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INDUSTRY AUDIT GUIDE

AUDITS OF STOCK LIFE INSURANCE COMPANIES

PREPARED BY THE COMMITTEE ON INSURANCE ACCOUNTING AND AUDITING

NOTICE TO READERS

This audit guide is published for the guidance of members of the Institute in examining and reporting on financial statements of stock life insurance companies. It represents the considered opinion of the Committee on Insurance Accounting and Auditing and as such contains the best thought of the profession as to the best practices in this area of financial reporting. Members should be aware that they may be called upon to justify departures from the Committee's recommendations.

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AUDITS OF STOCK LIFE INSURANCE COMPANIES

PREPARED BY THE COMMITTEE ON
INSURANCE ACCOUNTING AND AUDITING

American Institute of Certified Public Accountants
666 Fifth Avenue, New York, N.Y. 10019

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Preface

Applicability

At the time of the issuance of the initial exposure draft of the audit guide, the Committee reserved decision as to the applicability of parts of the guide to mutual life insurance companies. During and subsequent to the exposure period of the draft of the guide, substantial consideration was given to whether mutual life insurance companies should be required to present financial statements in the same form and following the same accounting principles as stock companies. The nature of mutual life insurance company operations, as distinguished from the operations of stock life insurance companies, and the purpose of mutual life insurance company financial statements were the principal considerations.

Some members of the Committee believed that the guide should apply to mutual companies and to stock companies; others believed that some, but not all, of the principles of accounting and reporting for stock companies should be applicable to mutual companies; and others believed that regulatory accounting and reporting practices for mutual life companies should be considered to be in conformity with generally accepted accounting principles. There was no consensus on any of these views. However, the Committee recognized that there is a need for an audit guide for stock companies, and there is general agreement as to the appropriate accounting and reporting principles for these companies. Consequently, the Committee believes that the needs of the

situation are best served by publishing an audit guide which applies to stock life insurance companies but not to mutual companies until applicability of generally accepted accounting principles to mutual life insurance companies has been determined.

Notwithstanding the foregoing, Part I, that section of Part III entitled "Reliance on Actuaries," and Appendices A and B should be used by auditors as a guide for audits of mutual life insurance companies. In addition, principal accounting policies and practices of mutual life insurance companies should be disclosed, as required by APB Opinion No. 22. Such disclosures should normally include those required for other business enterprises. The following should be considered in determining additional disclosures to be made:

a. A general statement that the financial statements have been prepared on the basis of accounting practices prescribed or permitted by insurance regulatory authorities.
b. Method of accounting for acquisition costs, maintenance and settlement costs.
c. Reserving methods and description of mortality tables and interest rates used.
d. Method of accounting for dividends to policyholders.
e. Method of accounting for income taxes.
f. Treatment of nonadmitted assets and mandatory securities valuation reserve.

Effective Date

Audit guides generally do not require an effective date. However, because the restrictions on expression of reliance on actuaries and the requirements for qualified, adverse or disclaimed opinions discussed in Part III will change practice which has heretofore been acceptable, such restrictions and requirements will not be effective with respect to auditors' reports on financial statements for periods ending before December 31, 1973. However, where practicable, independent public accountants should encourage early adoption of the principles of accounting and financial reporting discussed in Part II.

Implementation

The effect of accounting changes resulting from the implementation of this audit guide should be reported as prior period ad-

justments, which as stated in paragraph 18 of APB Opinion No. 9

> . . . should, in single period statements, be reflected as adjustments of the opening balance of retained earnings. When comparative statements are presented, corresponding adjustments should be made of the amounts of net income (and the components thereof) for all of the periods reported therein, to reflect the retroactive application of the prior period adjustments.

However, with respect to the accounting for certain stock dividends at par value as opposed to fair market value, retroactive application of generally accepted accounting principles for such distributions made prior to January 1, 1973, is not mandatory.

Acknowledgements

The Committee on Insurance Accounting and Auditing has worked closely with the Joint Committee on Financial Reporting Principles of the American Life Convention and the Life Insurance Association of America, and with the Joint Actuarial Committee on Financial Reporting of the American Academy of Actuaries, Canadian Institute of Actuaries, Conference of Actuaries in Public Practice and Society of Actuaries. The Committee wishes to express its sincere appreciation for the significant contributions made by these committees in the preparation of this audit guide.

Committee on Insurance
Accounting and Auditing

December 1972

Introduction

As indicated in the preface, this audit guide is applicable principally to stock life insurance companies. It has been prepared to provide guidance to independent auditors in examining and reporting on financial statements of life insurance companies. It contains information concerning the nature and conduct of the life insurance business, accounting practices prescribed or permitted by insurance regulatory authorities, the differences between regulatory practices and generally accepted accounting principles, auditing procedures and reports related to life insurance companies.

The accounting and reporting principles discussed in Part II are significant changes from existing practice. Their adoption in practice is likely to result in problems and questions. It was not practical in the guide to discuss all of the problems that could arise in the application of these principles or to identify or suggest solutions to some existing problems. Further experience in the implementation of the guide will undoubtedly lead to improvements. The Committee and industry groups will continue to work to provide additional guidance.

Organization

The guide has been organized into the following sections:

• Part I deals with the nature and conduct of the business and accounting and reporting practices prescribed or permitted by regulatory authorities. It also includes outlines of suggested

auditing procedures applicable to accounts maintained in conformity with regulatory practices.

• Part II discusses the differences between regulatory practices and generally accepted accounting principles and sets forth appropriate guidelines for accounting and financial reporting in conformity with generally accepted accounting principles. It also includes suggested additional auditing procedures resulting from the application of generally accepted accounting principles.

• Part III describes the various circumstances under which auditors may be required to give opinions and sets forth examples of opinions to be given in the circumstances.

• Appendix A includes illustrative financial statements for a company reporting in conformity with generally accepted accounting principles and supplementary data required to reconcile net income and stockholders' equity presented in financial statements prepared in accordance with regulatory practices to such amounts determined in conformity with generally accepted accounting principles.

• Appendix B discusses the procedures involved in accounting for the deferral and amortization of acquisition costs.

• Appendix C discusses deferred income taxes applicable to life insurance companies which are taxed under the Life Insurance Company Income Tax Act of 1959.

• Appendix D is a suggested internal control questionnaire intended to be used as a supplement to general internal control questionnaires. It is designed to assist the auditor in evaluating internal controls of the life insurance company whose accounts are maintained in conformity with regulatory practices.

• Appendix E is a glossary of terms commonly used in the life insurance industry.

PART I

Nature and Conduct of Business

History and General Nature of Business

The function of insurance is to provide for the pooling of risks among many persons who are exposed to similar risks. The primary purpose of life insurance is to provide financial assistance at the time of death. The long period of coverage involving the risk of death, a risk which increases with age, is the distinguishing characteristic by which life insurance is set apart from other forms of insurance.

Life insurance is a relatively modern development, although its origin has been traced back to around 1700 in England. Other forms of insurance were in existence long before life insurance. The development of life insurance required a greater sales effort and resulted in the full-scale agency system.

One of the earliest