guide . . . is adopted by the AICPA committee on insurance accounting and auditing."38

Major life companies that had, prior to year ended 1971, adopted a modified form of GAAP for reporting purposes included Aetna Life & Casualty Company, Transamerica Corporation's insurance subsidiaries, and Gulf Life Holding Company. One of the major companies that had planned to depart from statutory reporting was CNA Financial Corporation. Following the SEC edict, CNA reported that it would not report 1971 earnings on an adjusted basis as it had intended.39

The rationale for the SEC's position involved the industry reaction to the original draft of the AICPA audit guide and in particular, use of the natural reserve method. In his letter, Andy Barr noted that "a member of your committee (AICPA) had developed serious doubts as to the propriety of the natural reserve method."40 The SEC recommended additional research and investigation into the alternatives of reporting adjusted earnings.


A second exposure draft of the audit guide, *Audit of Stock Life Insurance Companies*, was issued by the AICPA in August 1972. Comments on the guide were to be forwarded to the AICPA Committee on Insurance Accounting and Auditing with a deadline of September 30, 1972.

Announcement of the approval of the audit guide was noted in the December 12, 1972 *Wall Street Journal*. The *Journal* reported that the Accounting Principles Board had "finally approved generally accepted accounting principles for life insurance companies." The audit guide recommended immediate implementation of GAAP for year ended 1972 and requires adoption of GAAP for year ended 1973. Some major life companies, including U. S. Life Corporation, Franklin Life Insurance Company, and Connecticut General Insurance Company, reported that they would not switch to GAAP for 1972. Other companies, including CNA, stated that they would restate earnings for 1972 according to GAAP.

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Now that the position of the SEC concerning using GAAP for life insurance reporting purposes has been established, enforcement power of the SEC will be considered.

"In order to carry out its functions, the Commission has the following direct power:
(1) It can prevent the distribution of a security being offered for sale.
(2) It can stop the trading in a security.
(3) It can take disciplinary actions (fines, suspension of privileges, etc.) against individuals and organizations."[*]

An example of SEC intervention in the affairs of life insurance companies can be noted in the Equity Funding case. In this case the SEC brought suit in federal court charging Equity Funding with fraud and violation of federal securities laws. Under the provision of the court order the SEC will oversee a complete accounting, have the power to file suits on behalf of the company to recover assets illegally transferred, wasted or used and to conserve existing assets.^[1]

In conclusion the SEC plays an important role in the determination of accounting and reporting procedures used by stock life insurance companies. The SEC's primary objective is to protect the stockholders and insure that adequate disclosure of all relevant information has been presented by the reporting company. Because of the increase in the number of stock life insurance companies listed on the national stock exchanges and the increase in the holding company method of accounting and reporting procedures.

[^1]: Hellerson, op. cit., p. 1215.
organization, more life insurance companies are subject to the SEC regulations.

Traditionally the method of reporting permitted by the SEC was comparable to the financial statements included in the NAIC Statement Blank. In January, 1973, following the adoption of the Audits of Stock Life Insurance Companies by the AICPA, the SEC accepted GAAP as a basis for life insurance financial reporting. Although the objectives of the AICPA and the SEC are compatible, the SEC has not always followed the Institute's position in establishing reporting requirements. Treatment of the investment tax credit is an example of an area where the AICPA and SEC allowed conflicting methods of reporting. The Institute modified its original position, Opinion #2, and accepted the SEC's position regarding reporting the investment tax credit in the financial statements. In the case of life insurance reporting, the SEC has stated its intent to allow application of the audit guide and as a result will permit life insurance companies to apply generally accepted accounting principles in reporting to stockholders and the SEC.

Other Areas of Federal Regulation

In addition to the SEC, life insurance companies are subject to other federal regulatory bodies. The Federal Trade Commission (FTC) has become involved in a 1969 case concerning American General and Fidelity & Deposit Company of Maryland. The question involves insurance mergers and whether the FTC or the state commissioners have the power to regulate such mergers. An initial position taken by an FTC examiner indicated "... that the commission lacked authority in
the case because the McCarran - Fergerson Act of 1945 exempts the insurance business from federal regulation to the extent that it's regulated by state law.\textsuperscript{45} The examiner further pointed out that the merger had been approved by the insurance departments of Texas and Maryland, the states in which the two companies are based. The FTC overruled the examiner in stating that "the business of insurance for which regulation by a state may preempt federal jurisdiction doesn't include mergers which may have a national impact on competition."\textsuperscript{46}

Regulation of variable life insurance is another area where there has been considerable controversy involving federal or state regulation. Variable life insurance links the proceeds paid upon death of the insured to the market value of an investment portfolio. Under the terms of the policy, the beneficiary would be guaranteed the face of the policy, but may receive an additional amount depending upon stock market conditions at date of death of the insured.

There have been a number of rulings on the regulation of variable life insurance. In an April, 1959 decision, the U. S. Supreme Court, in the case of the SEC vs. Variable Annuity Life Insurance Company ruled that variable annuities are securities and thus, are subject to SEC regulation.\textsuperscript{47} A January 31, 1973, ruling by the SEC


\textsuperscript{46}Ibid.

stated that "... the sale of variable life insurance is subject to federal disclosure requirements, but left the regulation of sales charges to state agencies."^48

The consequence of SEC regulation over variable life included the following requirements: (1) both agents and companies selling variable life insurance must register with the SEC, (2) companies must disclose various financial information, (3) companies must adhere to certain restrictions on advertising and sales materials. The SEC further ruled to exempt variable life insurance from provisions of the Investment Company Act of 1940.

In addition to the FTC and SEC, the U. S. Congress has also demonstrated some interest in insurance regulations. In 1958, the Senate Judiciary Antitrust Subcommittee was appointed to investigate the adequacy of state insurance regulation. The committee in its report to the Congress "charged that the administrative capacity of many insurance departments is inadequate and control over many insurance operations is lax and ineffective."^49

With some exceptions, Congress and the other federal agencies have conceded the regulation of life insurance to the states. Although state regulation dates back to the 1860's, it was the Armstrong Investigation in 1906 that resulted in revision and improvement in


^49Mehr and Osler, op. cit., p. 703.
state regulations. It can also be noted, that it was the 1929 stock market crash and the abuses of financial reporting that resulted in creation of the SEC in 1934.

The states, through the efforts of the state insurance commissioners and the NAIC, have done a creditable job in regulating life insurance operations. Continued responsibility for life insurance regulation depends upon the adequacy of state regulations to prevent major scandals or frauds from being perpetrated by unscrupulous life insurance companies. Future regulation by the states is subject to the wishes of Congress and influenced by the actual performance of life insurance companies.
CHAPTER III

Existing Accounting Practices

The accounting practices used by stock life insurance companies differ considerably from the methods used in conventional accounting. Much of the mechanical differences of recording transactions and preparing financial statements are caused by the life insurance technique of classifying assets into four categories: ledger, nonledger, admitted, and nonadmitted.

Mechanics of Accounting Cycle

A ledger asset is an item for which an account is maintained in the general ledger. Examples of ledger assets include cash, bonds, and accounts receivable. The fact that an item is considered as a ledger asset simply indicates that it is subject to general ledger control. Under conventional accounting, all assets are considered as ledger assets; but in life insurance accounting, only certain assets are classified as ledger assets.

A nonledger asset is an item that does not appear in the general ledger chart of accounts. A contributing factor to the nonledger classification is the fact that life insurance accounts are maintained on the cash basis rather than the accrual basis. Investment income is recorded in the ledger when it is received, which may not coincide with the period in which the revenue was earned. In order to present
the financial statements on the accrual basis, certain adjustments are made which are not recorded in the general ledger accounts. These adjustments are recognized as nonledger items.

In conventional accounting, all adjustments are recorded in the journal and posted to the ledger. The adjusted trial balance reports the amounts that will appear in the financial statements as well as the final balance of all general ledger accounts.

The term admitted asset means that the State Insurance Commissioner will accept valuation of an asset at a particular amount for financial statement purposes. An example of admitted assets is reflected in the reporting of common stock at market value. The cost of common stock is considered as a ledger item. However, the admitted value of common stock is the amount which the company can report in the financial statements.

Nonadmitted assets are those amounts which the State Insurance Commissioner will not allow to be reported in the financial statements. Certain items such as furniture and equipment, agents' debit balances, and other classes of receivables are considered nonadmitted assets. This classification results from the authority of the State Insurance Commissioner to regulate the items reported in the financial statements of stock life insurance companies. The intent of the regulation is to promote solvency on behalf of the insurance company and to protect the financial interest of the insured.

In conventional accounting, there are no comparable classifications to the admitted and nonadmitted categories used by life
insurance companies. In financial accounting, the balance of the accounts after all end of the period adjustments have been recorded are the amounts reflected in the financial statements.

The accounting equations used in life insurance accounting are similar to conventional accounting and can be summarized in six formulas.

At the beginning of the year only real accounts have balances. The following equation can be written for the beginning of the year:

$$\text{Assets} = \text{Liabilities} + \text{Capital} + \text{Surplus} \quad (1)$$

The transactions that occur during the year are recorded on a cash basis. The entries are recorded first in the journal and then posted to the ledger accounts. The transactions recorded during the year effect both real and nominal accounts (identified in equation #2 as increase and decrease). As of the end of the year, the accounts take the form:

$$\text{Assets} = \text{Liabilities} + \text{Capital} + \text{Surplus} + \text{Increase} - \text{Decrease} \quad (2)$$

After the ledger account balances have been computed, the non-ledger items are determined. The nonledger items may appear in the accounts or may be placed directly in the NAIC Statement Blank. The effect of recording the nonledger items is reflected in the following equation:

$$\Delta \text{Assets} - \Delta \text{Liabilities} - \Delta \text{Increase} + \Delta \text{Decrease} = 0 \quad (3)$$

After giving effect to the nonledger items, equation #2 can be updated and rewritten as follows:
Assets = Liabilities + Capital + Surplus + Revenue - Expense - Dividends + Other Items \hspace{1cm} (4)

The next step in the accounting process is to close nominal accounts (revenue and expenses). The equation takes the following form:

\[ \Delta \text{Surplus} = \text{Revenue} - \text{Expense} - \text{Dividends} + \text{Other Items} \]
\hspace{1cm} (5)

The final equation reflecting the relationship as of the end of the period can be written as follows:

Assets = Liabilities + Capital + Surplus \hspace{1cm} (6)

The final equation represents the balances in real accounts as of the end of the period and completes the accounting cycle for the current period. The year end balances are then recorded as the beginning balances for the next period.

Life insurance accounting and traditional financial accounting have differences in mechanics as well as differences in the treatment afforded certain items. Conventional accounting does not use the life insurance classifications of ledger, nonledger, admitted, and nonadmitted items. However, an understanding of the mechanics of life insurance accounting is not beyond the grasp of a qualified accountant.

Differences in the treatment afforded certain items by life insurance accounting, as compared to conventional accounting, are more difficult for a financial accountant to understand and reconcile. Some of the major differences include the following areas: accounting for investments, recognition of revenue and expense, deferred federal
income taxes, and nonadmitted assets. Each of the differences listed will be examined to determine the existing methods used in accounting for stock life insurance companies.

**Accounting for Investments**

The asset section of the Balance Sheet includes bonds, stocks, mortgages, real estate and other property, and other assets. A distribution of assets of U.S. life insurance companies for year ended 1970 is presented below:

<table>
<thead>
<tr>
<th>Corporate Securities</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bonds</td>
<td>35.3%</td>
</tr>
<tr>
<td>Stocks</td>
<td>7.4%</td>
</tr>
<tr>
<td>Total</td>
<td>42.7%</td>
</tr>
<tr>
<td>Government Securities</td>
<td>5.3</td>
</tr>
<tr>
<td>Mortgages</td>
<td>35.9</td>
</tr>
<tr>
<td>Real Estate</td>
<td>3.0</td>
</tr>
<tr>
<td>Policy Loans</td>
<td>7.8</td>
</tr>
<tr>
<td>Miscellaneous Assets</td>
<td>5.3</td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td>100.0%1</td>
</tr>
</tbody>
</table>

As indicated by the statistics quoted above, the category of corporate securities represent approximately forty-three per cent of the total assets reported by life insurance companies for 1970. The category consist of bonds, preferred stocks and common stocks. The accounting problems to be considered for these three types of investments include valuation and determination of mandatory securities valuation reserves.

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Valuation

Bonds are reported at amortized value, preferred stocks at cost and common stocks at market value. The basic premise in valuation of securities is to use a method which provides the greatest degree of stability to the financial statements. Bonds and preferred stocks are purchased to obtain a specific rate of return while common stocks are purchased for dividend income as well as capital appreciation.

Corporate Bonds

Bonds are purchased for the purpose of obtaining a specified rate of return on a certain investment over a given period of time. Normally, bonds are purchased to be held to maturity at which time the face amount of the bond is received by the insurance company. Corporate bonds are subject to money risks (decline in value as market rate of interest increases) and loss of value due to the possibility of default.

Bonds may be purchased at a premium or a discount. If the bond is purchased at an amount less than the face value, it is considered to be purchased at a discount. A bond purchased at a premium involves a purchase price in excess of the face value of the bond. Existence of a premium or discount results from a difference between the coupon rate of interest and the market yield rate of interest. If the coupon rate is higher than the market yield rate the bond will be purchased at a premium, if the coupon rate is lower, the bond will be purchased at a discount.
The following areas will be discussed in connection with investments in bonds: acquisition, receipt of interest, amortization of premium or discount, year and accruals and reporting bonds in the financial statements.

Upon purchase of a bond, the bond account is debited to reflect the cost of the bond plus brokerage fees and other incidental costs. Premium or discount is not formally recognized as the cost and not the face value of the bond is recorded in the account. If the bond is purchased between interest payment dates, accrued interest is recognized and accounted for in a separate account. Interest received during the life of the bond is recorded as an increase in cash and an increase in gross investment income. Most bonds pay interest on a semiannual basis.

Amortization of premium or discount is computed in order to reflect a constant rate of return on the investment over its entire life. This method of amortization is referred to as the scientific method as opposed to the straight line method which would amortize equal amounts over the life of the investment.

Assume on 4-1-19A the company purchased a $1,000 face value bond, six year life, interest at five per cent per year payable on 4-1 and 10-1. The bond was purchased at a price to yield a six per cent rate of return. Since the coupon rate is less than the yield rate, the bond would be purchased at a discount. The actual price paid for the bond (assuming no brokerage or incidental fees) would be computed as follows:
\[ V = M X \left( \frac{1}{1 + i} \right)^n + I \times a \ n \ i \]

\[ V = \$1,000 \times \left( \frac{1}{1.03} \right)^{12} + \$25 \times a \ 12 \cdot 03 \]

\[ V = \$1,000 \times 0.701380 + \$25 \times 9.954004 \]

\[ V = \$701.38 + \$248.85 \]

\[ V = \$950.23 \]

If the bond was purchased on 4-1-19A, the investment in bonds account would be debited for \$950.23 and cash credited for the same amount. On 10-1-19A the company would receive the first semiannual interest payment of \$25. On 12-31-19A it would be necessary to recognize the amortization of the discount and the year and accrual of interest earned but not received in 19A.

The adjusting journal entry made by the life insurance company at the end of the fiscal period would include the interest and accrual of the discount. The adjusting journal entry to be recorded for year ended 19A would be:

<table>
<thead>
<tr>
<th>Bonds</th>
<th>Gross Investment Income</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$5.32</td>
</tr>
</tbody>
</table>

The amounts to be reported by adjusting entry at the end of succeeding years are reflected in Table I.

The amount to be reported in the financial statements for investments in bonds is the book value or more often called "amortized value" at year end. For the example cited, the following amounts would be reported: 19A, \$955.55; 19B, \$962.99; 19C, \$970.88; 19D, \$979.26; 19E, \$988.14; and 19F, \$997.57. On 4-1-19G, \$1,000, the face value of the bond, will be received by the insurance company.
# TABLE I

**BOND ACQUIRED AT DISCOUNT**

FACE: $1,000 - SEMIANNUAL COUPON: $25.00 (COUPON RATE 5%)

PURCHASED TO YIELD 6%

<table>
<thead>
<tr>
<th>Coupon Date</th>
<th>Periods</th>
<th>3% P.V. Maturity</th>
<th>3% P.V. Annuity</th>
<th>P.V. of Face</th>
<th>P.V. of Interest</th>
<th>P.V. of Bond</th>
<th>3 Months Interest (.005 Per Month)</th>
<th>Accrued Interest</th>
<th>Book Value</th>
<th>Annual Accrual</th>
<th>Discount</th>
</tr>
</thead>
<tbody>
<tr>
<td>4-1-19A (Purchase)</td>
<td>12</td>
<td>.701380</td>
<td>9.954004</td>
<td>$701.38</td>
<td>$248.85</td>
<td>$950.23</td>
<td>$14.31</td>
<td>$12.50</td>
<td>$955.55</td>
<td>5.32 - 19A</td>
<td></td>
</tr>
<tr>
<td>4-1-19B</td>
<td>10</td>
<td>.744094</td>
<td>8.530203</td>
<td>744.09</td>
<td>213.25</td>
<td>957.34</td>
<td></td>
<td></td>
<td>970.86</td>
<td>7.89 - 19C</td>
<td></td>
</tr>
<tr>
<td>10-1-19B</td>
<td>9</td>
<td>.766417</td>
<td>7.706190</td>
<td>766.42</td>
<td>194.65</td>
<td>961.07</td>
<td>14.42</td>
<td>12.50</td>
<td>972.60</td>
<td>8.38 - 19D</td>
<td></td>
</tr>
<tr>
<td>4-1-19C</td>
<td>8</td>
<td>.789409</td>
<td>7.019692</td>
<td>789.41</td>
<td>175.49</td>
<td>964.90</td>
<td></td>
<td></td>
<td>981.14</td>
<td>8.88 - 19E</td>
<td></td>
</tr>
<tr>
<td>10-1-19C</td>
<td>7</td>
<td>.813092</td>
<td>6.320283</td>
<td>813.09</td>
<td>155.76</td>
<td>968.85</td>
<td>14.53</td>
<td>12.50</td>
<td>988.14</td>
<td>9.43 - 19F</td>
<td></td>
</tr>
<tr>
<td>4-1-19D</td>
<td>6</td>
<td>.837484</td>
<td>5.617191</td>
<td>837.48</td>
<td>135.43</td>
<td>972.91</td>
<td>14.66</td>
<td>12.50</td>
<td>997.26</td>
<td>9.43 - 19F</td>
<td></td>
</tr>
<tr>
<td>10-1-19D</td>
<td>5</td>
<td>.862609</td>
<td>4.917907</td>
<td>862.61</td>
<td>114.49</td>
<td>977.10</td>
<td>14.79</td>
<td>12.50</td>
<td>997.26</td>
<td>9.43 - 19F</td>
<td></td>
</tr>
<tr>
<td>4-1-19E</td>
<td>4</td>
<td>.888487</td>
<td>4.217098</td>
<td>888.49</td>
<td>93.93</td>
<td>981.42</td>
<td>14.93</td>
<td>12.50</td>
<td>997.57</td>
<td>9.43 - 19F</td>
<td></td>
</tr>
<tr>
<td>10-1-19E</td>
<td>3</td>
<td>.915142</td>
<td>3.518611</td>
<td>915.14</td>
<td>70.71</td>
<td>985.85</td>
<td>14.79</td>
<td>12.50</td>
<td>998.14</td>
<td>9.43 - 19F</td>
<td></td>
</tr>
<tr>
<td>4-1-19F</td>
<td>2</td>
<td>.942596</td>
<td>2.828611</td>
<td>942.60</td>
<td>47.81</td>
<td>990.44</td>
<td>14.93</td>
<td>12.50</td>
<td>997.57</td>
<td>9.43 - 19F</td>
<td></td>
</tr>
<tr>
<td>10-1-19F</td>
<td>1</td>
<td>.970874</td>
<td>2.138674</td>
<td>970.87</td>
<td>24.27</td>
<td>993.14</td>
<td></td>
<td></td>
<td>997.57</td>
<td>9.43 - 19F</td>
<td></td>
</tr>
<tr>
<td>4-1-19G (Maturity)</td>
<td>0</td>
<td>1.000000</td>
<td>-0-</td>
<td>1000.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>1000.00</td>
<td>2.43 - 19G</td>
<td></td>
</tr>
</tbody>
</table>
Normally bonds are reported at amortized value in the financial statements but under certain conditions a bond may be reported at an amount less than amortized value. If the issuing company is unable to comply with the terms of the bond indenture and the bond is in default as to principal or interest, the bond will not be included at amortized value. Under these conditions, the amount that the bond will be reported in the financial statements is the arbitrary value assigned by the Committee on Valuation of Securities of the NAIC which is referred to as the Association Value.²

Some insurance companies disclose the market value of bonds in a parenthetical comment included in the financial statements. In a survey of 125 stock life insurance companies, for year ended 1970, 44 per cent of the companies stated that bonds were valued on the basis of amortized cost. An additional 43 per cent also stated that bonds were valued at amortized cost and disclosed the market value of the bonds.³

preferred and Common Stock

The absolute amount of preferred stock owned by life insurance companies has increased over the past twenty-five years. As of


December 31, 1970, total preferred stock was reported at $3,545,000,000 which represents 1.7 per cent of total assets reported by life insurance companies. Although preferred stock does not represent a significant percentage of total assets, the accounting problems incidental to acquisition, holding and reporting will be considered briefly.

Upon acquisition of preferred stock, the investment in preferred stock account is debited for the total cost of the preferred stock. If the stock is purchased between the date of dividend declaration and the date of record, the amount of the dividend is recorded in a separate account.

Dividends on preferred stock are recorded when they are received and represent a surplus increase in the accounts (see equation #2). If the accounting period ends between the date of record and the date of payment, the dividend is recognized by an adjusting journal entry.

Preferred stocks in good standing are valued, for purposes of financial statement presentation, at cost. Preferred stocks not in good standing are reported at Association Value. In order to be classified in good standing preferred stocks must meet the following requirements: (1) if cumulative, no dividends in arrears; (2) if noncumulative, full dividends must have been paid for the past three years; (3) after tax earnings of the issuing company must be at least

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4Institute of Life Insurance, op. cit., p. 77.
entries used to account for preferred stock. The major differences between accounting for preferred and common stock is the basis of valuation used in reporting the respective amounts in the financial statements. Preferred stocks are stated at cost but common stocks are reported at market value.

Assume that on January 2, 19A, a life insurance company purchased 100 shares of common stock for a total cost, including brokerage, of $2,800. The stock account in the general ledger would be increased by $2,800, cash would be decreased by the same amount.

Assume that the common stock market value per share at the end of the year for the current year and the next three years was as follows: 19A, $30; 19B, $25; 19C, $28; 19D, $34. Incorporating the original transaction and the additional year end data, the following amounts would be reported:

**TABLE II**

<table>
<thead>
<tr>
<th>Year</th>
<th>Book Value</th>
<th>Nonledger Amount</th>
<th>Nonadmitted Amount</th>
<th>Admitted Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>19A</td>
<td>$2,800</td>
<td>$200</td>
<td>$-0-</td>
<td>$3,000</td>
</tr>
<tr>
<td>19B</td>
<td>2,800</td>
<td>-0-</td>
<td>300</td>
<td>2,500</td>
</tr>
<tr>
<td>19C</td>
<td>2,800</td>
<td>-0-</td>
<td>-0-</td>
<td>2,800</td>
</tr>
<tr>
<td>19D</td>
<td>2,800</td>
<td>600</td>
<td>-0-</td>
<td>3,400</td>
</tr>
</tbody>
</table>

The amount reported in the Balance Sheet as of the end of the year is the admitted amount shown in Table II.
The nonledger and nonadmitted amounts reported in Table II will ultimately be included in unassigned surplus for the appropriate year. Nonledger amounts will have the effect of capital gains and nonadmitted amounts are treated as capital losses. The following amounts would be reported as a result of the data reflected in Table II:

- **19A**: Capital Gain $200
- **19B**: Capital Loss $500
- **19C**: Capital Gain $300
- **19D**: Capital Gain $600

A better understanding of common stock transactions is facilitated by the NAIC Statement Blank. Supporting exhibits and schedules included in the NAIC Statement Blank provide a cross reference to the amounts reported in the financial statements. The yearly amount would appear in Column 5, Line 2 which reports net gain or loss from change in difference between book and admitted values. Exhibit 4, Capital Gains and Losses on Investments, also includes capital gains and losses resulting from sale or maturity of investments.

Total capital gains and losses computed in Exhibit 4 are transferred directly to the surplus account and are included in unassigned surplus at the end of the year.

Verification of the book value (ledger value) of common stocks, preferred stocks and bonds reported at year end is provided by Schedule D - Verification Between Years of the NAIC Statement Blank. This schedule reflects the following data:
Schedule D - Verification Between Years

Book value of bonds and stocks at beginning of year........... $XX

PLUS:

- Cost of bonds and stocks acquired.......................... XX
- Increase in book value - Bonds.............................. XX
- Increase in book value - Preferred Stocks.................. XX
- Increase in book value - Common Stocks.................... XX
- Profit on sale of bonds and stocks......................... XX

Total $XX

LESS:

- Consideration received from bonds and stocks sold....... $XX
- Decrease in book value - Bonds.............................. XX
- Decrease in book value - Preferred Stocks.................. XX
- Decrease in book value - Common Stocks.................... XX
- Loss on sale of bonds and stocks........................... XX

Total $XX

Book value of bonds and stocks at end of year............... $XX


The book value of bonds (amortized value) and preferred stocks (cost) are reported in the Balance Sheet. The book value of common stocks are adjusted using the following formula to derive the amount reported in the Balance Sheet: Book value + Nonledger amount - Nonadmitted amount = Net admitted asset. Application of this formula has the effect of reporting common stocks at market value.

Mandatory Securities Valuation Reserve

The mandatory securities valuation reserve (MSVR) is designed to absorb capital losses sustained by the securities in the investment
portfolio and to allow use of stabilized values rather than market values for reporting bonds and preferred stocks. The MSVR account is intended to act as a buffer to protect the surplus account from abrupt fluctuations that may occur in the portfolio.  

The year end balance of the MSVR is reported in the liability section of the Balance Sheet, generally as the last line item. The annual increase or decrease in the MSVR is reflected as part of the surplus reconciliation.

The MSVR was first reported in life insurance financial statements for the year ended December 31, 1951. Actual computation of the annual addition, as well as the maximum balance, was not complicated and consisted of the following items:

<table>
<thead>
<tr>
<th>ITEM #</th>
<th>DESCRIPTION</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>one twentieth of 1 per cent of amortizable bonds</td>
</tr>
<tr>
<td>2</td>
<td>1 per cent of all other bonds, preferred stocks and common stocks</td>
</tr>
<tr>
<td>3</td>
<td>plus - realized and unrealized net capital gains</td>
</tr>
<tr>
<td>4</td>
<td>less - 50 per cent of capital losses.</td>
</tr>
</tbody>
</table>

The maximum balance of the MSVR was limited to 1 per cent of item #1 plus 20 per cent of item #2.  

---

The method of computing the MSVR was revised by the Committee on Valuation of Securities of the NAIC beginning with the December 31, 1965 annual statement. The MSVR balance as of December 31, 1964 was placed in a Temporary Excess Reserve Component and allocated as (1) Bond and Preferred Stock Reserve Component and (2) Common Stock Reserve Component.

The current methods used to compute the annual addition to the MSVR and the maximum value of the MSVR are demonstrated in Tables III and IV. The actual computation is more complex than is indicated by the tables.

Component I of the MSVR computations includes bonds and preferred stocks. The annual addition to this component is initially computed in Table III. The mandatory addition for Component I consist of: (1) the amount determined in Table III; and (2) the excess of net realized and unrealized gains less federal income taxes on capital gains. Two voluntary additions to Component I MSVR may be made during the year computed as follows: (1) an amount that cannot exceed two times the amount computed in Table III; and (2) any net gain that cannot be credited to Component II because it has reached the maximum.

---

TABLE III
Annual Addition to Mandatory Securities Valuation Reserve

<table>
<thead>
<tr>
<th>Type of Security</th>
<th>Ratio Applied To Association Value</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>I. Bond and Preferred Stock Reserve Component</strong></td>
<td></td>
</tr>
<tr>
<td>This component includes all bonds (except those of the United States of America) all preferred stocks, and shares of federally insured savings and loan and building and loan associations.</td>
<td></td>
</tr>
<tr>
<td>A. Corporate bonds (other than oil and gas production loans)</td>
<td></td>
</tr>
<tr>
<td>1. Bonds that pass Test No. 1</td>
<td>.0010</td>
</tr>
<tr>
<td>2. Bonds that fail to pass Test No. 1, but pass Test No. 2</td>
<td>.0050</td>
</tr>
<tr>
<td>3. Bonds that fail Test No. 2</td>
<td>.0200</td>
</tr>
<tr>
<td>B. Oil and gas production loans</td>
<td></td>
</tr>
<tr>
<td>1. Loans that meet the requirements set down in Section 2(C), including the necessary engineers' and geological tests regarding the presence of oil, gas, or condensate in ground to secure the loan</td>
<td>.0010</td>
</tr>
<tr>
<td>2. Loans that fail to meet Section 2(C) requirements</td>
<td>.0200</td>
</tr>
<tr>
<td>C. Bonds (other than corporate bonds)</td>
<td></td>
</tr>
<tr>
<td>1. Bonds that meet the requirements of Section 2(D)</td>
<td>.0010</td>
</tr>
<tr>
<td>2. Bonds that fail to meet the requirements of Section 2(D)</td>
<td>.0200</td>
</tr>
<tr>
<td>D. Preferred stocks</td>
<td></td>
</tr>
<tr>
<td>1. Stocks in good standing (Section 3)</td>
<td>.0025</td>
</tr>
<tr>
<td>2. Stocks not in good standing (Section 3)</td>
<td>.0100</td>
</tr>
<tr>
<td>E. Shares of federally insured savings and loan associations</td>
<td>.0010</td>
</tr>
</tbody>
</table>

| II. Common Stock Reserve Component | |
| This component includes all common stock, warrants, and options other than shares of federally insured savings and loan and building and loan associations | .0100 |
Mandatory increase in Component II consist of (1) the amount determined in Table III; and (2) the excess of net realized and unrealized capital gains less federal income taxes on the realized gains. Two voluntary additions to Component II of the MSVR may be made during the year:

(1) an amount that cannot exceed 2 per cent of the aggregate statement value of common stocks; and (2) the portion of capital gains that cannot be credited to Component I since it has reached the maximum.

The MSVR is reduced if the company incurs a Component I or a Component II net loss. Component III, see Table IV, will be charged for Component I and II net losses until Component III is exhausted. After Component III is eliminated, bond and preferred stock losses will be charged to Component I and common stock losses will be charged to Component II.

TABLE IV

<table>
<thead>
<tr>
<th>Percentage Applied</th>
<th>To Association Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>I. Bond and Preferred Stock Reserve Component</td>
<td></td>
</tr>
<tr>
<td>Percentage Applied To Association Value</td>
<td></td>
</tr>
<tr>
<td>----------------------------------------</td>
<td></td>
</tr>
<tr>
<td>Maximum Value of Mandatory Securities Valuation Reserve</td>
<td></td>
</tr>
</tbody>
</table>

### A. Corporate bonds (other than oil and gas production loans)
1. Bonds that pass Test No. 1 .......... 2
2. Bonds that fail to pass Test No. 1, but pass Test No. 2 ............... 10
3. Bonds that fail Test No. 2 .......... 20

### B. Oil and gas production loans
1. Loans that meet Section 2(C) requirements ........................................... 2
2. Loans that fail to meet Section 2(C) requirements ................................... 20

### C. Bonds (other than corporate bonds)
1. Bonds that meet requirements of Section 2(D) ........................................ 2
2. Bonds that fail to meet the requirements of Section 2(D) ..................... 20

### D. Preferred stocks
1. Stocks in good standing (Section 3) .................................................. 5
2. Stocks not in good standing (Section 3) ............................................. 20

### E. Shares of federally insured savings and loan and building and loan associations .............................................. 2

### II. Common Stock Reserve Component
All common stock, warrants, and options .... 33-1/3

### III. Temporary Excess Reserve Component
This component was created on December 31, 1965. Each company was allowed to assign a portion of its 1964 reserve to it. At the end of any year, this component cannot exceed the amount included in this component at the end of the preceding year.
TABLE IV - continued

Maximum Value of Mandatory
Securities Valuation Reserve

Source: Joseph C. Noback, Life Insurance Accounting: A Study of the
Financial Statements of Life Insurance Companies in the
United States and Canada (Homewood: Richard D. Irwin, Inc.,

The MSVR plays an important role in protecting the surplus
account balance from violent fluctuations. The effect of an increase
in surplus resulting from capital gains is offset by an increase in
the MSVR. The effect of reporting capital losses is offset by a
reduction in the MSVR.

Recognition of Revenue and Expense

The method of recognition of revenues and expenses and the
selection of which individual line items will be considered are the
major factors which determine the amount reported as results from
operations. Recognition of revenue and expense will be discussed in
the succeeding paragraphs and the items to be included in the determi-
nation of net results from operations will be discussed in Chapter IV.

The two basic methods of recording financial transactions are
identified as the cash basis and the accrual basis. Of the two methods,
the cash basis is generally considered the easier to understand.

Under the strict cash basis, a financial transaction is record-
ed only when cash is received or disbursed. The traditional
financial statements, Balance Sheet, Income Statement, etc., are
replaced with a Schedule of Cash Receipts and Disbursements. The
emphasis, under the cash basis, is placed on determination of the ending cash balance and the transactions that resulted in increases or decreases of cash during the period covered by the statement.

Under the accrual basis of accounting, revenue is recognized in the period earned. The revenue earned is then matched with the expense incurred in earning such revenue to determine the results from operations.

The objective of financial accounting, under the accrual basis, is to provide a series of financial reports identified as follows: Balance Sheet—to report the financial position of the firm as of the end of the accounting period; Income Statement—to report the results from operations for the accounting period; Statement of Retained Earnings—to analyze the retained earnings account for the accounting period; and Statement of Changes in Financial Position—to report the sources and uses of financial resources for the accounting period.

Life insurance accounting is somewhat unique as the financial transactions that occur during the period are recorded, for the most part, on the cash basis, but the financial statements are presented on the accrual basis. The life insurance company presents a full set of financial statements although the books of the company are primarily maintained to provide a Schedule of Cash Receipts and Disbursements. Conversion from the modified cash basis to the accrual basis takes place at the end of the period and involves the ledger, nonledger, admitted and nonadmitted classifications.

Because of the long term nature of a basic life insurance contract, there is some question concerning the ability to accurately determine
the net results from operations. Judgment required in dealing with the long term nature is somewhat similar to the financial accounting problems "inherent in accounting for pension costs, long-term leases, construction projects, depreciation and amortization."\(^{11}\) Also, the fact remains that a company must in some way compute a figure which it reports and identifies in the NAIC Statement Blank as the "Net Gain from Operations After Dividends to Policyholders and Federal Income Taxes (excluding tax on capital gain) and Excluding Capital Gains and Losses."

Individual items to be considered in the area of recognition of revenue and expense include the following: (1) Premiums; (2) Increase in policy reserves; and (3) Acquisition costs.

**Premiums.**—Premiums on ordinary life policies can be recognized at any one of three points in time: (1) when due; (2) when collected or (3) on the policy anniversary date. As a matter of practice, most life insurance companies recognize the entire annual premium on the policy anniversary date.\(^ {12}\) Recognition of revenue at the anniversary date conforms to the accrual concept of recognition in the period earned.


\(^{12}\) Ibid., p. 74.
It is possible that an amount greater than the annual premium be paid the insurance company by the policyholder. Under this condition only the current year's premium would be recorded as income and any excess would be entered in the Premium Deposit Account.

Assume a policyholder paid the current premium and nine additional premiums in one payment. The annual premium is $100 and the insurance company discounts premiums paid in advance at 3% per annum. The total amount paid by the policyholder would amount to $878.61 (present value of annuity of 1 for 9 periods @ 3 per cent is 7.7861 $100 = $778.61 + $100.00 = $878.61). At the time the cash is received, the transaction would be recorded in the accounts as follows:

\[
\begin{align*}
\text{Cash} & : \quad 878.61 \\
\text{Premium Income} & : \quad 100.00 \\
\text{Premium Deposits} & : \quad 778.61
\end{align*}
\]

At the beginning of the second policy year, the following entry would be recorded:

\[
\begin{align*}
\text{Premium Deposits} & : \quad 76.64 \\
\text{Interest Paid on Policy and Contract Funds} & : \quad 23.36 \\
\text{Premium Income} & : \quad 100.00
\end{align*}
\]

The amount reported as Interest Paid on Policy and Contract Funds is computed as follows: $778.61 x 3\% = $23.36. The balance of the premium deposit account will systematically be reduced over the nine year period and will reflect a zero balance at the tenth anniversary of the policy.

The commission paid to the agent will coincide with the dates of income recognition. Consequently, the agent does not receive his
commission based on the policyholder's payment of the ten year premium. This method of computing the agent's commission is used as the policyholder may request that the prepaid premium be returned.  

Recognition of revenue, in the area of premium income, is based on the accrual concept of recording revenue in the period earned. Generally, the anniversary date of the policy is the date when revenue is recognized.

**Increase in Policy Reserves.**—The amount reported in the Income Statement as Increase in Policy Reserves is determined by subtracting the policy reserve requirements for the preceding year from the aggregate reserve requirements for the current year. The liability account, Policy Reserves, is the "aggregate of the policy reserves on all the individual outstanding life insurance policies and annuity contracts."  

The amount reported in the Income Statement is the "normal year-to-year increase arising from accumulation and advancing age."  

Amounts reported in the published financial statements generally represent the total policy reserves in the Balance Sheet and the increase in total reserves in the Income Statement. An analysis of

---


these amounts and supplemental information concerning their determination is provided in the NAIC Statement Blank.

On page three of the NAIC Statement Blank, Liabilities, Surplus and Other Funds, items number one, two and three represent a breakdown of the total reserves reported in the published Balance Sheet. Item one, the most significant amount, is the Aggregate Reserve for Life Policies and Contracts. The amount reported on page three of the NAIC Statement Blank is referenced to Exhibit 8 which reflects a detailed determination of aggregate life reserves. Exhibit 8 is further subdivided into eight categories and the actuary preparing the exhibit is required to indicate mortality and interest basis and valuation method by year of issue for all amounts reported. The final figure in Exhibit 8 is compared with the amount reported in the preceding year to determine the Increase in Aggregate Reserve for Policies and Contracts with Life Contingencies to be reported in the Summary of Operations, item seventeen.

The other two reserve items reported on page three of the NAIC Statement Blank are referenced to Exhibits 9 and 10. Increases in these reserves are computed in the same manner as previously explained and the increases are reported as items 10 and 11 in the Summary of Operations.

Because of its complexity, a detailed explanation of life insurance reserves is beyond the scope of this paper. However, because of its importance in the financial statements, the basis of the reserve computation will be explained briefly.
As noted earlier, the computation of policy reserves is the responsibility of the actuary because "its evaluation calls for the use of actuarial formulas, mortality tables, morbidity tables, and rates of interest."\textsuperscript{16}

In an attempt to explain the reserve computation, a simplified illustration will be presented. The emphasis in the illustration is placed on the effect of mortality in the determination of reserves. In actual practice, the reserve computation takes into effect mortality, interest, and other factors.

Computation of Reserves, Table V, is prepared under the following assumptions: (1) interest is ignored; (2) annual premiums are received at the beginning of each year; (3) death claims are paid at the end of each year.

Over the fifteen years of the illustration, 120 payments will be received (see Table V). A total of $15,000 will be paid to policyholders. In order to meet these payments, based on the assumed mortality of one death per year, the company must collect an annual premium of $125. The net premium is computed as follows: $15,000 \div 120 = $125.

The total net premium received by the company decreases each year as a result of the death rate of one insurer per year. The reserve balance increases in the early years, accumulates to a maximum balance

\textsuperscript{16}Noback, \textit{op. cit.}, p. 33.
### TABLE V

**Computation of Reserves**

15 Insured, $1,000 Face Amount

<table>
<thead>
<tr>
<th>Policy Year</th>
<th>Living at Beginning of Year</th>
<th>Died During Year</th>
<th>Rate of Mortality</th>
<th>Total Net Premium to Receive</th>
<th>Assumed Claims</th>
<th>Reserve At End Of Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>15</td>
<td>1</td>
<td>.0675</td>
<td>$1,875</td>
<td>$1,000</td>
<td>$875</td>
</tr>
<tr>
<td>2</td>
<td>14</td>
<td>1</td>
<td>.071</td>
<td>1,750</td>
<td>1,000</td>
<td>1,625</td>
</tr>
<tr>
<td>3</td>
<td>13</td>
<td>1</td>
<td>.077</td>
<td>1,625</td>
<td>1,000</td>
<td>2,250</td>
</tr>
<tr>
<td>4</td>
<td>12</td>
<td>1</td>
<td>.083</td>
<td>1,500</td>
<td>1,000</td>
<td>2,750</td>
</tr>
<tr>
<td>5</td>
<td>11</td>
<td>1</td>
<td>.091</td>
<td>1,375</td>
<td>1,000</td>
<td>3,125</td>
</tr>
<tr>
<td>6</td>
<td>10</td>
<td>1</td>
<td>.100</td>
<td>1,250</td>
<td>1,000</td>
<td>3,375</td>
</tr>
<tr>
<td>7</td>
<td>9</td>
<td>1</td>
<td>.111</td>
<td>1,125</td>
<td>1,000</td>
<td>3,500</td>
</tr>
<tr>
<td>8</td>
<td>8</td>
<td>1</td>
<td>.125</td>
<td>1,000</td>
<td>1,000</td>
<td>3,500</td>
</tr>
<tr>
<td>9</td>
<td>7</td>
<td>1</td>
<td>.143</td>
<td>875</td>
<td>1,000</td>
<td>3,375</td>
</tr>
<tr>
<td>10</td>
<td>6</td>
<td>1</td>
<td>.167</td>
<td>750</td>
<td>1,000</td>
<td>3,125</td>
</tr>
<tr>
<td>11</td>
<td>5</td>
<td>1</td>
<td>.200</td>
<td>625</td>
<td>1,000</td>
<td>2,750</td>
</tr>
<tr>
<td>12</td>
<td>4</td>
<td>1</td>
<td>.250</td>
<td>500</td>
<td>1,000</td>
<td>2,250</td>
</tr>
<tr>
<td>13</td>
<td>3</td>
<td>1</td>
<td>.303</td>
<td>375</td>
<td>1,000</td>
<td>1,625</td>
</tr>
<tr>
<td>14</td>
<td>2</td>
<td>1</td>
<td>.500</td>
<td>250</td>
<td>1,000</td>
<td>875</td>
</tr>
<tr>
<td>15</td>
<td>1</td>
<td>1</td>
<td>.000</td>
<td>125</td>
<td>1,000</td>
<td>-0-</td>
</tr>
</tbody>
</table>

Total: $15,000

- End
of $3,500 in the seventh and eighth years, and then is systematically decreased. In preparing a Summary of Operations for three selected years, the following information would be reported:

<table>
<thead>
<tr>
<th>Years Ended</th>
<th>1</th>
<th>5</th>
<th>10</th>
</tr>
</thead>
<tbody>
<tr>
<td>Premium Income</td>
<td>$1,875</td>
<td>$1,375</td>
<td>$750</td>
</tr>
<tr>
<td>Less:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Death Claims</td>
<td>$1,000</td>
<td>$1,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>Increase in Reserves</td>
<td>875</td>
<td>375</td>
<td>(250)</td>
</tr>
<tr>
<td>Net Results</td>
<td>$ -0-</td>
<td>$ -0-</td>
<td>$ -0-</td>
</tr>
</tbody>
</table>

The minimum valuation basis for ordinary life policies currently used by life insurance companies in establishing policy reserves is a combination of the Commissioners Reserve Valuation Method (CRVM), 3½ per cent interest, and the Commissioners 1958 Standard Ordinary Mortality Table.\(^{17}\)

A company has the option of changing the valuation basis to a more conservative one than required by law. This process is referred to as reserve strengthening, and amounts generated in this adjustment are not recognized as an expense in the Income Statement. The increase in reserves as a result of the use of a more conservative valuation basis will decrease the surplus account directly.\(^{18}\)

---

\(^{17}\)Ibid., p. 150.  
\(^{18}\)Van House, op. cit., p. 145.
When a company decides to strengthen its reserves, disclosure of this action must be made in the published financial statements.

Bankers National Life Insurance Company included the following footnote in its financial statements for the year ended December 31, 1970:

Notes to Financial Statements:

At the balance sheet date, December 31, 1970, the company continued its program of reserve strengthening. Total appropriations from surplus to provide for reserve strengthening were $927,996 at December 31, 1970.19

The importance of accurately determined reserves cannot be overemphasized when discussing the solvency of a life insurance company. The surplus balance will tend to increase when a company has computed its reserves on a sound basis. If the actual experience of the company is unfavorable, a resulting decrease in surplus will take place. The balance of the surplus account has a direct effect on both insurers and stockholders alike as the surplus account reflects both solvency and the ability of the company to pay dividends.

Acquisition Costs.—Life insurance companies are required to expense acquisition costs in the period such costs are incurred. The following items are examples of acquisition costs: (1) commissions; (2) medical investigation fees; (3) selection; and (4) cost incurred by the home office in preparing policies for issue.20 These items are identified as the costs of putting new business on the books.

19 Ernst & Ernst, *op. cit.*, p. 82.
Conservatism is cited as the reason for expensing acquisition costs. Additional support for this position is noted in the fact that the insured, at his discretion, may cancel the life insurance contract. As a result of conservatism and a lack of reliance on a continuing relationship, acquisition costs are expensed.

The major item of acquisition costs is the first year commission. Various commission schedules are used by life companies and the first year commission paid to the agent could range "from 55% to 100% or more of the first year premium." When the first year commission is added to the other issue costs, the total issue cost could easily exceed the first year's premium.

The effect of expensing issue costs in the year incurred will be reflected in the Income Statement at year end. In periods when the company is putting substantial amounts of new business on the books, results from operations may actually decrease. The excess of acquisition costs over premium income would have an adverse effect on net gain from operations and subsequently reduce surplus. In periods when new business is not being secured, acquisition costs will be nominal and the effect on net gain from operations will be favorable.


Under these conditions, net gain from operations may be adversely influenced by new business and favorably influenced by a decrease in new business.

The unfavorable effect of obtaining new business can be further complicated by the policy reserve requirements. The increase in policy reserves is an expense item which affects the determination of net results from operations.

Life companies have the option of selecting the method of computing policy reserves. The following methods may be adopted:

1. Net Level Premium
2. Select and Ultimate
3. Commissioners' Reserve Valuation or Modified Preliminary Term or Modified CRVM.
4. Full Preliminary Term

"The reserves resulting from these different methods of calculations rank in stringency in the order named; net level premium is the most stringent." 23

A comparison of the effect of using two of the alternative methods of computing policy reserves is demonstrated in Table VI.

A company using the Net Level Premium, 3 per cent, 1958 CSVO, would increase reserves by $22.50 in the year the policy was sold. A different company using the Commissioners Method, 3 per cent, 1958 CSVO, would not increase policy reserves in the year of sale. Table

23 A. M. Best Company, op. cit., p. XIII.
### TABLE VI

**Effect of Alternative Methods of Computing Reserves**

Net Level Premium vs Commissioners Method

Reserves - 20 Payment Life - Age 35 at Issue

(Terminal Reserves - Basis of Cash Valuation)\(^{24}\)

<table>
<thead>
<tr>
<th>Policy Year</th>
<th>1</th>
<th>7</th>
<th>10</th>
<th>20</th>
</tr>
</thead>
<tbody>
<tr>
<td>1941 Commissioners Standard Ordinary</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net Level Premium - 3%</td>
<td>$23.74</td>
<td>$175.80</td>
<td>$264.65</td>
<td>$604.67</td>
</tr>
<tr>
<td>Commissioners Method - 3%</td>
<td>None</td>
<td>160.86</td>
<td>243.06</td>
<td>604.67</td>
</tr>
<tr>
<td>1958 Commissioners Standard Ordinary</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net Level Premium - 3%</td>
<td>$22.50</td>
<td>$170.09</td>
<td>$252.14</td>
<td>$573.02</td>
</tr>
<tr>
<td>Commissioners Method - 3%</td>
<td>None</td>
<td>153.35</td>
<td>238.67</td>
<td>573.02</td>
</tr>
<tr>
<td>Net Level Premium -3%</td>
<td>$19.94</td>
<td>$152.27</td>
<td>$227.50</td>
<td>$527.07</td>
</tr>
<tr>
<td>Commissioners Method - 3%</td>
<td>None</td>
<td>137.56</td>
<td>215.35</td>
<td>527.07</td>
</tr>
</tbody>
</table>

VI also reflects the effect of interest and mortality in computing policy reserve requirements. Finally, it should be noted, that there is no permanent difference in the reserve computations resulting from the use of the Net Level Premium or the Commissioners Method.

The effect of expensing acquisition costs is offset and the problem alleviated, to some extent, by use of the Commissioners Method of computing reserves rather than the Net Level Premium. However, the

\(^{24}\)Ibid.
relief afforded by the use of a less stringent method of reserve computation does not eliminate the potential of Net Results from Operations decreasing during a period when sales of new business is increasing.

Nonadmitted Assets

The designation, "Nonadmitted Assets," is indigenous to life insurance accounting and is regarded as one of the more serious differences between traditional financial accounting and life insurance accounting. Nonadmitted assets can be classified in the two following categories: (1) assets of which no part of their value is reported in the balance sheet; (2) assets of which some part of their value is reported as an admitted asset and the remainder is identified as a nonadmitted asset.

The first category of nonadmitted assets, those amounts totally ignored, was discussed briefly in the early part of this chapter in presenting the explanation of the mechanics of life insurance accounting.

"Various items, such as equipment, furniture and fixtures, amounts receivable from agents, uncollected premiums past due over three months, mortgage loans other than first liens and loans on company stock, are considered to be 'nonadmitted assets,' without regard to their ultimate realizability. Such assets are required to be omitted from the balance sheet."25

Although nonadmitted assets are not reported in the financial statements, a life insurance company at its discretion may disclose, by footnote, the amount of nonadmitted items. The following footnote was included as part of the financial statements of American Fidelity Life Insurance Company for year ended December 31, 1970:

"Notes to Financial Statements:

The nonadmitted assets which have been excluded from the accompanying balance sheet consist of the following items:

<table>
<thead>
<tr>
<th>Agents’ Balances</th>
<th>$1,005,154</th>
</tr>
</thead>
<tbody>
<tr>
<td>Furniture &amp; Fixtures</td>
<td>$116,275</td>
</tr>
<tr>
<td></td>
<td>$1,121,429</td>
</tr>
</tbody>
</table>

Footnote disclosure of nonadmitted assets is not required in reporting on the financial position of the firm at year end.

By means of the NAIC Statement Blank, an interested party can determine the following information concerning nonadmitted assets: (1) types of nonadmitted assets owned by the company, (2) beginning and end of year balance of each nonadmitted item, and (3) increase or decrease throughout the year. Exhibit 14 of the NAIC Statement Blank, Analyses of Non-Admitted Assets and Related Items, reflects the following information.

<table>
<thead>
<tr>
<th>End of Previous Year</th>
<th>End of Current Year</th>
<th>Changes for Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Company’s stock owned</td>
<td></td>
<td>XXXXX</td>
</tr>
<tr>
<td>Loans on company’s stock</td>
<td></td>
<td>XXXXX</td>
</tr>
<tr>
<td>Supplies, stationery, printed matter</td>
<td></td>
<td>XXXXX</td>
</tr>
</tbody>
</table>

26Ernst & Ernst, op. cit., p. 42.
<table>
<thead>
<tr>
<th>End of Previous Year</th>
<th>End of Current Year</th>
<th>Changes for Year Increase (-) or Decrease (+)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Furniture and equipment</td>
<td></td>
<td>XXXXX</td>
</tr>
<tr>
<td>Committed commissions</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Agents' balances (net)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash advanced to or in the hands of officers or agents</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loans on personal security endorsed or not</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bills receivable</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Premium notes, etc., in excess of net value and other policy liabilities on individual policies</td>
<td></td>
<td>XXXXX</td>
</tr>
<tr>
<td>Accident and health premiums due unpaid</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other assets not admitted (itemize)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Agents' credit balances</td>
<td></td>
<td>XXXXX XXXX</td>
</tr>
<tr>
<td>TOTAL CHANGE</td>
<td></td>
<td>XXXXX</td>
</tr>
</tbody>
</table>


If nonadmitted assets decrease, the amount is carried to page 4 of the NAIC Statement Blank and added to the surplus account. In the case of an increase in nonadmitted assets, the amount is reported as a reduction in the surplus account.

The second classification of nonadmitted assets involves the reporting of investments. Normally, bonds are reported at amortizable value, preferred stock at cost, and common stock at market value. All of these types of investments are initially recorded as ledger items, at cost. A bond, not subject to amortization, with a ledger value of $960 but a market value of $940 would be reported at the lower amount, the market value. The $20 difference would be treated as a nonadmitted
asset. In the case of investments in common stock, when the cost is
greater than market value, the difference is recognized as a non-
admitted asset. (See Table II for an example of recognition of non-
admitted amounts resulting from investments in common stock.)

The rationale for the nonadmitted asset category reflect the
conservative nature of life insurance accounting and the objective to
protect the policyholder. The contrast can once again be made be-
tween the objective of traditional financial accounting which may be
interpreted as profit-oriented to the objective of life insurance
accounting which can be identified as solvency oriented.27

Deferred Federal Income Tax

Recognition of deferred federal income tax results from a
different treatment of certain items in the financial statements
compared to the treatment of those same items for federal income tax
purposes. The varied treatment can be rationalized by the difference
between the objective of preparing financial statements versus the
objective of preparing the federal income tax return. In preparing
the federal income tax return, the objective is to minimize taxes.

In financial accounting, one of the frequent conditions re-
quiring recognition of deferred federal income tax is the use of
straight line depreciation for book purposes and accelerated depreciation
for tax purposes. When it is necessary for a company to recognize

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27Van House, op. cit., p. 143.
deferred federal income tax, the amount reported on the Income
Statement reflects the tax based on book income. The liability that
is reported on the Balance Sheet is based on the tax return computation,
and the difference is reported as deferred federal income tax. Use
of accelerated depreciation for tax and straight line for books, will
cause deferred tax to be reported as a credit balance.

Traditionally, the determination of a company's federal income
tax liability is a complex process and requires some degree of
expertise on the part of the preparer. A preparer of the tax return
for a life insurance company must not only have a general knowledge
of federal tax law, but must also be able to understand and apply the
taxable income is composed of three elements:

Phase I  Investment income
Phase II  Gain from operations and policyholders' surplus
Phase III  Interrelationship of Phase I and Phase II income

In life insurance accounting, the two most common items that
prompt the recognition of deferred federal income tax are reserve
timing differences and unrealized appreciation on common stock. Reserve

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28 Committee on Insurance Accounting and Auditing, Audits of Stock
Life Insurance Companies, Exposure Draft, August 1972. (New York:
timing differences result from calculation of policy reserves based on preliminary term for NAIC Statement Blank purposes and a not level method for tax purposes. The resulting variance in the book and tax amounts could be recognized as deferred tax, but generally is not reported as such in the financial statements of stock life insurance companies. In the 1971 Ernst and Ernst Insurance Financial Reporting Trends, 67 per cent of the 200 stock life insurance companies surveyed for 1970 did not disclose amounts of deferred taxes resulting from reserve timing differences.29

In the case of unrealized appreciation, 73 per cent of the insurance companies surveyed by Ernst and Ernst for 1970 did not disclose deferred taxes on unrealized appreciation.30 Ignoring the tax consequence of unrealized appreciation on common stock is supported, in theory, by the workings of the mandatory securities valuation reserve. The position taken contends that MSVR is adequate to offset the effect of taxes resulting from the sale of common stock and subsequent realization of capital gains.

As a matter of practice, stock life insurance companies do not report deferred federal income taxes as a line item in the published financial statements. Also, the NAIC Statement Blank does not provide for determination or reporting of deferred federal income taxes.

29Ernst & Ernst, op. cit., p. 50.
30Ibid.
In summary, it can be concluded that existing accounting procedures used by stock life insurance companies differ considerably from procedures used in traditional financial accounting. The basic reason for many of these differences can be traced to the objectives of life insurance accounting. Life insurance accounting is influenced, to a great extent, by the need to protect the policyholder.

Some of the accounting procedures, presently followed by life insurance companies which have been discussed in this chapter are:

(1) mechanics of the life insurance accounting cycle; (2) accounting for investments; (3) recognition of revenue and expense; (4) accounting for nonadmitted assets; and (5) deferred federal income tax. A more complete understanding of the financial statements of stock life insurance companies and the effect of accounting procedures on those financial statements is developed in the next chapter.
Present Financial Reporting Practices

The form and content of financial reports presented by stock life insurance companies has been a function of reporting requirements prescribed or permitted by state insurance commissioners. An in-depth understanding of life insurance reporting techniques is predicated on a thorough knowledge of the NAIC Statement Blank. Existing reporting requirements of stock life insurance companies are examined as follows: (1) the NAIC Statement Blank, (2) the financial statements included in the annual report to the stockholders, and (3) the Certified Public Accountant's opinion expressed on the financial statements.

The NAIC Statement Blank

Annually life insurance companies are required to file a NAIC Statement Blank with the appropriate state regulatory agency. The Blank, in its present form, consist of (1) Statements, (2) Schedules, and (3) Exhibits. The basic financial information is reported in Statements and are identified as follows:

<table>
<thead>
<tr>
<th>Page #</th>
<th>Statement Title</th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>Assets</td>
</tr>
<tr>
<td></td>
<td>Liabilities, Surplus and Other Funds</td>
</tr>
</tbody>
</table>
Most of the information reported in the Statements is referenced to and supported by certain Exhibits and Schedules. The Blank includes Exhibits 1-11 and Schedules A-T. Schedules A, B, C and D reflect supporting financial data, but the other Schedules report an additional breakdown of operating statistics and other required information. Because of the number and complexity of the Exhibits included in the NAIC Statement Blank, it is beyond the scope of this paper to present a replica of each Exhibit. Some of the Exhibits have been included in Chapter III. A listing of the title of each Exhibit follows:

<table>
<thead>
<tr>
<th>Exhibit #</th>
<th>Title</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Part 1 Premiums and Annuity Considerations</td>
</tr>
<tr>
<td></td>
<td>Part 2 Dividends Applied, Reinsurance Ceded and Commissions Incurred</td>
</tr>
<tr>
<td>2</td>
<td>Net Investment Income</td>
</tr>
<tr>
<td>3</td>
<td>Gross Investment Income</td>
</tr>
<tr>
<td>4</td>
<td>Capital Gains and Losses on Investments</td>
</tr>
<tr>
<td>5</td>
<td>General Expenses</td>
</tr>
<tr>
<td>6</td>
<td>Taxes, Licenses and Fees (Excluding Federal Income Taxes)</td>
</tr>
<tr>
<td>7</td>
<td>Dividends to Policyholders</td>
</tr>
<tr>
<td>8</td>
<td>Aggregate Reserve for Life Policies and Contracts</td>
</tr>
<tr>
<td>9</td>
<td>Aggregate Reserve for Accident and Health Policies</td>
</tr>
<tr>
<td>10</td>
<td>Supplementary Contracts Without Life Contingencies and Dividend Accumulations</td>
</tr>
<tr>
<td>11</td>
<td>Policy and Contract Claims</td>
</tr>
</tbody>
</table>
Copies of the four basic financial statements included in the Blank are attached and identified as Exhibits I, II and III. As demonstrated by these Exhibits, the approach to preparation is basically a line item technique. Each of the items appearing in these Statements are assigned a specific line item number. A brief explanation of the composition of the Statements will provide additional understanding of the reporting practices used by stock life insurance companies.

**Assets**

The assets reported in the Blank resemble, to some extent, the assets reported in a traditional Balance Sheet. In order to establish the relevance of asset categories, the distribution of assets of the 100 largest life insurance companies doing business in the United States is listed below.

**Allocation of Assets by Company**

<table>
<thead>
<tr>
<th></th>
<th>Amount</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bonds</td>
<td>$84,987,078</td>
<td>39.7</td>
</tr>
<tr>
<td>Stocks</td>
<td>13,361,002</td>
<td>6.2</td>
</tr>
<tr>
<td>Mortgages</td>
<td>75,327,233</td>
<td>35.1</td>
</tr>
<tr>
<td>Real Estate</td>
<td>6,935,575</td>
<td>3.2</td>
</tr>
<tr>
<td>Policy Loans</td>
<td>16,418,133</td>
<td>7.7</td>
</tr>
<tr>
<td>Cash</td>
<td>1,063,009</td>
<td>.5</td>
</tr>
<tr>
<td>Separate Account</td>
<td>7,670,101</td>
<td>3.6</td>
</tr>
<tr>
<td>Other Assets</td>
<td>8,541,421</td>
<td>4.0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$214,304,252</strong></td>
<td><strong>100.0</strong></td>
</tr>
</tbody>
</table>

---

## Assets

<table>
<thead>
<tr>
<th>Item</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Bonds (Schedule D)</td>
<td>$1,234,567</td>
</tr>
<tr>
<td>2</td>
<td>Stocks (Schedule I)</td>
<td>$789,012</td>
</tr>
<tr>
<td>2.1</td>
<td>Preferred stocks</td>
<td>$345,678</td>
</tr>
<tr>
<td>2.2</td>
<td>Common stocks</td>
<td>$456,789</td>
</tr>
<tr>
<td>3</td>
<td>Mortgage loans on real estate (Schedule B)</td>
<td>$998,765</td>
</tr>
<tr>
<td>4</td>
<td>Real estate (Schedule A)</td>
<td>$1,001,001</td>
</tr>
<tr>
<td>4.1</td>
<td>Properties occupied by the Company (less encumbrances)</td>
<td>$1,001,001</td>
</tr>
<tr>
<td>4.2</td>
<td>Properties acquired in satisfaction of debt (less encumbrances)</td>
<td>$999,999</td>
</tr>
<tr>
<td>4.3</td>
<td>Investment real estate (less encumbrances)</td>
<td>$987,654</td>
</tr>
<tr>
<td>5</td>
<td>Policy loans</td>
<td>$888,888</td>
</tr>
<tr>
<td>6</td>
<td>Premium notes</td>
<td>$777,777</td>
</tr>
<tr>
<td>7</td>
<td>Collateral loans (Schedule C)</td>
<td>$666,666</td>
</tr>
<tr>
<td>8</td>
<td>Cash and bank deposits (Exhibit 13)</td>
<td>$555,555</td>
</tr>
<tr>
<td>9</td>
<td>Investments in process</td>
<td>$444,444</td>
</tr>
<tr>
<td>10</td>
<td>Other invested assets (Schedule BA)</td>
<td>$333,333</td>
</tr>
<tr>
<td>10A</td>
<td>Cash and invested assets</td>
<td>$222,222</td>
</tr>
<tr>
<td>11</td>
<td>Amounts recoverable from reinsurers (Schedule S)</td>
<td>$111,111</td>
</tr>
<tr>
<td>12</td>
<td>Life insurance premiums and annuity considerations deferred and uncollected</td>
<td>$100,100</td>
</tr>
<tr>
<td>13</td>
<td>Net premiums earned</td>
<td>$99,999</td>
</tr>
<tr>
<td>14</td>
<td>Accrued interest and dividends</td>
<td>$88,888</td>
</tr>
<tr>
<td>15</td>
<td>Accrued interest on loans</td>
<td>$77,777</td>
</tr>
<tr>
<td>16</td>
<td>Accrued interest on investments</td>
<td>$66,666</td>
</tr>
<tr>
<td>17</td>
<td>Income from investment activities</td>
<td>$55,555</td>
</tr>
<tr>
<td>18</td>
<td>Investment income and dividends</td>
<td>$44,444</td>
</tr>
<tr>
<td>19</td>
<td>Total amounts recoverable from reinsurers</td>
<td>$333,333</td>
</tr>
<tr>
<td>20</td>
<td>Net amounts due to foreign exchange rates</td>
<td>$222,222</td>
</tr>
<tr>
<td>21</td>
<td>Accrued interest on fixed maturities</td>
<td>$111,111</td>
</tr>
<tr>
<td>22</td>
<td>Investment income on realized gains</td>
<td>$100,100</td>
</tr>
<tr>
<td>23</td>
<td>Investment income on unrealized gains</td>
<td>$99,999</td>
</tr>
<tr>
<td>24</td>
<td>Investment income on capital appreciation</td>
<td>$88,888</td>
</tr>
<tr>
<td>25</td>
<td>NET ACCOUNTS RECEivable</td>
<td>$77,777</td>
</tr>
<tr>
<td>26</td>
<td>NET ACCOUNTS PAYABLE</td>
<td>$66,666</td>
</tr>
<tr>
<td>27</td>
<td>NET OTHER ACCOUNTS</td>
<td>$55,555</td>
</tr>
<tr>
<td>28</td>
<td>NET INVESTMENT</td>
<td>$44,444</td>
</tr>
<tr>
<td>29</td>
<td>NET INCOME</td>
<td>$33,333</td>
</tr>
<tr>
<td>30</td>
<td>NET INCOME FROM INVESTMENTS</td>
<td>$22,222</td>
</tr>
<tr>
<td>31</td>
<td>NET INCOME FROM OTHER ACTIVITIES</td>
<td>$11,111</td>
</tr>
<tr>
<td>32</td>
<td>NET INCOME FROM OPERATIONS</td>
<td>$10,100</td>
</tr>
<tr>
<td>33</td>
<td>NET INCOME FROM NONOPERATING ACTIVITIES</td>
<td>$9,999</td>
</tr>
<tr>
<td>34</td>
<td>NET INCOME FROM EXPENSES</td>
<td>$8,888</td>
</tr>
<tr>
<td>35</td>
<td>NET INCOME FROM OPERATING ACTIVITIES</td>
<td>$7,777</td>
</tr>
<tr>
<td>36</td>
<td>NET INCOME FROM NONOPERATING ACTIVITIES</td>
<td>$6,666</td>
</tr>
<tr>
<td>37</td>
<td>NET INCOME FROM OPERATIONS AND NONOPERATING ACTIVITIES</td>
<td>$5,555</td>
</tr>
<tr>
<td>38</td>
<td>NET INCOME FROM OPERATIONS AND NONOPERATING ACTIVITIES</td>
<td>$4,444</td>
</tr>
<tr>
<td>39</td>
<td>NET INCOME FROM OPERATIONS AND NONOPERATING ACTIVITIES</td>
<td>$3,333</td>
</tr>
<tr>
<td>40</td>
<td>NET INCOME FROM OPERATIONS AND NONOPERATING ACTIVITIES</td>
<td>$2,222</td>
</tr>
<tr>
<td>41</td>
<td>NET INCOME FROM OPERATIONS AND NONOPERATING ACTIVITIES</td>
<td>$1,111</td>
</tr>
<tr>
<td>42</td>
<td>NET INCOME FROM OPERATIONS AND NONOPERATING ACTIVITIES</td>
<td>$10,100</td>
</tr>
<tr>
<td>43</td>
<td>NET INCOME FROM OPERATIONS AND NONOPERATING ACTIVITIES</td>
<td>$9,999</td>
</tr>
<tr>
<td>44</td>
<td>NET INCOME FROM OPERATIONS AND NONOPERATING ACTIVITIES</td>
<td>$8,888</td>
</tr>
<tr>
<td>45</td>
<td>NET INCOME FROM OPERATIONS AND NONOPERATING ACTIVITIES</td>
<td>$7,777</td>
</tr>
<tr>
<td>46</td>
<td>NET INCOME FROM OPERATIONS AND NONOPERATING ACTIVITIES</td>
<td>$6,666</td>
</tr>
<tr>
<td>47</td>
<td>NET INCOME FROM OPERATIONS AND NONOPERATING ACTIVITIES</td>
<td>$5,555</td>
</tr>
<tr>
<td>48</td>
<td>NET INCOME FROM OPERATIONS AND NONOPERATING ACTIVITIES</td>
<td>$4,444</td>
</tr>
<tr>
<td>49</td>
<td>NET INCOME FROM OPERATIONS AND NONOPERATING ACTIVITIES</td>
<td>$3,333</td>
</tr>
<tr>
<td>50</td>
<td>NET INCOME FROM OPERATIONS AND NONOPERATING ACTIVITIES</td>
<td>$2,222</td>
</tr>
<tr>
<td>51</td>
<td>NET INCOME FROM OPERATIONS AND NONOPERATING ACTIVITIES</td>
<td>$1,111</td>
</tr>
<tr>
<td>52</td>
<td>NET INCOME FROM OPERATIONS AND NONOPERATING ACTIVITIES</td>
<td>$10,100</td>
</tr>
<tr>
<td>53</td>
<td>NET INCOME FROM OPERATIONS AND NONOPERATING ACTIVITIES</td>
<td>$9,999</td>
</tr>
<tr>
<td>54</td>
<td>NET INCOME FROM OPERATIONS AND NONOPERATING ACTIVITIES</td>
<td>$8,888</td>
</tr>
<tr>
<td>55</td>
<td>NET INCOME FROM OPERATIONS AND NONOPERATING ACTIVITIES</td>
<td>$7,777</td>
</tr>
<tr>
<td>56</td>
<td>NET INCOME FROM OPERATIONS AND NONOPERATING ACTIVITIES</td>
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</tr>
<tr>
<td>57</td>
<td>NET INCOME FROM OPERATIONS AND NONOPERATING ACTIVITIES</td>
<td>$5,555</td>
</tr>
<tr>
<td>58</td>
<td>NET INCOME FROM OPERATIONS AND NONOPERATING ACTIVITIES</td>
<td>$4,444</td>
</tr>
<tr>
<td>59</td>
<td>NET INCOME FROM OPERATIONS AND NONOPERATING ACTIVITIES</td>
<td>$3,333</td>
</tr>
<tr>
<td>60</td>
<td>NET INCOME FROM OPERATIONS AND NONOPERATING ACTIVITIES</td>
<td>$2,222</td>
</tr>
<tr>
<td>61</td>
<td>NET INCOME FROM OPERATIONS AND NONOPERATING ACTIVITIES</td>
<td>$1,111</td>
</tr>
<tr>
<td>62</td>
<td>NET INCOME FROM OPERATIONS AND NONOPERATING ACTIVITIES</td>
<td>$10,100</td>
</tr>
<tr>
<td>63</td>
<td>NET INCOME FROM OPERATIONS AND NONOPERATING ACTIVITIES</td>
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</tr>
<tr>
<td>64</td>
<td>NET INCOME FROM OPERATIONS AND NONOPERATING ACTIVITIES</td>
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</tr>
<tr>
<td>65</td>
<td>NET INCOME FROM OPERATIONS AND NONOPERATING ACTIVITIES</td>
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</tr>
<tr>
<td>66</td>
<td>NET INCOME FROM OPERATIONS AND NONOPERATING ACTIVITIES</td>
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</tr>
<tr>
<td>67</td>
<td>NET INCOME FROM OPERATIONS AND NONOPERATING ACTIVITIES</td>
<td>$5,555</td>
</tr>
<tr>
<td>68</td>
<td>NET INCOME FROM OPERATIONS AND NONOPERATING ACTIVITIES</td>
<td>$4,444</td>
</tr>
<tr>
<td>69</td>
<td>NET INCOME FROM OPERATIONS AND NONOPERATING ACTIVITIES</td>
<td>$3,333</td>
</tr>
<tr>
<td>70</td>
<td>NET INCOME FROM OPERATIONS AND NONOPERATING ACTIVITIES</td>
<td>$2,222</td>
</tr>
<tr>
<td>71</td>
<td>NET INCOME FROM OPERATIONS AND NONOPERATING ACTIVITIES</td>
<td>$1,111</td>
</tr>
<tr>
<td>72</td>
<td>NET INCOME FROM OPERATIONS AND NONOPERATING ACTIVITIES</td>
<td>$10,100</td>
</tr>
<tr>
<td>73</td>
<td>NET INCOME FROM OPERATIONS AND NONOPERATING ACTIVITIES</td>
<td>$9,999</td>
</tr>
<tr>
<td>74</td>
<td>NET INCOME FROM OPERATIONS AND NONOPERATING ACTIVITIES</td>
<td>$8,888</td>
</tr>
<tr>
<td>75</td>
<td>NET INCOME FROM OPERATIONS AND NONOPERATING ACTIVITIES</td>
<td>$7,777</td>
</tr>
<tr>
<td>76</td>
<td>NET INCOME FROM OPERATIONS AND NONOPERATING ACTIVITIES</td>
<td>$6,666</td>
</tr>
<tr>
<td>77</td>
<td>NET INCOME FROM OPERATIONS AND NONOPERATING ACTIVITIES</td>
<td>$5,555</td>
</tr>
<tr>
<td>78</td>
<td>NET INCOME FROM OPERATIONS AND NONOPERATING ACTIVITIES</td>
<td>$4,444</td>
</tr>
<tr>
<td>79</td>
<td>NET INCOME FROM OPERATIONS AND NONOPERATING ACTIVITIES</td>
<td>$3,333</td>
</tr>
<tr>
<td>80</td>
<td>NET INCOME FROM OPERATIONS AND NONOPERATING ACTIVITIES</td>
<td>$2,222</td>
</tr>
<tr>
<td>81</td>
<td>NET INCOME FROM OPERATIONS AND NONOPERATING ACTIVITIES</td>
<td>$1,111</td>
</tr>
<tr>
<td>82</td>
<td>NET INCOME FROM OPERATIONS AND NONOPERATING ACTIVITIES</td>
<td>$10,100</td>
</tr>
<tr>
<td>83</td>
<td>NET INCOME FROM OPERATIONS AND NONOPERATING ACTIVITIES</td>
<td>$9,999</td>
</tr>
<tr>
<td>84</td>
<td>NET INCOME FROM OPERATIONS AND NONOPERATING ACTIVITIES</td>
<td>$8,888</td>
</tr>
</tbody>
</table>

**NOTE:** The items on this page to agree with Exhibit 19, Col. 1.

State basis of valuation:

Assets are valued according to statutory requirements and the bases of valuation prescribed by the

National Association of Insurance Commissioners.
### LIABILITIES, SURPLUS AND OTHER FUNDS

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Agency reserve for life policies and contracts (Exhibit B)</td>
<td>$2,500,150</td>
</tr>
<tr>
<td>2</td>
<td>Agency reserve for accident and health policies (Exhibit B)</td>
<td>$2,500,150</td>
</tr>
<tr>
<td>3</td>
<td>Contingency reserves (Exhibit 11, Part A)</td>
<td>$71,574,352</td>
</tr>
<tr>
<td>4</td>
<td>Policy and contract liabilities (Exhibit 11, Part B)</td>
<td>$71,574,352</td>
</tr>
<tr>
<td>5</td>
<td>Policyholders' dividends due and unpaid</td>
<td>$71,574,352</td>
</tr>
<tr>
<td></td>
<td>Provision for policyholders' dividends payable in following calendar year—estimated amounts</td>
<td>$71,574,352</td>
</tr>
<tr>
<td>7.3</td>
<td>Appointed for payment to December 31</td>
<td>$71,574,352</td>
</tr>
<tr>
<td>7.2</td>
<td>Not yet appointed</td>
<td>$71,574,352</td>
</tr>
<tr>
<td>9</td>
<td>Amounts provisionally held for deferred dividend policies not included in Item 7</td>
<td>$71,574,352</td>
</tr>
<tr>
<td>10</td>
<td>Liabilities for policy contracts held for other than own account</td>
<td>$71,574,352</td>
</tr>
<tr>
<td>11</td>
<td>Policy and contract liabilities not included elsewhere</td>
<td>$71,574,352</td>
</tr>
<tr>
<td>11.1</td>
<td>Surrender values on cancelled policies</td>
<td>$71,574,352</td>
</tr>
<tr>
<td>11.2</td>
<td>Provision for experience rating refunds</td>
<td>$71,574,352</td>
</tr>
<tr>
<td>13</td>
<td>Dividends to stockholders declared and unpaids</td>
<td>$71,574,352</td>
</tr>
<tr>
<td>13.1</td>
<td>Separate Account Business (see Separate Account Statement)</td>
<td>$71,574,352</td>
</tr>
</tbody>
</table>

**Total Liabilities (Except Capital):** $5,616,697,877

---

**Exhibit II**

---

**Table**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agent Reserve</td>
<td>$2,500,150</td>
</tr>
<tr>
<td>Agency Reserve</td>
<td>$2,500,150</td>
</tr>
<tr>
<td>Contingency Reserves</td>
<td>$71,574,352</td>
</tr>
<tr>
<td>Policy and Contract Liabilities</td>
<td>$71,574,352</td>
</tr>
<tr>
<td>Policyholders' Dividends Due and Unpaid</td>
<td>$71,574,352</td>
</tr>
<tr>
<td>Provision for Dividends</td>
<td>$71,574,352</td>
</tr>
<tr>
<td>Provision for Other Liabilities</td>
<td>$71,574,352</td>
</tr>
<tr>
<td>Total Liabilities</td>
<td>$5,616,697,877</td>
</tr>
</tbody>
</table>
## SUMMARY OF OPERATIONS

### ACCRUAL BASIS:

<table>
<thead>
<tr>
<th>Description</th>
<th>2001</th>
<th>2000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Premiums and annuity considerations, Exhibit I Part I</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1.1 Life</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1.2 Accident and health</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1.3 Considerations for supplementary contracts with life contingencies</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1.4 Considerations for supplementary contracts without life contingencies and dividend accumulations</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2 Net investment income, Exhibit 1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3 Div. insurance and health policies</td>
<td></td>
<td></td>
</tr>
<tr>
<td>4 Other sources of revenue</td>
<td></td>
<td></td>
</tr>
<tr>
<td>5 Total</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### SURPLUS ACCOUNT

<table>
<thead>
<tr>
<th>Description</th>
<th>2001</th>
<th>2000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Special surplus fund (December 31), current year</td>
<td>$146,432,440</td>
<td>$6,454,210</td>
</tr>
<tr>
<td>1.1 Dividend in arrears</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1.2 Reinvestment in capital stock</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1.3 Change in capital surplus in accordance with Exhibit 3</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1.4 Current surplus in accordance with Exhibit 3</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1.5 Total</td>
<td>$146,432,440</td>
<td>$6,454,210</td>
</tr>
</tbody>
</table>
As discussed in Chapter III, bonds are reported at amortized cost, preferred stocks at cost, and common stocks at quotations prescribed by the National Association of Insurance Commissioners (Market-value). Mortgage loans are carried at cost to the company or at amortized cost. Amortization is required as a result of the mortgages being purchased at either a premium or a discount. Real estate is normally reported at cost less depreciation. Policy loans are reported at the outstanding balance owed by the policyholder. All other assets, including cash, some receivables, and equipment, are reported at cost.

Liabilities, Surplus and Other Funds

The total liabilities of a stock life insurance company are reported on Line 26 of Exhibit II, Liabilities, Surplus, and Other Funds. A tabulation of the line items comprising Exhibit II for seven established stock companies (each more than 45 years old) reported in the 1964 New York Insurance Department Report is listed as follows:

Liabilities of 7 Selected Stock Companies by
NAIC Statement Blank Liability Item-1964
New York Insurance Department Report

<table>
<thead>
<tr>
<th>NAIC Statement Blank Item</th>
<th>Title</th>
<th>(dollars shown in millions)</th>
<th>Established Companies Stock Dollars</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Aggregate reserve for life policies and contracts ..........</td>
<td>$12,129</td>
<td>72.74</td>
<td></td>
</tr>
</tbody>
</table>

### New York Insurance Department Report - continued

<table>
<thead>
<tr>
<th>NAIC Statement</th>
<th>Blank Item</th>
<th>Title</th>
<th>Establishment Companies Stock Dollars</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>2.</td>
<td>Aggregate reserve for accident and health policies</td>
<td>$264</td>
<td>1.58</td>
<td></td>
</tr>
<tr>
<td>3.</td>
<td>Supplementary contracts without life contingencies</td>
<td>503</td>
<td>3.02</td>
<td></td>
</tr>
<tr>
<td>4.</td>
<td>Policy and contract claims</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4.1</td>
<td>Life</td>
<td>159</td>
<td>.95</td>
<td></td>
</tr>
<tr>
<td>4.2</td>
<td>Accident and health</td>
<td>215</td>
<td>1.29</td>
<td></td>
</tr>
<tr>
<td>5.</td>
<td>Policyholders' dividend accumulations</td>
<td>146</td>
<td>.88</td>
<td></td>
</tr>
<tr>
<td>6.</td>
<td>Policyholders' dividends due and unpaid</td>
<td>2</td>
<td>.01</td>
<td></td>
</tr>
<tr>
<td>7.</td>
<td>Provision for policyholders' dividends</td>
<td>89</td>
<td>.53</td>
<td></td>
</tr>
<tr>
<td>8.</td>
<td>Amount provisionally held for deferred dividend policies</td>
<td>0</td>
<td>.00</td>
<td></td>
</tr>
<tr>
<td>9.</td>
<td>Premiums and annuity considerations received in advance</td>
<td>136</td>
<td>.82</td>
<td></td>
</tr>
<tr>
<td>10.</td>
<td>Liability for premium deposit funds</td>
<td>218</td>
<td>1.31</td>
<td></td>
</tr>
<tr>
<td>11.1</td>
<td>Surrender values on canceled policies</td>
<td>95</td>
<td>.57</td>
<td></td>
</tr>
<tr>
<td>11.2</td>
<td>Provision for experience rating refunds</td>
<td>79</td>
<td>.47</td>
<td></td>
</tr>
<tr>
<td></td>
<td>All write-in items except those numbered 25</td>
<td>42</td>
<td>.25</td>
<td></td>
</tr>
<tr>
<td>13-15A.</td>
<td>Commissions, expenses, and taxes due or accrued</td>
<td>129</td>
<td>.77</td>
<td></td>
</tr>
<tr>
<td>16-24.</td>
<td>Amounts withheld, remittances not allowed, etc</td>
<td>132</td>
<td>.79</td>
<td></td>
</tr>
<tr>
<td>25.</td>
<td>Miscellaneous liabilities, excluding line 25.1</td>
<td>377</td>
<td>2.26</td>
<td></td>
</tr>
<tr>
<td>25.1</td>
<td>Mandatory Securities Valuation Reserve</td>
<td>277</td>
<td>1.66</td>
<td></td>
</tr>
<tr>
<td>27-29.</td>
<td>Surplus</td>
<td>1,443</td>
<td>8.65</td>
<td></td>
</tr>
<tr>
<td>28.</td>
<td>Capital paid-up</td>
<td>241</td>
<td>1.45</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>$16,676</td>
<td>100.00</td>
<td></td>
</tr>
</tbody>
</table>

Policy reserves, the major item in the Statement, represents the amounts needed to pay future policy benefits. An explanation of the computation of policy reserves and the effect of interest, mortality, and morbidity assumptions was presented in Chapter III.
Policyholders' dividend accumulations represents dividends declared on participating policies and left on deposit with the company at interest. Provision for policyholders' dividends reflects the amount of future dividends on participating policies. The amount reported is "an estimate of those dividends that will be paid to owners of participating policies during a specific period in the calendar year following the date of the statement." Liabilities for premium deposit funds, as discussed in Chapter III, represents premiums that have been paid in advance of the due date by the policyholder.

The item identified as Capital paid-up "represents the par value of all shares of stock outstanding (i.e., sold to the stockholders)." If the stock is sold at a price in excess of par value, the difference is reported in the Surplus Account, Exhibit III, as Surplus paid-in.

The amount reported in Exhibit II for Special Surplus Funds, line item #27, and Unassigned Surplus, line item #29, are computed in the Surplus Account, Exhibit III. Special surplus funds are reserves accumulated to provide for anticipated contingencies.

Summary of Operations

Total income reported in the Blank consist of premium income and investment income. Premium income is usually recognized on the anniversary date of the policy. Investment income, reported as line item

\[4\text{Ibid., p. 115.}\]

4, is computed in Exhibit II of the Blank. The amount reported is gross investment income (interest on bonds and mortgages, dividends on stock, etc.) minus investment expense, investment taxes (excluding federal income tax) and depreciation on real estate.

Major items of expense include payment of benefits, increase in reserves, commissions, and other operating expenses.

Item 28, net gain from operations before dividends to policyholders and excluding capital gains and losses, represents total income reported, item 7, less deductions, item 27.

Determination of the amount reported as Dividends to Policyholders, item 29, is supported by Exhibit 7 of the Blank. It is somewhat confusing to see the account title "Dividends to Policyholders" when the insurance company is organized as a stock company. Usually dividends of this sort are associated with a mutual company operation. However, it is possible for stock companies to issue policies on both a non-participating or a participating basis. "A participating policy is a type of insurance contract under which the policyholder receives periodic refunds (unfortunately called dividends) to the extent that the management of the insurer deems such refunds warranted as a result of the company's experience."^6

Federal income tax is deducted from net gain from operations after dividends to policyholders but before federal income tax to determine the final figure reported in the Summary of Operations. The

federal income tax reported is determined under the provisions of the U. S. Life Insurance Income Tax Act of 1959 and excludes prior period items and tax on capital gains. The final figure reported in the Summary of Operations is transferred to the Surplus Account for determination of total surplus at year end.

**Surplus Account**

The Surplus Account provides the traditional link between the Summary of Operations, Exhibit III, and Liabilities, Surplus, and Other Funds, Exhibit II. The determination of Unassigned Surplus at year end is usually a product of the following computation:

Unassigned surplus at end of previous year

Plus:
- Net gain from operations
- Net capital gains
- Net gain from nonadmitted assets

Less:
- Dividends to stockholders
- Increase in MSVR
- Increase in reserve resulting from change in valuation basis.

Equal:
Unassigned Surplus reported as (1) Surplus Account, item 50B, and (2) Unassigned Surplus, item 29B, Liabilities, Surplus, and Other Funds

In addition to the Unassigned Surplus, the Surplus Account reflects the reconciliation of the ending balance of Special Surplus Funds and Gross Paid-In and Contributed Surplus. The amounts computed in the Surplus Account are reported in Exhibit III, Liabilities, Surplus, and Other Funds as items 27 and 29A.
The discussion of the Surplus Account concludes the examination of the financial statements included in the NAIC Statement Blank. A detail explanation of each line item included in the financial statements is not possible within the limits imposed on this study. Materiality, as determined through use of various tables, was used as a criteria in selecting individual NAIC Statement Blank items to be examined. Also, an effort was made to relate the discussion of accounting techniques described in Chapter III to the reporting requirements reflected in the NAIC Statement Blank.

The form and content of the financial statements included in the NAIC Statement Blank have evolved over a number of years. As indicated earlier, New York state in 1849 imposed the first formal reporting requirements on life insurance companies. Since then, the Blank has developed into its present form, with the last major revision occurring in 1951. The overall objective of the NAIC Statement Blank is to provide ample information to the state regulatory agency to allow an evaluation of the operations of the life insurance company with an emphasis on protection of the policyholder.

In addition to the NAIC Statement Blank, stock life insurance companies prepare annual reports intended for policyholders, stockholders, and other interested parties. The financial statements of the company are included as part of the annual report. Such financial statements and the Certified Public Accountant's opinion expressed on those statements is considered for the remainder of this chapter.
Annual Reports to Stockholders

The published annual reports presented to the shareholders of stock life insurance companies include four basic financial statements. These financial statements are identified as the Balance Sheet, Statement of Operations, Surplus Statement, and Statement of Changes in Financial Position. Statement presentation is influenced by the NAIC Statement Blank, and in some states, such as New York, the published annual statements can not depart from the NAIC Statement Blank.

The individual financial statements presented by stock life insurance companies will be compared with conventional financial statements in order to establish significant differences in the content and form of presentation. Because of the material differences in concept and presentation, the Owners Equity accounts will be investigated in detail in a separate section.

Form and Content of Financial Statements

The financial statements included in the annual report published by stock life insurance companies differs from conventional financial statements in both form and content. Basic conventional financial statements are identified as follows: Balance Sheet, Income Statement, Statement of Retained Earnings and Statement of Changes in Financial Position. The objective of the Balance Sheet is to report the financial position of the accounting entity as of the end of the accounting period. The Income Statement reports the revenues earned and expenses incurred for the accounting period. The Statement of Retained Earnings reflects an analysis of the retained earnings account for the period and provides
a link between the Income Statement and the Balance Sheet. The Statement of Changes in Financial Position reflects the financing and investing activities occurring during the accounting period and acts to supplement the other financial statements.

The Statement of Changes in Financial Position is a recent addition to the basic financial statements. In its original form, the Statement of Changes in Financial Position was identified as the Statement of Sources and Application of Funds. Opinion No. 3 of the Accounting Principles Board, issued in October 1963, encouraged the presentation of the funds statement but did not require its presentation. In March 1971, the APB issued Opinion No. 19 which stated "When financial statements ... are issued, a statement summarizing changes in financial position should also be presented as a basic financial statement for each period for which an income statement is presented." As a result of Opinion No. 19, the Statement of Changes in Financial Position is now considered as a basic financial statement and is included along with the other financial statements in the annual report to the stockholders.

The basic financial statements published by stock life insurance companies are identified as the Balance Sheet, Statement of Operations, Surplus Statement, and Statement of Changes in Financial Position. For

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year ended December 31, 1971, eighty-four per cent of the 156 audited stock life companies included in the Ernst & Ernst Life Insurance Financial Reporting Trends presented all four statements in their annual report. 8

The major difference in the identification of conventional financial statements and life insurance financial statements is the Surplus Statement designation. The surplus account designation, used at one time in financial accounting, has evolved from surplus, to earned surplus, to its current designation, retained earnings. Presently, in financial accounting, the term "surplus" is sanctioned only when referring to an appropriation of retained earnings. 9

The form of the Balance Sheet presented by life insurance companies differs from conventional Balance Sheets in two ways. The conventional Balance Sheet appears as a classified Balance Sheet. Assets are classified as Current Assets, Investments, Plant and Equipment and Other Assets. Liabilities are classified as Current and Long Term. Owner Equity is classified as Contributed Capital and Retained Earnings. The conventional classifications provide a basis for the determination of a series of ratios, such as the current ratio

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(CA\textsuperscript{+}CL), and other financial indicators, such as working capital (CA-CL). Life insurance companies do not publish classified Balance Sheets but instead merely list the individual Assets, Liabilities, Capital and Surplus as of the end of the accounting period.

The second difference, reflected in the Balance Sheet of life insurance companies, is the order of listing the Assets and Liabilities. Instead of reporting cash and accounts payable as the first items in the Balance Sheet, life insurance companies report bonds as the first asset and report policy reserves as the first liability. These differences in reporting practices result from the use of the NAIC Statement Blank format in preparing financial statements to be presented to the shareholders.

Although the NAIC Statement Blank influences the published annual reports, "eighty-three per cent of stock companies (included in the Ernst & Ernst 1972 Financial Reporting Trends) used other than NAIC Statement Blank terminology to describe the income statement in 1971."\textsuperscript{10} The terminology used in the NAIC Statement Blank is the Summary of Operations. The title used in published reports was Statement of Operations or Statement of Income.

The published Statement of Operations follows the prescribed form of the NAIC Statement Blank Summary of Operations. The method of presentation can be identified as a basic single step income statement with minor modifications.

\textsuperscript{10} Ernst & Ernst, \textit{op. cit.}, 145.
The form of the conventional single step income statement is presented as follows:

Revenues $ XXX

Cost and expenses XXX

Income before extraordinary items $ XX

Extraordinary items (less applicable income tax) X

Net income $ XX

The Statement of Operations presented by a life insurance company is summarized as follows:

Income:
Total Premiums $ XXX
Net Investment Income XXX
Total Income $ XXX

Benefits and Expenses:
Benefits to Policyholders $ XXX
Additions to Reserves XXX
Commissions XXX
Other Expenses XXX
Dividends to Life Policyholders XXX
Total Benefits and Expenses $ XXX

Net Income $ XX

Instead of the term "Cost and Expenses" life insurance companies report "Benefits and Expenses." For a conventional merchandising operation, the Cost of Goods Sold is one of the material deductions.

affecting the determination of net income. For a life insurance company, Benefits Paid to Policyholders is a major deduction in computing net income.

A problem of identifying expenses not experienced in conventional Income Statement presentation involves the life insurance account "Dividends to Policyholders." The NAIC Statement Blank (See Exhibit III) reports on line 29, Dividends to Life Policyholders. The origin of this account has been previously mentioned and its presentation in published reports causes some difficulty. Normally, dividends are associated with stockholders and consequently are reported as Owners Equity or Surplus items. For published annual reports by life insurance companies the most prevalent method of reporting dividends and/or taxes was a separate line in the expense section of the Statement of Operations.\footnote{The Ernst & Ernst 1972 Financial Reporting Trends, Life Insurance, p. 147, stated that sixty-three per cent of audited stock companies reported a separate line for dividends and/or taxes.}

Life insurance companies do not adhere to the treatment of extraordinary items required of conventional accounting by Opinion No. 9 of the APB. Instead the method of presentation used by life insurance companies is comparable to the current operating concept, used at one time in conventional accounting. Under the current operating concept, extraordinary items were reported in the retained earnings account rather than included in the income statement. Life
insurance companies reflect only current items in the Statement of Operations and record extraordinary and prior period adjustments directly in the surplus account.

The Statement of Retained Earnings prescribed by Opinion No. 9 of the APB is outlined as follows:

Retained earnings at beginning of year
As previously reported $ XXX
Prior period adjustment XX
As restated $ XXX
Net income XX
Dividends XX
Retained earnings at end of year $ XXX

The Statement of Retained Earnings does not include contributed capital transactions. Any contributed capital or paid-in capital transactions that occurred during the period are reflected in a separate schedule reconciling the beginning and ending balances of contributed capital accounts.

The Surplus Statement, included in the NAIC Statement Blank (Exhibit III) differs considerably, in both form and content, from the Statement of Retained Earnings. Item #37, Net Gain, and item #43, Dividends to Stockholders, are comparable to Net Income and Dividends reported in the Statement of Retained Earnings. However, except for these two items, there is little similarity between the Surplus Statement and the Statement of Retained Earnings.
Reporting practices used by the audited stock life insurance companies included in the 1972 Ernst & Ernst survey were as follows:

- 80% presented a separate earned surplus statement
- 20% presented a combined or unsegregated surplus statement or no surplus statement.\(^{13}\)

A more detailed comparison and contrast of conventional and life insurance surplus reporting practices will be presented in the discussion of reporting owners equity accounts. Special consideration of owners equity is justified because the effects of owners equity transactions are reflected in both the Surplus Statement and Balance Sheet.

The final financial statement to be considered is the Statement of Changes in Financial Position. As previously indicated, the Statement of Changes in Financial Position was required as part of the published financial reports by Opinion No. 19 of the APB adopted in March 1971.

In conventional financial reporting, 559 companies out of the 600 included in the Accounting Trends & Techniques for year ended February 10, 1971, included certification of the Statement of Changes in Financial Position in the auditors' report. Forty-one of the companies included in the 1971 Accounting Trends & Techniques did not present such a statement or the statement was not included in the auditors' opinion.\(^{14}\)

\(^{13}\)Ernst & Ernst, op. cit., p. 185.

The Statement of Changes in Financial Position as prescribed by the APB may be based on the cash or working capital concept and should include all financing and investing activities conducted by the firm. The statement can either be of a balancing form or can reflect the determination of increase or decrease in cash or working capital.

There is no statement in the NAIC Statement Blank to compare with the Statement of Changes in Financial Position. Although the statement is not required by state insurance commissioners, 146 of the 200 audited stock life companies included in the 1972 Ernst & Ernst survey, included the funds statement in the published annual reports for year ended December 31, 1971. Out of the 146 companies presenting the funds statement, 130 companies defined "funds" as cash.

The form and content of the financial statements presented by stock life insurance companies differs from conventional financial statements. The primary differences are attributable to the influence of statutory reporting requirements, the NAIC Statement Blank, on the financial statements presented by life insurance companies. The published financial statements presented by insurance companies are normally identified as the Balance Sheet, Statement of Operations, Surplus Statement, and Statement of Changes in Financial Position.

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16Ernst & Ernst, op. cit., p. 194.
One of the major differences between insurance financial statements and conventional financial statements is the presentation of Owners Equity accounts which will be discussed in the next section.

**Composition of Owners Equity Accounts**

Conventional financial statement presentation of owners equity accounts is, in part, influenced by Opinion No. 12 of the APB. This opinion states that "when both financial position and results from operations are presented, disclosure of changes in the separate accounts comprising stockholders' equity (in addition to retained earnings) . . . is required to make such statements sufficiently informative."\(^{17}\)

The format of the Statement of Retained Earnings, as required by Opinion No. 9 of the APB, has been previously presented. The owners equity accounts, other than retained earnings, are capital stock and other contributed capital and these items may be included in the financial statements in the following form:

<table>
<thead>
<tr>
<th></th>
<th>Preferred Stock</th>
<th>Common Stock</th>
<th>Additional Paid-In Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shares</td>
<td>Amount</td>
<td>Shares</td>
<td>Amount</td>
</tr>
<tr>
<td>Balance, January 1, 1971</td>
<td>XXX $ XXX</td>
<td>XXX $ XXX</td>
<td>$ XX</td>
</tr>
<tr>
<td>Exercise of common stock options</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Common stock dividend</td>
<td></td>
<td>XX</td>
<td>XX</td>
</tr>
<tr>
<td>Sale of preferred stock</td>
<td>XX</td>
<td>XX</td>
<td></td>
</tr>
<tr>
<td>Balance, December 31, 1971</td>
<td>XXX $ XXX</td>
<td>XXX $ XXX</td>
<td>$ XX</td>
</tr>
</tbody>
</table>

The year end balances of the owners equity accounts are individually presented in the Balance Sheet. In addition to the account titles previously listed, the owners equity section of a conventional Balance Sheet may include Appropriated Retained Earnings and Treasury Stock. "Appropriation of retained earnings constitute a restriction on a specific portion of accumulated earnings for specific purposes." The appropriation can result from legal requirements, contractual commitments or discretionary acts by the board of directors. The individual appropriations are reported separately but combined with unappropriated amounts to reflect total retained earnings. Treasury stock represents the company's own stock that has been reacquired. The company must disclose the number of shares and can report treasury stock using the cost or par-value method. The balance of treasury stock can be deducted from the applicable stock account or may be reported as the last item in the owners equity section of the conventional Balance Sheet.

The term "stockholders or shareholders equity or investment" was used in 531 of the 600 annual reports included in the 1971 Accounting Trends & Techniques. However, "stockholders equity" was used in only thirty-seven per cent of the audited stock life insurance


companies included in the Ernst & Ernst 1972 Financial Reporting Trends. One of the terms frequently used by stock life companies was "capital stock and surplus."

The owner equity section of the Balance Sheet of an insurance company does not appear as complicated as a conventional owners equity section. Many insurance annual reports have only two or three items listed in the owners equity section. The following are examples:

Republic National Life Insurance Company

Stockholders' Equity
Capital stock of $1.00 par value per share.  
Authorized: 1971--9,411,834 shares, issued:  
1971--9,383,161 shares  
Unassigned surplus  
Total Stockholders' Equity

Connecticut General Life Insurance Company

Capital and Surplus:
Common stock  
Contingency reserves  
Unassigned surplus  

Progressive National Life Insurance Company

Capital stock and surplus:
Common stock, $ par value, Authorized and issued 1,639,333 shares  
Surplus:
Gross paid in  
Unassigned since June 30, 1970  
Total capital stock and surplus

20Ernst & Ernst, op. cit., p. 136.
21Ibid., pp. 140-141
The Surplus Statement presented by stock life insurance companies in annual reports is comparable to the Surplus Account included in the NAIC Statement Blank (Exhibit III). The Surplus Statement is segregated as to earned surplus and paid-in surplus by most life companies.

In the Ernst & Ernst 1972 survey, 151 out of 156 audited stock companies included a surplus statement as part of the annual report. The occurrence of individual items included in the Surplus Statement are listed as follows:

Percentage of reports presenting surplus statements which contained separate entries for:

<table>
<thead>
<tr>
<th>Item</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gain from operations</td>
<td>100</td>
</tr>
<tr>
<td>Change in mandatory securities valuation reserve</td>
<td>74</td>
</tr>
<tr>
<td>Change in non-admitted assets</td>
<td>66</td>
</tr>
<tr>
<td>Unrealized capital gains</td>
<td>66</td>
</tr>
<tr>
<td>Realized capital gains</td>
<td>55</td>
</tr>
<tr>
<td>Capital gains (not segregated)</td>
<td>12</td>
</tr>
<tr>
<td>Cash dividends</td>
<td>59</td>
</tr>
<tr>
<td>Stock dividends</td>
<td>6</td>
</tr>
<tr>
<td>Prior-year adjustment</td>
<td>8</td>
</tr>
<tr>
<td>Reserve strengthening</td>
<td>9</td>
</tr>
<tr>
<td>Treasury stock transactions</td>
<td>7</td>
</tr>
<tr>
<td>Reinsurance transactions</td>
<td>5</td>
</tr>
<tr>
<td>Merger expense</td>
<td>522</td>
</tr>
<tr>
<td>Miscellaneous or other - no other disclosure</td>
<td>40</td>
</tr>
</tbody>
</table>

The Surplus Statement presented by stock life companies appears more complicated and includes more items than does the conventional Statement of Retained Earnings as required by Opinion #9 of the APB.

---

22Ibid., p. 188.
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Surplus:
Gross paid in
Unassigned since June 30, 1970
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20 Ernst & Ernst, op. cit., p. 136.
21 Ibid., pp. 140-141
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<table>
<thead>
<tr>
<th>Item</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gain from operations</td>
<td>100</td>
</tr>
<tr>
<td>Change in mandatory securities</td>
<td>74</td>
</tr>
<tr>
<td>Change in non-admitted assets</td>
<td>66</td>
</tr>
<tr>
<td>Unrealized capital gains</td>
<td>66</td>
</tr>
<tr>
<td>Realized capital gains</td>
<td>55</td>
</tr>
<tr>
<td>Capital gains (not segregated)</td>
<td>12</td>
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<tr>
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<td>59</td>
</tr>
<tr>
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<tr>
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<td>8</td>
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<td>Merger expense</td>
<td>5</td>
</tr>
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<td>Miscellaneous or other - no other disclosure</td>
<td>40</td>
</tr>
</tbody>
</table>

The Surplus Statement presented by stock life companies appears more complicated and includes more items than does the conventional Statement of Retained Earnings as required by Opinion #9 of the APB.

---

\[22\] Ibid., p. 188.
The form of the Surplus Statement in the Balance Sheet is not the same form as is presented in the NAIC Statement Blank. The financial statement presentation of unappropriated surplus computes the balance as of the end of the period rather than reconciling total debits and credits as is reflected in the NAIC Statement Blank.

In conclusion it can be noted that life insurance financial reporting, in the case of owners equity, differs considerably from conventional financial reporting. For Balance Sheet presentation, conventional statements reflect a more complex arrangement of the equity section than does life insurance reporting. The reverse is true in reporting retained earnings or unappropriated surplus, where life insurance reporting appears more complex than conventional reporting. The major differences are once again attributed to the influence of the NAIC Statement Blank on life insurance reporting practices.

Certified Public Accountants' Report on Financial Statements

The standard short form auditor's report reads as follows:

We have examined the balance sheet of X Company as of December 31, 19--, and the related statements of income and retained earnings and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the aforementioned financial statements present fairly the financial position of X company at December 31, 19--., and the results of its operations and the changes in its financial position for the year then ended,
in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year. 23

The audit report rendered on the financial statements of a stock life insurance company differs from the standard short form audit report and may take the following form:

Continental American Life Insurance Company

We have examined the statement of assets and liabilities of Continental American Life Insurance Company as of December 31, 1971, and the related statements of earnings and surplus account and changes in financial position for the year then ended. The amounts at which the actuarial items are reflected in the financial statements were certified by E. P. Higgins and Company, consulting actuaries. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting and actuarial records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, relying upon the certificate mentioned in the preceding paragraph with regard to the actuarial items, such financial statements present fairly the statutory financial position of Continental American Life Insurance Company at December 31, 1971, and the results of its operations, and changes in conformity with insurance accounting principles prescribed or permitted under statutory authority, applied on a basis consistent with that of the preceding year. These principles vary in some respects from generally accepted accounting principles followed by other business enterprises in determining financial position, changes therein, and results of operations (see note 1 to financial statements). 24


24 Ernst & Ernst, op. cit., p. 52.
The material differences that can be noted in comparing the two types of audit reports are reflected in (1) the opinion paragraph which mentions "accounting principles prescribed or permitted under statutory authority," and (2) the scope paragraph which mentions the determination of actuarial items.

**Expression of Opinion on Financial Statements**

Special attention is focused on the first sentence of the opinion paragraph of the standard short form report which states "in conformity with generally accepted accounting principles." When financial statements examined are not in conformity with GAAP the independent auditor must render a qualified or adverse opinion. A qualified opinion can be rendered as a result of a departure from GAAP but only when the financial statements taken as a whole are fairly presented. An adverse opinion is given when the financial statements are not fairly presented.

The rule that published financial statements must be presented in accord with GAAP applies to both regulated and non-regulated companies. "The basic postulates and broad principles of accounting . . . which pertain to business enterprises in general apply also to companies whose accounting practices are prescribed by governmental regulatory authorities or commissions."\(^{25}\)

Out of the 156 stock life insurance companies included in the 1972 Ernst & Ernst survey for year ended December 31, 1971, seventy-four

\(^{25}\)Committee on Auditing Procedure, *op. cit.*, p. 111.
per cent of the companies were given a qualified opinion by certified public accountants.\textsuperscript{26} A more detailed distribution of the opinions rendered is presented as follows:

| Accountants' Reports | Percentage of audited reports in which the accountants' opinion stated that the financial statements were in conformity with: | \%
|----------------------|-------------------------------------------------------------------------------------------------------------------|---
| Generally accepted accounting principles | 25 | 
| Practices prescribed or permitted by regulatory authority, which vary from generally accepted accounting principles | 60 | 
| Practices prescribed or permitted by regulatory authority | 5 | 
| Practices prescribed or permitted by regulatory authority, and in all material respects with generally accepted accounting principles | 1 | 
| Generally accepted accounting principles, except as modified to conform with practices prescribed or permitted by regulatory authority | 4 | 
| Generally accepted accounting principles, except (qualification mentioned in opinion) | 5 | 
| \hline | 100 | 

The results of the 1972 Ernst & Ernst survey can be contrasted to the information reported in the 1971 Accounting Trends and Techniques for year ended December 31, 1970.

\footnotesize{\textsuperscript{26}Ernst & Ernst, \textit{op. cit.}, p. 38.}

\footnotesize{\textsuperscript{27}Ibid.}
Number of Auditors' Reports Containing28

<table>
<thead>
<tr>
<th>Description</th>
<th>Quantity</th>
</tr>
</thead>
<tbody>
<tr>
<td>An unqualified expression of opinion</td>
<td>515</td>
</tr>
<tr>
<td>A qualified expression of opinion</td>
<td>83</td>
</tr>
<tr>
<td>Disclaimer of opinion</td>
<td>2</td>
</tr>
<tr>
<td><strong>Total companies included in survey</strong></td>
<td><strong>600</strong></td>
</tr>
</tbody>
</table>

Out of the companies included in the 1971 *Accounting Trends and Techniques* survey, approximately eighty-six per cent were given unqualified opinions by their auditors. This figure can be compared to the twenty-six per cent of audited stock life insurance companies, included in the Ernst & Ernst survey, that received unqualified opinions on their financial statements.

In order to express an opinion on the financial statements of a company the auditor must determine that the statements are fairly presented. The audit is conducted in accordance with generally accepted auditing standards, identified as: (1) general standards, (2) standards of field work and (3) standards of reporting.

The value of auditing the financial statements of stock life insurance companies has been questioned by various groups from time to time. In this context, auditing is identified as that function conducted by a certified public accounting firm and not an examination conducted by the state insurance department. Obviously, there are opinions that support, as well as discredit the need for audits by CPA firms.

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Carl P. Collins, president of Fidelity Union Life Insurance Company, after discharging his auditors stated "Our internal auditing and the (state) examiners from around the U.S. give us a more thorough audit than that of any CPA."^29 A similar position concerning the role of the CPA in life insurance auditing was expressed by Melvin Gold in The National Underwriter, Life & Health Edition, "Letters to the Editor." Mr. Gold stated

The Equity Funding debacle proves once again what knowledgeable people in life insurance have known for a long time—namely that an accounting audit of a life insurance company leaves much to be desired. It certainly doesn't insure, to the board of directors, that all is well.

Most accountants just don't have an intimate understanding of the inner workings of a life insurance company. They can't sense in their gut that something doesn't look right.^30

The positions of Mr. Collins and Mr. Gold appear to conflict with that of Fred Mauck, Illinois director of insurance. At a May 1973 meeting of the Chicago Board of Underwriters, Mr. Mauck stated that he has "... proposed for Illinois and all other states an annual examination of all insurance companies by outside independent CPA firms."^31

The role of the CPA and the reliance that can be placed on audited financial statements is usually questioned following a serious financial scandal such as Equity Funding. The firm of Seidman &

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Seidman had "audited both the life company and the parent company in 1972, and the parent company in 1971." Following the discovery of the scandal the court appointed Touche Ross & Company to audit the financial statements of Equity Funding for 1972 and reaudit the books of Equity Funding Life Insurance Company for 1970 and 1971. In its appointment of Touche Ross the court reaffirmed its confidence in the accounting profession and in particular in Touche Ross, to conduct an audit of Equity Funding.

As previously noted, the Equity Funding case will have a serious effect on the state regulation of life insurance companies and a potential effect on the auditing function performed by Certified Public Accountants. There is no anticipated change in the working of the standard short form report, but there is a possibility that certain auditing procedures will be revamped to prevent another Equity Funding. An AICPA resolution has resulted in formation of a "special committee to examine whether the irregularities in Equity Funding's financial statements indicate the need for a change in the auditing procedures in general use."  

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Auditors express an opinion on the fairness of financial statements following an examination of those statements. The examination is conducted in accordance with generally accepted auditing standards and is not primarily intended to detect or discover fraud. Users of financial statements normally place more reliance on audited financial statements than on unaudited statements.

The opinion rendered by a CPA on the financial statements of a stock life insurance company differs from the standard opinion. Since stock life insurance companies do not adhere to GAAP the opinion states "in conformity with insurance accounting principles prescribed or permitted under statutory authority." The second major difference in the opinion on stock life insurance companies involves mention of the amounts appearing in the statements resulting from actuarial determinations.

**Determination of Actuarial Amounts**

The standard short form audit report includes the statement that the "examination was made in accordance with generally accepted auditing standards." Included in generally accepted auditing standards are the Standards of Field Work. The third standard of field work states: "Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination." 35

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35Committee on Auditing Procedure, op. cit., p. 55.
Assuming that sufficient evidence can be acquired, the auditor's report will contain an unqualified opinion on the financial statements. If sufficient evidence cannot be obtained, the auditor will be required to qualify or disclaim an opinion on the financial statements.

In the normal course of gathering evidence, the auditor will obtain a number of representation letters from the client as well as from outside sources. One of the required representation letters is the legal representation letter. The legal representation letter is obtained from the company's legal council and "since council is an independent outside party with recognized expertise in the subject of the representations, the auditor is entitled to rely on his statements without further investigation." Once the legal representation letter is obtained it becomes a part of the evidence which provides a basis for the auditor's opinion. The legal representation letter is not identified in either the scope or opinion paragraph of the audit report.

In expressing an opinion on the financial statements of a stock life insurance company, the auditor must comply with the standards of field work. Sufficient evidence, including a legal representation letter, must be obtained prior to expressing an opinion on the financial statements. In life insurance auditing an additional representation is obtained from an outside source in the form of a statement from an actuary.

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The example of the wording of an audit report rendered on a stock life insurance company was previously presented. The consulting actuary, E. P. Higgins and Company, was identified in the scope paragraph and the opinion paragraph also made reference to reliance on the actuary's certificate.

Of the 156 audited stock companies included in the 1972 Ernst & Ernst survey, the following was noted:

Percentage of audited reports in which the accountants' report included:

<table>
<thead>
<tr>
<th>Reference to actuaries</th>
<th>37%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consulting actuary</td>
<td>34%</td>
</tr>
<tr>
<td>State insurance department</td>
<td>2%</td>
</tr>
<tr>
<td>Company actuary and state insurance department</td>
<td>1%</td>
</tr>
<tr>
<td>Accounting firm's own actuary</td>
<td>3%</td>
</tr>
</tbody>
</table>

No reference to actuaries                                     62%

In a number of audit reports the certificate provided by the actuary was included in the published annual report. Excerpts from one of the actuarial certificates is presented as follows:

We have examined the calculation for due and deferred premiums, and for reserves required on life and annuity policies, accident and health policies, supplemental contracts, life claims and accident and health claims made by . . . and reported in its 1971 Annual Statement.

In our opinion amounts shown for the items listed below are, in the aggregate, fairly stated in accordance with generally accepted actuarial principles, meet statutory requirements and are consistent with the various methods and reserve bases previously employed.

37Ernst & Ernst, op. cit., p. 48.

38Ibid., p. 58.
The reserve computation is complicated and reserves have a material effect on the financial statements of stock life insurance companies. Factors affecting computation of reserves were presented in Chapter III in the section on revenue and expense determination. The materiality of reserves in the Balance Sheet was established earlier in this chapter by reference to the New York Insurance Department Report, reflecting aggregate reserves for life policies to represent 72.7 percent of total reported Liabilities and Capital.

The problem of determination and reporting reserves are peculiar to the insurance industry. The actual determination of reserves is a complicated process, requiring a thorough knowledge and understanding of actuarial science. Some auditing firms include a reference to the consulting actuary in expressing an opinion on the financial statements, while other firms make no mention of the actuary in the opinion.

Existing financial reporting practices used by stock life insurance companies in reporting to stockholders and other groups have been dominated by the NAIC Statement Blank. The primary objective of the NAIC Statement Blank is to allow the state regulatory agency to determine the solvency of a life insurance company. The financial statements included in the annual report vary, to some extent, with the form prescribed by the NAIC Statement Blank. The auditor's report rendered on the published financial statements include a qualified opinion, stating that the financial statements are prepared in conformity with insurance accounting principles prescribed or permitted under statutory authority.
CHAPTER V

**Suggested Life Insurance Accounting Methods**

Before specific accounting methods or practices can be recommended it is essential to establish the objectives of financial reporting. Accounting practices evolve from the objectives of financial reporting and the individual amounts reported in financial statements are a function of accounting practices.

One of the objectives of conventional financial accounting is to present meaningful financial statements which will allow the users to evaluate the performance of the company and provide a basis for investment decisions. As previously noted, the AICPA has stated that such objectives as relevance, understandability, verifiability, neutrality, timeliness, comparability, and completeness should be reflected in the financial statements.

The accounting practices recommended in this study are intended to apply only to the published financial statements of stock life insurance companies. The recommendations applicable to the determination of net income and the physical appearance of the published financial statements are not applicable to the NAIC Statement Blank. The purpose of the Blank is to promote regulation of life insurance companies and the major emphasis is on the Balance Sheet. For financial reporting purposes, the emphasis is on the Income Statement and the determination of net income.
The life insurance accounting practices to be recommended are limited to the following areas: valuation of investments in bonds and stocks, recognition of revenue and expenses, accounting for nonadmitted assets, and deferred federal income taxes. The practices to be recommended have as their objectives the presentation of more meaningful financial statements and are designed to permit the earnings and earnings per share of life insurance companies to be comparable to the reported earnings and earnings per shares of other industries.

**Valuation of Securities**

The technique that is used to value securities has a direct effect on the amounts reported in the financial statements. Under existing life insurance accounting methods the year end balances of bonds, at amortized value, preferred stocks, at cost, and common stocks, at market value, are reported in the Balance Sheet. Net investment income, including interest and amortization on bonds and dividends on stocks, is reported in the Summary of Operations. Realized and unrealized gains or losses on investment in stocks are computed in Exhibit 4 of the NAIC Statement Blank, Capital Gains and Losses on Investments, and is reported in the Surplus Account. Finally, the Mandatory Securities Valuation Reserve is reported in the liability section of the Balance Sheet, offset by a charge or credit in the Surplus Account.

Differences between life insurance accounting and GAAP involve the following major areas: reporting of investment in common stocks at market value, reporting both realized and unrealized gains or losses on
stocks in the Surplus Account, and reporting the Mandatory Securities Valuation Reserve as a liability.

Bonds

Investment in bonds should be reported in the published financial statements at amortized value. Amortized value is defined as original cost adjusted for premium or discount since date of acquisition. Reporting bonds at amortized value is predicted on the following conditions: (1) bonds are in good standing (not in default as to interest or principal) and (2) the insurance company is planning to hold the bonds until maturity. Bonds that are not in good standing are to be reported at market value or such value as determined by the NAIC Securities Valuation Committee. Bonds that are to be sold prior to maturity should be reported at market value.

Amortization of premium or accrual of discount is recognized at the end of the fiscal period and is reflected as investment income in the Income Statement. In computing the amount to be recognized the scientific method (compound interest method, effective rate method, level-yield method) should be used. This method is more accurate than the straight line method as it reports a constant rate of return over the life of the bond investment.

Table I, presented in Chapter III, reflects the computation of accrual of discount on a bond of $1,000 face value, six year life, five per cent interest per year, payable semianually. The bond cost $950.23 which represents the amount paid in order to obtain a yield of six per cent on the bond investment. Accrual of discount for the year of acquisition was computed to be $5.32.
Continuing this example, the market value of the bond is influenced by the market rate of interest. Over the life of the bond, as the market rate of interest increases the market value of the bond will decrease. However, since the bond will be redeemed for face value at maturity, the market value will be approximately $1,000 as the bond approaches maturity.

The recommended method of reporting investment in bonds at amortizable value is the present method being used for the NAIC Statement Blank, and is also in accord with GAAP. However, under GAAP a company may use either the straight line method or the scientific method to compute amortization of premium or accrual of discount. A choice of methods is allowed because, in most industries, investment in bonds is not a material item on the balance sheet. In the life insurance industry, investment in bonds is material (approximately 35 per cent of total admitted assets for year ended 1970) and consequently determination of an amortization method is more important. Investment in bonds should be reported at amortized value and amortization of premium or accrual of discount should be computed using the scientific method.

Final consideration of investment in bonds involves financial statement disclosure of the market value of bonds. During periods of severe interest fluctuations there is an inherent danger in disclosing the market value of bonds in the financial statements. Assuming the company is planning to hold the bond until maturity, market value is irrelevant and could be confusing to the reader of the financial
statements. If the company plans to sell the bonds prior to maturity, bonds should be reported at market value and footnote disclosure of the anticipated sale should be included in the financial statements. If the life insurance company plans to hold the bonds until maturity, bonds should be reported at amortized value. Market value of the bonds as of the end of the fiscal period need not be disclosed.

**Stocks**

Stock life insurance companies report investments in preferred stocks at cost and common stocks at market value. GAAP requires that investment in stocks be reported at cost or the lower of cost or market. In order to make their financial statements more meaningful, stock life insurance companies should report all stocks at current market value. In discussing valuation of investments in stocks investments made for the purpose of obtaining a controlling interest in another company will not be considered.

As previously reported, stocks represent about 7 per cent of the total admitted assets reported by the life insurance industry for year ended 1970. In conventional financial statements, investment in stocks may be reported as a current asset or a long term asset, depending upon the marketability of the stock and the intent of management. As a result of this method of classification in the financial statements, there are no comparable relevant statistics to reflect the total investment in stocks held by other industries for year ended 1970.
Although GAAP provides that short term investment in stock may be reported at cost or lower of cost or market, only fourteen companies out of the 600 included in the 1971 Accounting Trends & Techniques reported investments at lower of cost or market.\(^1\) Application of the lower of cost or market rule is influenced by the AICPA's Committee on Accounting Procedure which stated that:

In the case of marketable securities where market value is less than cost by a substantial amount and it is evident that the decline in market value is not due to a mere temporary condition, the amount to be included as a current asset should not exceed the market value.\(^2\)

Under GAAP when stocks are written down as a result of a decrease in market value, a valuation account may be used or the investment account itself may be reduced. The loss is reported in the income statement for the current period but no loss is recognized for federal income tax reporting.

When the market value of investment in stocks increase, the appreciation is not formally recorded in the asset account and the gain is not recognized until the stocks are sold. GAAP requires the disclosure of the market value of investment as a parenthetical remark or footnote to the financial statements.

\(^1\) Of the 600 companies included in the survey, 225 reported the method of valuation of marketable securities at cost, 41 companies reported cost plus accrued interest, 83 companies did not indicate the basis for valuation. American Institute of Certified Public Accountants, Accounting Trends & Techniques, 1971, Twenty-Fifth Edition (New York: American Institute of Certified Public Accountants, 1971), p. 53.

Although GAAP requires reporting investments at cost or lower of cost or market, there are a number of exceptions to this rule. In the investment company industry (mutual fund companies) investments are reported in the balance sheet at market value. Financial statements presented by investment companies do not follow conventional financial statement presentation. The investment companies present a Statement of Realized and Unrealized Gains on Investments and a Statement of Changes in Net Assets which includes the realized and unrealized gains for the period. Reporting investments at market value for investing companies is justified as such a practice results in presentation of more meaningful financial statements.

As discussed in Chapter III, life insurance companies report common stock at market value and reflect gains and losses on investments in their surplus account. Insurance companies identify the cost of common stock as book value and annually record the difference between book value and market value. Market value is identified by life insurance companies as admitted value. During the time the investment is held, the unrealized gains and losses are recorded in reporting common stock at market value. When common stock is sold, the realized gain or loss is recorded.

The NAIC Statement Blank reports the amount of capital gains and losses on investments in Exhibit A. A copy of Exhibit A presented by Connecticut General Life Insurance Company for year ended 1971 is presented as follows:
### Exhibit IV: Capital Gains and Losses on Investments

<table>
<thead>
<tr>
<th></th>
<th>Increase in Book Value</th>
<th>Profit on Sale or Maturity</th>
<th>Decrease in Book Value</th>
<th>Loss on Sale or Maturity</th>
<th>Net Gain (+) or Loss (−) From Change in Difference Between Book and Admitted Values</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1. Bonds</strong></td>
<td>10,215</td>
<td>1,355,344</td>
<td>0</td>
<td>2,025,187</td>
<td>+1,719,197</td>
</tr>
<tr>
<td><strong>2.1 Preferred stocks</strong></td>
<td>0</td>
<td>444,926</td>
<td>0</td>
<td>40,324</td>
<td>−356,172</td>
</tr>
<tr>
<td><strong>2.2 Common stocks</strong></td>
<td>0</td>
<td>10,750,897</td>
<td>0</td>
<td>2,759,798</td>
<td>+2,534,044</td>
</tr>
<tr>
<td><strong>3. Mortgage loans</strong></td>
<td>0</td>
<td>363,960</td>
<td>0</td>
<td>7,473</td>
<td>−6,718</td>
</tr>
<tr>
<td><strong>4. Real estate</strong></td>
<td>0</td>
<td>112,356</td>
<td>0</td>
<td>111,745</td>
<td>0</td>
</tr>
<tr>
<td><strong>5. Premium notes, policy loans and liens</strong></td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td><strong>6. Collateral loans</strong></td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td><strong>7. Cash and bank deposits</strong></td>
<td>0</td>
<td>7,959</td>
<td>0</td>
<td>30,756</td>
<td>0</td>
</tr>
<tr>
<td><strong>8. Other invested assets (Schedule BA)</strong></td>
<td>0</td>
<td>42,236</td>
<td>0</td>
<td>36</td>
<td>+39,470</td>
</tr>
<tr>
<td><strong>9. Foreign exchange</strong></td>
<td>XXX</td>
<td>XXX</td>
<td>XXX</td>
<td>XXX</td>
<td>+163,498</td>
</tr>
<tr>
<td><strong>9.1 Miscellaneous Gain</strong></td>
<td>0</td>
<td>504</td>
<td>0</td>
<td>0</td>
<td>504</td>
</tr>
<tr>
<td><strong>10. Totals</strong></td>
<td>10,215</td>
<td>11,355,344</td>
<td>0</td>
<td>4,984,576</td>
<td>−4,127,021</td>
</tr>
<tr>
<td><strong>10.1 Less federal income taxes incurred on capital gains (show figure in Col. 6)</strong></td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td><strong>10.2 Balance to Surplus Account, Page 4 (show figure in Col. 6)</strong></td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

**Distribution of Line 10.2, Col. (6):** (Attach statement or memorandum explaining basis of division)

- **11. Net realized capital gains (+) or losses (−) on assets disposed of during the year $7,942,640** less $3,040 = $7,909,600 reflected in previous years' statements and less $0 = $7,909,600
- **12. Net unrealized capital gains (+) or losses (−) of the year $4,147,236**

*Additional due to amortization to be reported in Exhibit 3.
**Excluding $6,665,646 depreciation on real estate included in Exhibit 3, Line 3.

Attention is directed to Common stocks, item 2.2. The realized profit from sale of common stocks was $10,786,987 and the realized loss was $2,759,763. The unrealized gain on common stocks, due to the difference between book value and admitted value was $2,534,044. The net gain on investment in common stocks for year ended 1971 was $10,561,268. This amount is added to other gains and losses to arrive at the total reported gain of $12,089,876. Although the total unrealized gain ($4,127,021) is determined separately in Exhibit 4, only the total gain, net of federal income taxes, is reported in the surplus account. Connecticut General's surplus account for year ended 1971 is included in the NAIC Statement Blank exhibits presented in Chapter IV and reports Net Capital Gains of $12,098,876.

The recommendation of reporting investment in stocks at market value must also include consideration of the determination and reporting of realized and unrealized gains and losses on investments. Using the information presented in Table II, Chapter III, the following accounting entries would be recommended:

<table>
<thead>
<tr>
<th>Year ended</th>
<th>Investment in Common Stocks</th>
<th>Unrealized Gain on Investments</th>
</tr>
</thead>
<tbody>
<tr>
<td>19-A</td>
<td>$200</td>
<td>$200</td>
</tr>
<tr>
<td>19-B</td>
<td>$500</td>
<td>$500</td>
</tr>
<tr>
<td>19-C</td>
<td>$300</td>
<td>$300</td>
</tr>
<tr>
<td>19-D</td>
<td>$600</td>
<td>$600</td>
</tr>
</tbody>
</table>

Further, assume that on 3-1-19E the insurance company sold the investment in common stocks and received proceeds of $3,500. The entry to record this transaction is as follows:
3-1-19E  Cash $3,500  
Investment in Common Stocks $3,400  
Realized Gain on Investments 100

The amount of realized gain is determined by subtracting the market value as of the end of 19-D ($3,400) from the proceeds from sale in 19-E ($3,500).

Using existing conventional accounting rules, reporting investments at lower of cost or market, the following entries would be recorded for the common stock investment illustration:

<table>
<thead>
<tr>
<th>Year Ended</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>19-A</td>
<td>No entry. Disclosure of market value of $3,000.</td>
</tr>
</tbody>
</table>
| 19-B       | Loss Due to Decrease in Market Value of Investments $300  
Investment in Common Stocks $300 |
| 19-C       | (1) Investment in Common Stocks $300  
Gain on Write-up of Common Stocks to Original Cost $300  
or (2) No entry. Disclosure of market value of $2,800. |
| 19-E       | (1) Cash $3,500  
Investment in Common Stocks $2,300  
Gain on Sale of Common Stocks $700  
or If no entry was made in 19-C (2) Cash $3,500  
Investment in Common Stocks $2,500  
Gain or Sale of Common Stocks $1,000 |

Under conventional accounting, Loss Due to Decrease in Market Value of Investments, Gain on Write-up of Common Stocks to Original Cost, and Gain on Sale of Common Stocks would be reported in the Income Statement. This statement is in accord with Opinion 9 of the AFA which states:
"Adjustments related to prior periods—and thus excluded from the determination of net income for the current period—are limited to those material adjustments which (a) can be specifically identified with and directly related to the business activities of particular prior periods, and (b) are not attributable to economic events occurring subsequent to the date of the financial statements for the prior period, and (c) depend primarily on determinations by persons other than management and (d) were not susceptible of reasonable estimation prior to such determination. Such adjustments are rare in modern financial accounting."³

Strict application of Opinion 9 to life insurance accounting prohibits the reporting of gains and losses on investments in surplus (Retained Earnings) and requires they be reported as part of the determination of net income. The application of this rule applies to both realized and unrealized gains and gains and losses.

For stock life insurance published financial statements, realized and unrealized gains and losses on investments for the year should be combined and reported as one amount in the Income Statement. Reporting the gains and losses in the Income Statement instead of the Surplus Statement would make the Income Statement and the final net income figure more relevant. Presenting this item in the Income Statement would also make the stockholder aware of the fact that gains and losses from investments are a material factor in determining the earnings of a life insurance company.

The reporting of investment in stocks at market value is in accordance with existing life insurance accounting practices and is also in accord with accounting procedures used by investment companies. The recommendation of reporting gains and losses on investment in stocks in the income statement is contrary to reporting practices currently promulgated by the NAIC and reflected in the NAIC Statement Blank. Reflecting gains or losses on investment in stocks would enhance the value of the Income Statement by reporting the factors that affect the determination of earnings.

**Reporting Revenue and Expenses**

For statutory reporting purposes the NAIC Statement Blank reports revenue and expenses on the accrual basis. In the case of revenue, premium income is recognized on the anniversary date of the policy. Expenses for the period are matched with revenues and recognized on the accrual basis with the exception of acquisition costs. For statutory purposes, acquisition costs are recognized in the year incurred.

Recognition of revenue from premiums by life insurance companies is in accordance with revenue recognition as prescribed by GAAP. There is no recommendation to change the method of premium income recognition which is presently used by life insurance companies.

For expense recognition, two recommendations are presented for financial statement purposes: (1) policy reserves should be computed using realistic estimated future investment yields, mortality and
withdrawals, and (2) policy acquisition costs should be amortized over a period of time and matched against premium revenue.

As indicated in Chapter III, the addition to reserve is a function of the determination of total reserves for the current year relative to reserves for the prior year. Exhibit 8 of the NAIC Statement Blank reflects the determination of aggregate reserves for life policies and contracts. The total reported in Exhibit 8 for the current year is transferred to the balance sheet and the increase in reserves is reported in the income statement.

Statutory reserves which are reported in the NAIC Statement Blank are determined based on conservative assumptions as to interest and mortality. Effective January 1, 1966, reserves for all ordinary life new business issued by a company must be computed using the 1958 Commissioners Standard Ordinary Table. Interest rates are somewhat flexible, but the maximum rate that can be used is 3½ per cent. In addition to mortality and interest, the company must select one of the valuation methods, such as the Net Level Term or the Commissioners Reserve Valuation Method.

Table VI in Chapter III reflects some of the differences resulting from variation in the interest rate, mortality table and

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valuation method. The following conclusions can be noted from the information reported in Table VI: (1) interest—increasing the interest rate, decreases the reserve; (2) mortality—using the 1958 CSO, instead of the 1941 CSO, causes a reduction in reserve; and (3) valuation method—the Commissioners Valuation Method does not require reserves in early years but over the life of the contract, total policy reserves will eventually equal the reserves computed under the Net Level Premium method.

For purposes of financial statement presentation, reserves should be computed by applying realistic interest and mortality assumptions. The AICPA Insurance Audit Guide states the following recommendation concerning reserve computation:

"Unlike statutory reserves . . . , a company calculating reserves in conformity with generally accepted accounting principles should develop its own factors based on assumptions that are reasonably conservative and that include provision for the risk of adverse deviation from such assumptions."

Interest rates used for reserve calculations represent return on investments in the form of interest, dividends and rents. Traditionally, interest rates used for statutory reserve calculations are lower than actual yield rates. The effect of calculating reserves using lower than actual rates results in deferring the recognition of income. Low interest rates overstate reserves and recognition of the difference

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caused by higher actual yields is postponed until the policy is surrendered or the death of the policyholder. The interest rate that should be used in reserve computations for published financial statements "... should be based on the estimate of future interest expected at the time that the policies were issued." 7

The Commissioners 1958 Standard Ordinary Mortality Table was developed from the actual mortality experience of a number of major life companies during the period 1950-1954. 8 Prior to the adoption of the 1958 CSO, insurance companies used the 1941 CSO for reserve computations.

Some life insurance companies disclose the factors used in the reserve computation as a footnote to the financial statements. An example of such disclosure was presented in the 1971 financial statements of American National Insurance Company.

The following table sets forth the percentage of the companies' life insurance reserves at the end of the last two years based upon each of the Mortality Tables and assumed rates of interest listed below:

<table>
<thead>
<tr>
<th>Mortality Table and Assumed Rates of Interest</th>
<th>Percent of Life Reserves 1971</th>
</tr>
</thead>
<tbody>
<tr>
<td>American Experience 3% and 3½%</td>
<td>8.9</td>
</tr>
<tr>
<td>Standard Industrial 3½%</td>
<td>11.3</td>
</tr>
<tr>
<td>1941 CSO 2½%, 2-3/4%, 3%, and 3½%</td>
<td>41.4</td>
</tr>
<tr>
<td>1941 Standard Industrial</td>
<td>17.6</td>
</tr>
</tbody>
</table>

7Ibid., p. 76.

8Ernst & Ernst Insurance Industry Committee, Natural Reserves and Life Insurance Accounting (Ernst & Ernst, 1970), p. 71.
With the passage of time, American National will report a reduction in the reserve element computed using the 1951 CSO and will reflect an increase in the 1958 CSO percentage. This change in the composition of reserves will result from the surrender of policies and the death of policyholders.

Determination of reserves through use of realistic estimates of mortality, interest and withdrawals will result in a better matching of revenue and expenses. The problems resulting from deriving and applying realistic reserve factors, necessary for the preparation of life insurance financial statements, can be compared to the difficulty of using estimates in various conventional accounting applications.

In financial accounting, the use of estimates are required in the following areas: depreciation, amortization, pensions, standard costs, allowance for uncollectibles, warranties, and long-term construction contracts. Determination of depreciation expense to be reported in the Income Statement is predicted upon two estimates: useful life and salvage value. Both estimates are established when the asset is acquired and are based on the most reliable information available at that time. As the asset is placed into service and used,

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9Ernst & Ernst, Financial Reporting Trends, Life Insurance 1972 (Ernst & Ernst, 1972), p. 120.
the useful life and salvage value are reviewed and revised if the
actual experience indicates a material difference from the original
estimate. In financial accounting, a change in an accounting estimate
(i.e., increase the useful life of a depreciable asset) should be
accounted for in the period of the change and the future periods that
the change affects. 10 Thus, the increase in the remaining life of a
depreciable asset would result in the reduction of depreciation expense
for the current period and for all future periods that the asset is
used. Applying financial accounting techniques to the area of life
insurance reserve computations results in the following recommendations:
(1) reserve computations should be based on realistic estimates of
mortality, interest and withdrawals at the time the policy is issued
and (2) material differences from the original estimates should be
recognized currently and the effects of deviations should be reported
in the determination of net income.

For statutory reserve computations, life insurance companies
cannot use an interest rate to exceed 3½ per cent. As indicated
earlier, this is the maximum rate that can be used and many companies,
including American National, use rates lower than 3½ per cent in the
reserve computation. The actual rate of return on investments as
reported by the life insurance industry has increased over the past
years as follows: 1960—4.11%, 1965—4.61%, 1970—5.30%, and 1971—5.44% 11

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10 Accounting Principles Board, Opinions of the Accounting
Principles Board No. 20, Accounting Changes, July 1971 (New York:

11 Institute of Life Insurance, Life Insurance Fact Book 1972
Computation of statutory reserves during periods of increasing interest rates, has caused reported net income to be understated and the reserve liability to be overstated.

The reserve computation requires the application of a valuation method. The Net Level Method of valuation is considered as more stringent than the Commissioners Reserve Valuation Method. The CRMV does not require any reserve in the year of sale and use of this method is intended to offset the effect of expensing acquisition costs. For statutory reporting purposes, acquisition costs are expensed in the year incurred and the company has the option of computing reserves using the NLFM or the CRVM. If the company elects to amortize acquisition costs it must compute reserves using the NLFM of valuation. Acquisition costs, as discussed in Chapter III, includes such items as: first year commission, underwriting, and policy issue costs.

The consequence of treating acquisition costs as a current expense item is reflected in the reported net income of a life insurance company. Whereas in most businesses, as sales increase net income increases, in life insurance as sales increase net income may decrease. This condition is caused by the fact that the premium revenue generated from sales is not adequate to offset the acquisition costs incurred in those sales.

In financial accounting, current expenditures for goods and services applicable to future periods are identified as prepayments or
deferred charges. Some basic examples would include prepaid rent, prepaid interest, store supplies, and prepaid advertising. Normally, prepayments are made for a short period of time and if the benefit of the prepayment extends beyond the next operating cycle, the item is identified as a deferred charge. Prepayments and deferred charges are amortized over the life of the benefit and matched against the resulting revenues.

For published financial statement purposes, life insurance companies should capitalize acquisition costs and amortize those costs over the period of time for which premium revenue is recognized. The direct effects of this recommendation are to create an additional asset to be recognized in the balance sheet, Deferred Acquisition Costs; and to eliminate the inconsistency of having to report a lower net income in periods of increasing sales.

Two major problems must be solved before it will be possible to defer and amortize acquisition costs. First, the life insurance company must determine the amount of acquisition costs applicable to each new block of policies. Normally, the major item of acquisition costs is the first year commission paid to the agent selling the policy. Variable expense items that fluctuate with sales and are related to placing new business on the books would also be identified as acquisition costs. After the company has determined acquisition costs for a block of policies, it then must derive a method of matching the acquisition costs with premium revenues to be received over the life of the policies.
Assume that a company is able to determine that it incurred acquisition costs of $20,000 applicable to the sale of 500 policies with an average life of ten years. Applying the basic financial accounting rules of amortization to this problem would result in the recognition of $2,000 ($20,000 - 10 years) expense per year. Initially, the $2,000 appears to be the amount that would be charged off for the first year, leaving a balance of $18,000 to be reported as Deferred Acquisition Costs.

This solution, although it appears logical, is not correct. If expenses are to be matched with revenue, the above method of computing amortization is invalid. The fallacy of the computation resulting in recognition of $2,000 expense is that revenues will be received equally over the life of the policies. Due to the lapse rate, the surrender of policies and the payment of death benefits, the revenue received will decrease from the first year high and continue to decrease until the block of policies are no longer outstanding.

One method of amortization of acquisition costs involves the determination of total revenue to be received and amortization based on the anticipated revenue factor. Assume, that in the previous example, the total number of annual premiums to be received was 2,750\(^{12}\) and each annual premium was $50. Based on these factors the total premium revenue would amount to $137,500 ($50 x 2,750). Assume that in the first

\(^{12}\)Assume that 500 premiums are received in the first year and that the number of premiums are reduced by 50 each year, until the tenth year.
year, all 500 policyholders paid their $50 annual premium. Premium revenue for the first year would amount to $25,000. Acquisition costs could be amortized based on the relationship of total revenue to annual revenue, which for the first year would amount to $3,636 (25,000 ÷ $137,500 X $20,000). As premium revenue reduces from year to year, the amount of acquisition costs to be amortized will be reduced accordingly.

Life insurance companies that decide to present their financial statements in accord with GAAP will be required to adjust both their reserve calculations and the treatment of acquisition costs. If a company is using the Commissioners Reserve Valuation Method to compute its reserves, and it wants to defer acquisition costs, it must convert to the Net Level Premium Method and recompute its reserves.

An example of this condition can be found in the 1972 published annual report of American Family Life Assurance Company. In adjusting its statutory statements to conform with GAAP, American Family Life reported Deferred Acquisition Costs of $34,292,405 for year ended 1972. The company also reported an increase in reserves of $5,755,626 resulting from computing reserves using a Net Level Premium Method instead of the Commissioners Reserve Valuation Method.

The recommended treatment of determination of reserves and amortization of acquisition costs will have a profound effect on the financial statements of stock life insurance companies. Statutory treatment of these items is justified from the standpoint of conservatism and the feeling that the policyholder must be protected.
of more realistic factors in reserve computations and amortization of
acquisition costs is justified from the standpoint of making the
published financial statements more meaningful and applying conventional
accounting techniques, as promulgated by the AICPA's Accounting Principles
Board, to life insurance accounting.

**Accounting for Nonadmitted Assets**

Nonadmitted assets are those assets which cannot be reported
in the financial statements of stock life insurance companies. The
practice of identifying assets as nonadmitted can be traced to an 1871
ruling of the New York State Life Insurance Commissioner which stated
that the following items be listed as Not Admitted as Available Assets:
(1) Furniture and fixtures, (2) Commuted commissions, (3) Cash advanced
to, or in the hands of, officers and agents, (4) Agents' balances owed
to the company, (5) Loans on personal security, and (6) Supplies,
printed matter, and stationery. The assets that are currently
identified as nonadmitted assets are listed in Exhibit 14 of the NAIC
Statement Blank and include most of the items initially listed by the
New York State Life Insurance Commissioner in 1871. The individual
items comprising the nonadmitted asset category have been listed in
Chapter III of this study.

Nonadmitted assets appear in two exhibits included in the NAIC
Statement Blank: Exhibit 13—Assets and Exhibit 14—Analysis of Non-
admitted Assets and Related Items. The objective of Exhibit 13 is to

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13 Noback, op. cit., p. 94.
determine the Net Admitted Assets which are to be reported in the Annual Statement. In the case of Connecticut General Life Insurance Company the NAIC Statement Blank for year ended 1971 reported the following amounts in Exhibit 13:

<table>
<thead>
<tr>
<th>Ledger Assets</th>
<th>$5,435,487,886</th>
</tr>
</thead>
<tbody>
<tr>
<td>Plus: Nonledger Assets</td>
<td>270,809,107</td>
</tr>
<tr>
<td>Less: Assets Not-Admitted</td>
<td>37,478,122</td>
</tr>
<tr>
<td>Net Admitted Assets</td>
<td>$5,668,818,871</td>
</tr>
</tbody>
</table>

The total reported in Exhibit 13 agrees with the total Assets reported Connecticut General Life Insurance Company in the NAIC Statement Blank included in Chapter IV of this study.

Some of the amounts reported in Exhibit 13 as Assets Not Admitted are included in Exhibit 14. Connecticut General reported the following items in Exhibit 14:

<table>
<thead>
<tr>
<th>Item</th>
<th>Previous Year</th>
<th>Current Year</th>
<th>Change for Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>30. Furniture and equipment</td>
<td>$4,912,640</td>
<td>$6,369,863</td>
<td>$ - 1,457,223</td>
</tr>
<tr>
<td>34. Loans on personal security endorsed or not</td>
<td>59,253</td>
<td>133,835</td>
<td>- 74,577</td>
</tr>
<tr>
<td>37. Accident and health premiums due and paid</td>
<td>1,913,729</td>
<td>1,908,875</td>
<td>4,854</td>
</tr>
<tr>
<td>38. Other assets not admitted</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>38.1 All other debt balances</td>
<td>253,066</td>
<td>323,302</td>
<td>- 65,235</td>
</tr>
<tr>
<td>40. Total Change</td>
<td></td>
<td></td>
<td>$ - 1,592,181</td>
</tr>
</tbody>
</table>

The total change in nonadmitted assets reported in Exhibit 14 influences the determination of unassigned surplus. An increase in nonadmitted
assets results in a decrease in unassigned surplus. Connecticut General reported an increase of $1,592,181 in nonadmitted assets in Exhibit 14 and also reflected the same amount in the Surplus Account included in Chapter IV.

The accounting effects of treating furniture and equipment as nonadmitted assets are listed as follows: (1) assets that should be capitalized are written off for financial reporting purposes against unappropriated surplus in the period incurred, (2) in recording depreciation expense, a direct charge against the asset account is recorded in the ledger, instead of setting up a contra account and (3) depreciation expense is not identified in the Income Statement. In the case of Connecticut General, the 1971 increase in furniture and equipment of $1,457,223 will not appear as part of total assets even though the furniture and equipment may have utility in future periods. For accounting purposes, depreciation expense applicable to the addition is recorded by a debit to expense and a credit to furniture and equipment. The reported increase in furniture and equipment of $1,457,223 represents Gross Additions - Retirements - Current Year Depreciation on Additions - Current Year Depreciations on Beginning Balance of Furniture and Equipment.

The recommended method that stock life insurance companies should use in accounting for furniture and equipment is comparable to the method presently used in conventional financial accounting. Upon acquisition of furniture and equipment, those items which have an estimated useful life that will extend beyond the current operating
period should be capitalized and depreciated. The amount to appear in
the Balance Sheet is the original cost minus the accumulated depreci-
ation. The amount to be reported in the Income Statement is the current
year depreciation expense.

This treatment will result in the periodic reduction of re-
tained earnings by recognition of depreciation expense. Furniture and
equipment will be reported as an asset and will be depreciated over
its estimated useful life. The depreciation expense will be reflected
in the Income Statement and, consequently, will reduce reported net
earnings. A reduction in net earnings will result in a reduction in
year end retained earnings.

A second type of nonadmitted asset is agents' debit balances.
This account represents the balance due the company for amounts advanced
to agents in the early stages of their employment. In order to attract
and develop an agency force, many companies pay a level monthly salary
for a period of time with the understanding that future commissions
earned will be applied against the monthly payments.

Although Connecticut General reports a zero balance for agents'
debit balances, the balance of this account for other life companies
can be material. In Chapter III of this study, it was reported that
American Fidelity Life Insurance Company had a balance of $1,005,154 in
Agents' balances for year ended December 31, 1970. The following
information was reported in the 1970 statutory financial statements of
American Fidelity Life Insurance Co.: Admitted Assets—$20,665,894, 
Unassigned Surplus—$63,811 and Net Gain from Operations—$524,363.14

Agents’ debit balance is a ledger asset and is reported in 
Exhibit 14. Assume the following events occurred during 19A: (1) 
October 2, 19A, hired an agent at a level monthly salary of $800. 
(2) Commission earned by agent during 19A; October $-0-, November $450, 
December $900. After recording these transactions, the following 
information would be reported in the agents’ debit balance account.

<table>
<thead>
<tr>
<th>Agents’ Debit Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Oct. 19A</td>
</tr>
<tr>
<td>Nov.</td>
</tr>
<tr>
<td>Dec.</td>
</tr>
<tr>
<td></td>
</tr>
</tbody>
</table>

Dec. 31, 19A Balance $1,050

Agents’ debit balance of $1,050 would be reported in Exhibit 14 as a 
ledger asset and the same amount would be listed in column 3, Asset 
Not Admitted. This would result in $-0- being reported in column 4 of 
Exhibit 14, Net Admitted Assets.

In Exhibit 15, agents’ debit balance for the end of the current 
year would be reported at $1,050. Assuming the balance at the beginning 
of the year was $-0-, the change for the year would be $1,050. This 
would represent an increase in nonadmitted assets and thus a decrease 
in unassigned surplus. The company would also report Commission Expense

14A. M. Best Company, Best’s Insurance Reports Life-Health 1971
of $1,350 in the Income Statement for year ended 19A. The total effect of these transactions is a reduction of net income by $1,350 and a direct charge against unassigned surplus of $1,050. The total effect on unassigned surplus is a reduction of $2,400.

Continuing this illustration, assume the following transactions took place in 19B: (1) Agent quits in 19B before he draws his salary for January 19B. (2) Business in process at the end of 19A results in $300 commissions due the agent.

The balance of agents' debit balance at the end of 19B, before adjustment, is $750. The company decides to write off the amount due and records an adjusting journal entry which reduces the balance of the account to $-0-. The agents' debit balance at the beginning of the year was $1,050 and the end of the year is $-0-. The consequence of this condition is an increase in unappropriated surplus.

Using existing stock life insurance accounting methods, as reflected in this illustration, the following effects on the determination of net income is noted: (1) Commission expense, 19A $1,350, (2) Commission expense, 19B $300, and (3) Other salary expense, 19B $750. The total expenses reported for the two year period is $2,400. This amount is equal to the three level monthly salary payments of $800.

A question can be raised concerning proper recognition of expense and the adequacy of reporting assets. As previously stated, expenses should be reported and matched, to the extent possible, with
revenue earned in incurring such expenses. Assets, such as agents' debit balances, should appear in the Balance Sheet if it is probable that such amounts will be offset against future commissions.

In order to make stock life insurance accounting practices and the resulting financial statements more meaningful and comparable to other industries, agents' debit balances should be reported as an asset and the resulting expense should be matched against revenue. The accounting for agents' debit balances would be conducted the same way it is presently being done with the following exception, at the end of the period a complete review of the individual agents balances be conducted to establish collectability. Individual amounts that cannot be offset against expected future commissions should be written off. An allowance account should be set up to reflect the fact that all account balances will not be collected. This method of accounting is comparable to the conventional accounting method of accounting for and reporting trade accounts receivable.

Applying the recommended procedure to the previous illustration would result in the following amounts being reported: (1) Commission expense, 19A $1,350, (2) Other expense, 19A $750, and (3) Commission expense, 19B $300. For purposes of this illustration, the amount reported in the 19A Balance Sheet for agents' debit balances would be $0 because the agent quit and no future commissions are forthcoming. The expense to be recognized for 19A is $2,100 and 19B $300.
The accounting and reporting of all nonadmitted assets should be comparable to the accounting methods presently used in conventional financial accounting. Under conventional accounting it is necessary to review all assets to determine that amounts reported have future utility and thus can be recovered against future operations.

**Recognition of Deferred Federal Income Taxes**

A stock life insurance company determines its federal income tax liability under the provisions of the Life Insurance Company Income Tax Act of 1959. The intent of the 1959 Act was to tax life insurance companies essentially in the same manner as other corporations. As stated in Chapter III, the determination of the tax liability involves the designation of taxable income as Phase I, II, or III.

The NAIC Statement Blank reports federal income tax liability in the statement of Liabilities, Surplus and Other Funds. The federal income tax expense is reported in the Summary of Operations as the last deduction prior to determination of net gain from operations. Connecticut General Life Insurance Company in its NAIC Statement Blank included in Chapter IV of this study, reported a federal income tax liability of $24,451,009 and federal income tax expense of $29,000,000 for 1971. Federal income tax allocation is not recognized for NAIC Statement Blank purposes nor is tax allocation used in presenting published financial statements.

Many of the accounting methods prescribed by the NAIC Statement Blank are used in determining taxable income and thus, tax liability.
In determining reserves, "a life insurance company which has computed reserves on the preliminary term basis may elect under section 818(c), to revalue the reserves on a net level premium basis for tax purposes, even though the preliminary term method is retained for annual statement purposes.\textsuperscript{15} As previously noted, the preliminary term method is a less stringent method of computing reserves, thus the tax liability is minimized by use of the net level reserve method.

In conventional financial accounting there is both interperiod and intraperiod income tax allocation. Interperiod allocation relates primarily to recognition of timing differences between book and taxable income. Intraperiod allocation requires that the tax effect be offset against the item giving rise to the tax liability. The Accounting Principles Board took the following position in Opinion \#11, \textit{Accounting for Income Taxes}, December 1967: "The Board has considered the various concepts for income taxes and has concluded that comprehensive interperiod tax allocation is an integral part of the determination of income tax expense."\textsuperscript{16} In the same Opinion, the Board listed as an area requiring additional study the amount designated as policyholders' surplus by stock life insurance companies.

Opinion \#23 of the APB, \textit{Accounting for Income Taxes - Special Areas}, issued in April 1972, included a discussion and opinion on


policyholders' surplus. The Board stated that since the life insurance company controls the events creating the tax consequence that it is not necessary to accrue income tax on the difference between taxable income and pretax accounting income identified as policyholders' surplus. Thus, policyholders' surplus is treated as a permanent difference between book and taxable income.

For financial statement reporting purposes, it is recommended that stock life insurance companies comply with the position taken by the APB and recognize both interperiod and intraperiod tax allocation. One of the timing differences that will result from accounting recommendations previously porposed in this study involves recognition of acquisition expense. For tax purposes, acquisition expense can be charged off in the period incurred. If for financial statement purposes, acquisition expense is amortized, it will be necessary to recognize deferred federal income taxes resulting from the different treatment for book and tax purposes.

Allocation of federal income tax has as its objective the meaningful determination of net income. When timing differences arise, those differences must be recognized and properly accounted for in order to make the financial statements of stock life insurance companies comparable to conventional financial statements.

In summary the following recommendations have been made in an effort to improve the accounting practices used by stock life insurance companies. Bonds should be reported at amortized values and amortization should be computed based on the scientific method. Both preferred and common stocks should be reported at market value and unrealized gain or loss should be recognized in the Income Statement. Policy reserves should be computed using realistic estimates of future yields, mortality and withdrawals, and adjustments for differences between actual and expected results should be reflected in the current year determination of net income. Acquisition costs should be matched with revenue which would result in amortization of acquisition costs over the expected life of the policies. Nonadmitted assets should be recognized as assets, if they have future utility, and related expenses should be reported in the period to which they relate. Both interperiod and intraperiod federal income tax allocation should be used in reflecting differences between book and taxable income. The implementation of these suggestions will be reflected in the proposed set of financial statements that a stock life insurance company should prepare in reporting to its stockholders.
CHAPTER VI

Recommended Form and Content of Financial Statements

The recommended form and content of the financial statements presented by stock life insurance companies will include the accounting recommendations advanced in Chapter V. The financial statements are intended to be used by stockholders for decision purposes and are not intended as a substitute for the NAIC Statement Blank or the federal income tax return.

The terminology used in the recommended financial statements will coincide with the current terminology used in conventional financial accounting. If the financial statements of stock life insurance companies are to be comparable to other industries, the reader must be able to identify and relate amounts being used for comparative purposes.

This chapter includes illustrations of the following financial statements recommended for presentation by stock life insurance companies: Income Statement, Statement of Stockholders' Equity, Balance Sheet, and Statement of Changes in Financial Position. The items listed in the financial statements apply to the typical stock life insurance company as a function of the transactions occurring during the accounting period and the year end balances.

Disclosure of financial information can be presented in the body of the financial statement or in footnotes which are considered as an
integral part of the financial statements. Since too much descriptive information in the body of the financial statements would detract from the amounts being reported, it is usually necessary to present a series of footnotes to accompany the financial statements. The four sample footnotes presented in this chapter relate to the previously recommended methods of accounting and reporting practices for stock life insurance companies.

The expression of an opinion on the financial statements by a CPA lends an added degree of credibility to those financial statements. Depending upon the circumstances, an auditor’s report may include an unqualified, qualified, or adverse opinion on the fairness of the financial statements taken as a whole. The accounting and reporting recommendations proposed in this study will influence the type of audit report that may be rendered by a CPA. Since the audit report expresses an opinion on the financial statements of the company, this chapter will include consideration of the following subject areas: (1) a series of suggested financial statements, (2) footnotes to those financial statements and (3) the type of auditor’s report to be presented on such financial statements.

**Income Statement**

The Income Statement is intended to reflect the results of opinions for the accounting period. Opinion 9, *Reporting the Results of Operations*, issued by the Accounting Principles Board in 1966 has significantly influenced the form and content of the Income Statement.
Some of the provisions of Opinion 9 have been included in Chapter V and will not be repeated at this time. Basically, the Opinion calls for the following major classifications when preparing an Income Statement: ordinary, extraordinary and prior period.

Of the life insurance accounting recommendations made in Chapter V, the recommendation which will have the greatest impact on the Income Statement is the reporting of total realized and unrealized gains and losses on equity investments in the Income Statement.

The 1970 Exposure Draft of the Audit Guide did not take a position on the reporting of realized and unrealized gains and losses on investments in stocks. The Exposure Draft stated that the AICPA Committee on Insurance Accounting and Auditing had furnished to the Accounting Principles Board a separate position paper on reporting realized and unrealized gains and losses on equity investments.\(^1\)

One of the members of the committee provided some insights as to the feelings of the committee in an article published in the Spring 1971 edition of World (quarterly publication of Peat, Marwick, Mitchell & Company). The author of the article, Bobby F. Dunn,\(^2\) pointed out that life companies, under statutory requirements, report both realized and

---


\(^2\)Bobby F. Dunn is a partner of Peat, Marwick, Mitchell & Co., and is head of the firm’s life insurance practice. Mr. Dunn was a member of the AICPA’s Committee on Insurance Accounting and Auditing during the time the following publications were issued: *Audits of Life Insurance Companies, Exposure Draft, December 1970; Audits of Stock Life Insurance Companies, Exposure Draft, August, 1972; and Audits of Stock Life Insurance Companies, Industry Audit Guide.*
unrealized capital gains and losses in the surplus account. The committee felt that investment gains and losses should be recognized in the income statement. ³

The final position promulgated by the AICPA Committee on Insurance Accounting and Auditing in the 1972 Exposure Draft and in the Audit Guide contradicts the previously quoted statement of Mr. Dunn. The 1972 Exposure Draft and the Audit Guide outlines the following basic alternatives in reporting realized and unrealized gains and losses on equity securities:


2. Report realized and unrealized gains and losses in a separate account.

3. Report realized and unrealized gains and losses in unappropriated surplus (as is currently being done).

4. Report realized and unrealized gains and losses in the Income Statement. ⁴

Instead of indicating the most preferable way of reporting realized and unrealized gains and losses the committee stated that all of the alternatives, with the exception of #4, would be acceptable for financial reporting purposes. Since the AICPA is studying the area of reporting gains and losses on investments the Life Insurance Committee...
did not want to require a method of reporting which would eventually conflict with the pronouncements of the Accounting Principles Board or the Financial Accounting Standards Board.

Other recommendations made in Chapter V that will be reflected in the Income Statement include recognition of policy reserves using realistic estimates, amortization of acquisition costs, recognition of all assets and comprehensive federal income tax allocation. Most of these recommendations were included in both the 1970 Exposure Draft and the final Industry Audit Guide.

The recommended form and content of the income Statement for stock life insurance companies, incorporating the accounting recommendations advanced in Chapter V, is presented as follows:

<table>
<thead>
<tr>
<th>XYZ Life Insurance Company</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Income Statement</td>
<td></td>
</tr>
<tr>
<td>For Year Ended December 31, 19A</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Revenue</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Life and annuity premiums</td>
<td>$ XX</td>
</tr>
<tr>
<td>Accident and health premiums</td>
<td>XX</td>
</tr>
<tr>
<td>Gain on equity investments (Note 1)</td>
<td>XX</td>
</tr>
<tr>
<td>Investment income</td>
<td>XX</td>
</tr>
<tr>
<td><strong>Total revenue</strong></td>
<td><strong>$ XX</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Benefits and Expenses</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Policy benefits</td>
<td></td>
</tr>
<tr>
<td>Death benefits</td>
<td>$ XX</td>
</tr>
<tr>
<td>Accident and health benefits</td>
<td>XX</td>
</tr>
<tr>
<td>Increase in reserve liability for future policy benefits (Note 2)</td>
<td>XX</td>
</tr>
<tr>
<td><strong>Total policy benefits</strong></td>
<td><strong>$ XX</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Expenses</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Premium taxes, licenses and fees</td>
<td>$ XX</td>
</tr>
<tr>
<td>Amortization of acquisition costs (Note 3)</td>
<td>XX</td>
</tr>
<tr>
<td>Other operating expenses</td>
<td>XX</td>
</tr>
<tr>
<td>Federal income taxes (Note 4)</td>
<td>XX</td>
</tr>
<tr>
<td><strong>Total expenses</strong></td>
<td><strong>$ XX</strong></td>
</tr>
</tbody>
</table>
XYZ Life Insurance Company
continued

Total benefits and expenses
Income before extraordinary items
Extraordinary items, net of tax effect
Net income
Per share:
Income before extraordinary items
Extraordinary items
Net income

The accompanying notes are an integral part of these financial statements.

Statement of Stockholders' Equity

The content of the Statement of Stockholders' Equity is influenced by the stockholders' equity transactions occurring during the accounting period. The purpose of the Stockholders' Equity Statement is to reflect an analysis of the following accounts: Capital Stock, Capital in Excess of Par Value, Appropriated and Unappropriated Retained Earnings.

The major departure in the recommended statement and statutory reporting requirements is the presentation of unappropriated retained earnings (unassigned surplus for statutory purposes). As recommended for financial reporting purposes, the determination of unappropriated retained earnings is influenced by prior period adjustments (if there are any), net income and dividends. Thus, the recommended determination of retained earnings is in compliance with Opinion 9 of the Accounting
Principles Board. This approach represents a significant departure from the statutory technique of determining unassigned surplus included in Chapter IV.

The recommended presentation of the Statement of Stockholders' Equity is as follows:

**XYZ Life Insurance Company**  
**Statement of Stockholders' Equity**  
**For the Year Ended December 31, 19A**

<table>
<thead>
<tr>
<th>Capital Stock</th>
<th>Capital in Excess of Par Value</th>
<th>Retained Earnings</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance, beginning of year</td>
<td>$ XX</td>
<td>$ XX</td>
</tr>
<tr>
<td>Sale of capital stock</td>
<td>XX</td>
<td>XX</td>
</tr>
<tr>
<td>Issue of stock dividend</td>
<td>XX</td>
<td>XX</td>
</tr>
<tr>
<td>Net income</td>
<td>XX</td>
<td>XX</td>
</tr>
<tr>
<td>Dividends to stockholders</td>
<td>XX</td>
<td>XX</td>
</tr>
<tr>
<td>Other (as appropriate)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The accompanying notes are an integral part of these financial statements.

**Balance Sheet**

The suggested form of the Balance Sheet for financial reporting purposes includes assets that for statutory purposes are nonadmitted and unamortized acquisition costs. Investments in bonds are stated at
amortized cost and all stocks are reported at market value. In addition to the usual liabilities reported by a stock life insurance company, the suggested Balance Sheet includes both current and deferred federal income tax liability.

The recommended form of the Balance Sheet for financial reporting purposes is presented as follows:

**XYZ Life Insurance Company**

**Balance Sheet**

**December 31, 19A**

**ASSETS**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ XX</td>
</tr>
<tr>
<td>Accrued investment income</td>
<td>XX</td>
</tr>
<tr>
<td>Agents' balances and accounts receivable (net of allowance for uncollectibles of $ XX)</td>
<td>XX</td>
</tr>
<tr>
<td>Policy loans</td>
<td>XX</td>
</tr>
<tr>
<td>Investments</td>
<td></td>
</tr>
<tr>
<td>Bonds, amortized cost</td>
<td>$ XX</td>
</tr>
<tr>
<td>Preferred stocks, market value (Note 1)</td>
<td>XX</td>
</tr>
<tr>
<td>Common stocks, market value (Note 1)</td>
<td>XX</td>
</tr>
<tr>
<td>Mortgages on real estate, amortized cost</td>
<td>XX</td>
</tr>
<tr>
<td>Real estate, cost (less $ XX accumulated depreciation)</td>
<td>XX</td>
</tr>
<tr>
<td>Property and equipment at cost:</td>
<td></td>
</tr>
<tr>
<td>Land</td>
<td>$ XX</td>
</tr>
<tr>
<td>Buildings</td>
<td>XX</td>
</tr>
<tr>
<td>Furniture and equipment</td>
<td>XX</td>
</tr>
<tr>
<td>$ XX</td>
<td></td>
</tr>
<tr>
<td>Less accumulated depreciation</td>
<td>XX</td>
</tr>
<tr>
<td>Unamortized acquisition costs (Note 3)</td>
<td>XX</td>
</tr>
<tr>
<td>Other assets</td>
<td></td>
</tr>
<tr>
<td>Assets held in separate accounts</td>
<td>XX</td>
</tr>
<tr>
<td>Total assets</td>
<td>$ XX</td>
</tr>
</tbody>
</table>
The accompanying notes are an integral part of these financial statements.

XYZ Life Insurance Company
Balance Sheet
December 31, 19A

<table>
<thead>
<tr>
<th>LIABILITIES</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Policy liabilities (Note 2)</td>
<td>$ XX</td>
</tr>
<tr>
<td>Notes payable</td>
<td>XX</td>
</tr>
<tr>
<td>Accrued expenses payable</td>
<td></td>
</tr>
<tr>
<td>Federal income taxes payable (Note 4)</td>
<td></td>
</tr>
<tr>
<td>Current</td>
<td>$ XX</td>
</tr>
<tr>
<td>Deferred</td>
<td>XX</td>
</tr>
<tr>
<td>Other liabilities</td>
<td>XX</td>
</tr>
<tr>
<td>Liabilities related to separate accounts</td>
<td>XX</td>
</tr>
<tr>
<td>Total liabilities</td>
<td>$ XX</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>STOCKHOLDERS' EQUITY</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital stock—authorized XXX shares of $ XX par value,</td>
<td>$ XX</td>
</tr>
<tr>
<td>issued and outstanding XXX shares</td>
<td></td>
</tr>
<tr>
<td>Capital in excess of par value</td>
<td>XX</td>
</tr>
<tr>
<td>Total contributed capital</td>
<td>$ XX</td>
</tr>
<tr>
<td>Retained earnings:</td>
<td></td>
</tr>
<tr>
<td>Unappropriated</td>
<td>$ XX</td>
</tr>
<tr>
<td>Appropriated (describe purpose)</td>
<td>XX</td>
</tr>
<tr>
<td>Total stockholders' equity</td>
<td>$ XX</td>
</tr>
<tr>
<td>Total liabilities and stockholders' equity</td>
<td>$ XX</td>
</tr>
</tbody>
</table>

The accompanying notes are an integral part of these financial statements.

Statement of Changes in Financial Position

As noted in Chapter IV, the NAIC Statement Blank does not include a statement comparable to the Statement of Changes in Financial Position. For financial reporting purposes, the Statement of Changes in Financial
Position is a required financial statement since the issue of Opinion 19 of the Accounting Principles Board.

The recommended form and content of the Statement of Changes in Financial Position for stock life insurance companies financial reporting purposes is presented as follows:

XYZ Life Insurance Company
Statement of Changes in Financial Position
For the Year Ended December 31, 19A

<table>
<thead>
<tr>
<th>Cash provided:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Income before extraordinary items</td>
<td>$ XX</td>
</tr>
<tr>
<td>Decrease (increase) in income not affecting cash:</td>
<td></td>
</tr>
<tr>
<td>Increase in reserve liability for future policy benefits</td>
<td>XX</td>
</tr>
<tr>
<td>Amortization of deferred acquisition costs</td>
<td>XX</td>
</tr>
<tr>
<td>Deferred federal income taxes</td>
<td>XX</td>
</tr>
<tr>
<td>Other</td>
<td>XX</td>
</tr>
<tr>
<td>Cash provided by operations before extraordinary items</td>
<td>$ XX</td>
</tr>
<tr>
<td>Extraordinary items</td>
<td>XX</td>
</tr>
<tr>
<td>Cash provided from operations</td>
<td>$ XX</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Other sources of cash</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Bonds sold or matured</td>
<td>XX</td>
</tr>
<tr>
<td>Stocks sold</td>
<td>XX</td>
</tr>
<tr>
<td>Repayment of mortgage loans</td>
<td>XX</td>
</tr>
<tr>
<td>Repayment of policy loans</td>
<td>XX</td>
</tr>
<tr>
<td>Other</td>
<td>XX</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$ XX</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Cash applied:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in bonds</td>
<td>$ XX</td>
</tr>
<tr>
<td>Investment in stocks</td>
<td>XX</td>
</tr>
<tr>
<td>Mortgage loans</td>
<td>XX</td>
</tr>
<tr>
<td>Policy loans</td>
<td>XX</td>
</tr>
<tr>
<td>Acquisition costs</td>
<td>XX</td>
</tr>
<tr>
<td>Dividends to stockholders</td>
<td>XX</td>
</tr>
<tr>
<td>Other</td>
<td>XX</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$ XX</td>
</tr>
</tbody>
</table>

| Net increase (decrease) in cash | $ XX |

<table>
<thead>
<tr>
<th>Cash balances:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>January 1, 19A</td>
<td>XX</td>
</tr>
<tr>
<td>December 31, 19A</td>
<td>$ XX</td>
</tr>
</tbody>
</table>
The accompanying notes are an integral part of these financial statements.

The published financial statements are intended to reflect the information necessary for an informed investor to make a buy, sell or hold decision. This decision is based on an analysis of the financial condition and the results of operations and a comparison to companies within the life insurance industry and other industries.

To arrive at a decision, an informed investor needs more information than is presented in the illustrated financial statements. Additional facts and information relating to the financial condition and the results of operations is obtained through means of a description of significant accounting policies and footnotes to the financial statements.

**Footnotes to the Financial Statements**

Disclosure of financial information can be made in the body of the financial statements or through use of footnotes to the financial statements. Opinion 22, *Disclosure of Accounting Policies*, issued by the AICPA in April 1972 resulted in an additional method of disclosure of financial information. The Opinion requires that "... a description of all significant accounting policies of the reporting entity should be included as an integral part of the financial statements." The Opinion does not require the disclosure of accounting policies be

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designated as a footnote and consequently various methods have been used in reporting this information. For purposes of the annual report, some companies report the disclosure of accounting policies immediately preceding the financial statements, some companies place the information between the financial statements and the footnotes, and some companies identify the disclosure of accounting policies as the first footnote to the financial statements.

There is some overlap between the disclosure of accounting policies and the footnotes to the financial statements. The disclosure of accounting policies is somewhat general whereas the footnotes relate to specific items. For purposes of this paper, examples of specific footnotes as related to the recommended accounting practices and the recommended financial statements will be presented. A listing, identifying the footnotes, is presented below:

<table>
<thead>
<tr>
<th>Footnote #</th>
<th>Financial Statement</th>
<th>Item</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Income Statement</td>
<td>Gain on equity securities</td>
</tr>
<tr>
<td></td>
<td>Balance Sheet</td>
<td>Investment in stocks</td>
</tr>
<tr>
<td>2</td>
<td>Income Statement</td>
<td>Increase in reserve liability</td>
</tr>
<tr>
<td></td>
<td>Balance Sheet</td>
<td>for future policy benefits</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Policy liabilities</td>
</tr>
<tr>
<td>3</td>
<td>Income Statement</td>
<td>Amortization of acquisition costs</td>
</tr>
<tr>
<td></td>
<td>Balance Sheet</td>
<td>Unamortized acquisition costs</td>
</tr>
<tr>
<td>4</td>
<td>Income Statement</td>
<td>Federal income taxes</td>
</tr>
<tr>
<td></td>
<td>Balance Sheet</td>
<td>Federal income taxes payable</td>
</tr>
</tbody>
</table>

Examples of the wording for these footnotes listed above are presented as follows:
Footnote #1: The company reports investment in preferred and common stocks (equity securities) at market value. Market value is the quoted market price as of the last day of the year. Gain on equity investment of $... reported in the Income Statement represents the total net realized and unrealized gains on investments in preferred and common stocks. Net realized gains for the year was $... and net unrealized gains was $... .

Footnote #2: Policy liabilities were computed by use of the net level premium method using realistic estimates as to future investment yields, mortality and withdrawals. Interest rates used in the reserve computations range from 4% to 6%.

Footnote #3: The cost of acquiring new business, principally agents' commissions, policy issue costs and other variable costs, have been deferred and are reported as unamortized acquisition costs. The costs are being amortized over the premium payment period of the policies in proportion to the relationship of annual premiums to total anticipated premiums.

Footnote #4: For federal income tax purposes, the company deducts total acquisition costs in the year incurred and does not include unrealized gains on investments in determining current federal income taxes payable. Deferred income taxes result from the timing differences in reporting these items for financial accounting and tax purposes. The deferred portion included in the federal income tax expense for 19A is $... .

The four footnotes presented are not intended to represent all of the footnote disclosure required in the financial statements of stock life insurance companies but relate only to the accounting and reporting recommendations included in this study. Other footnotes are normally presented, where applicable, in such areas as notes payable, dividend restrictions, stock options, contingencies and profit-sharing plans.

The footnotes and financial statements must provide adequate disclosure of all information required by stockholders to arrive at
economic decisions. Disclosure of necessary information is the primary responsibility of the life insurance company but the adequacy of such disclosure is reviewed by the company’s certified public accountants in expressing an opinion on the financial statements. 6

Expression of Opinion on Financial Statements

A standard short form opinion was presented in Chapter IV along with an opinion rendered on the financial statements of Continental American Life Insurance Company. The major differences between the opinions were in the mention of accounting principles prescribed or permitted under statutory authority and mention of the determination of actuarial items.

The opinion paragraph of an unqualified CFA's report states that the financial statement are "... presented fairly ... in conformity with generally accepted accounting principles ... ." The AICPA has identified GAAP, as they relate to the accounting and reporting practices of stock life insurance companies, through the publication of an Industry Audit Guide, Audits of Stock Life Insurance Companies. The accounting and reporting recommendations advanced in this paper are, for the most part, in accordance with the provisions of the Audit Guide. If the recommendations were in complete accord

6The standard short form opinion reads "Our examination was made in accordance with generally accepted auditing standards. . . ." Generally accepted auditing standards include general standards, standards of field work and standards of reporting. The third standard of reporting requires that, "Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report." Committee on Auditing Procedure, Statement on Auditing Standards, Codification of Auditing Standards and Procedures 1. (New York: American Institute of Certified Public Accountants, 1973), pp. 81 & 78.
with an Audit Guide, it would be possible for a company to implement them and obtain an unqualified opinion from its CPA.

The Audit Guide prohibits the reporting of unrealized gains on investments in the Income Statement and requires that the Income Statement show the Income Before Realized Investment Gains and Losses. This study has recommended the combining of realized and unrealized gains and losses on preferred and common stocks and reporting the total gain in the revenue section of the Income Statement as Gain on Equity Securities.

Assuming that a company does present its financial statements in accordance with the recommendations included in this study, the CPA auditing those financial statements may render an unqualified, qualified or adverse opinion depending upon the materiality of Gain on Equity Securities.

If the amount of realized and unrealized gains is immaterial, the CPA may issue an unqualified opinion. If realized and unrealized gains are material, but the CPA feels that the overall financial statements are fairly presented, a qualified opinion should be issued. Finally, if the realized and unrealized gains are so material that the financial statements taken as a whole are not fairly presented, the CPA will render an adverse opinion.

If the suggested method of reporting gain on equity securities necessitates the issuance of a qualified opinion, the report may take the following form.
Scope paragraph — Unqualified

Middle paragraph — Part of opinion

The company reports realized and unrealized gains and losses on investments in stocks as gains on equity securities in the Income Statement. Generally accepted accounting principles require that unrealized gains on investments be reported in a separate equity account in the Balance Sheet and that the Income Statement report Income Before Realized Investment Gains and Losses. The unrealized gains on investments for XYZ Life Insurance Company for 19A amounted to $ . . . . If unrealized gains would have been reported in the Balance Sheet, the Net Income for 19A would have been $ . . . .

Opinion paragraph — Qualified

In our opinion, except for the reporting of unrealized gains on investments, the accompanying financial statements present fairly . . . .

The necessity of a qualified opinion is justified in the fact that the recommended method of reporting gain on equity investments in the Income Statement results in the most meaningful presentation of the determination of net income. The Audit Guide requires that realized gains be reported in the Income Statement and unrealized gains appear as a separate item in the Stockholders' Equity Statement. Prior to the issue of Opinion 9, certain gains and losses were reported directly in the Stockholders' Equity Statement. The trend that has developed, since the issue of Opinion 9, is to report gains and losses as ordinary items in the Income Statement and to reduce the number of items qualifying as extraordinary items or prior period adjustments.  

The auditor's opinion and the form and content of financial statements presented by stock life insurance companies have been significantly altered by the issue of the Audit Guide. Prior to the Audit Guide, stock life insurance companies used statutory methods of accounting in preparing the financial statements presented to its stockholders. Following the issue of the Audit Guide, companies may present their financial statements in accordance with GAAP which are influenced by the needs of the stockholders and designed to achieve comparability between life insurance financial reporting and other industries.

The issue of an Audit Guide is not intended to halt all research in a particular area, but instead to promote additional research. Although some of the recommendations advanced in this study are similar to those presented in the Audit Guide, the study also proposed other recommendations not included in or contrary to the Audit Guide. The recommendations proposed in this study, represent an attempt to accelerate progress in financial reporting.

A major responsibility of suggesting changes in accounting and reporting practices is the implementation of such changes and the responsibility of the stockholders aware of the nature and consequences of the changes. Both the life insurance industry and the accounting profession share the responsibility of educating the reader as to the effect of the changes in the financial statements of most stock life insurance companies for 1973 and other changes that will take place in the future.
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Vita

Lloyd Brandt, Jr., son of Mr. and Mrs. Lloyd Brandt, Sr., was born in New Orleans, Louisiana, on February 9, 1935. He attended public elementary and high school in New Orleans.

In September, 1951, he enrolled in Southeastern Louisiana University in Hammond, Louisiana and completed degree requirements for a Bachelor of Arts Degree in June, 1955. After graduation he entered the armed forces of the United States, where he remained until released from active duty in March, 1958. In September, 1958, he entered graduate school at Louisiana State University and received a Master of Business Administration degree in August, 1960.

He was employed by Arthur Andersen & Company on the audit staff from August, 1960, until August, 1963. He completed all requirements and became a Certified Public Accountant in July 1962.

In September, 1963, he was employed as an Instructor in Accounting at Louisiana State University in New Orleans and began his doctoral studies at Louisiana State University. In September, 1967, he moved to Baton Rouge where he taught as a Graduate Assistant in the Accounting Department. In September, 1968, he was appointed as an Instructor of Accounting and taught full time at Louisiana State University.
In August, 1970, he returned to the Accounting Department of Louisiana State University in New Orleans as an Assistant Professor and is now a candidate for the Doctor of Philosophy degree at Louisiana State University.

He is a member of Beta Alpha Psi. He is married and is the father of four daughters.
EXAMINATION AND THESIS REPORT

Candidate: Lloyd Brandt, Jr.

Major Field: Accounting

Title of Thesis: A Study of Selected Accounting and Reporting Practices Used by Stock Life Insurance Companies

Approved:

[Signature]
Major Professor and Chairman

[Signature]
Dean of the Graduate School

EXAMINING COMMITTEE:

[Signature]

[Signature]

[Signature]

Date of Examination: November 12, 1973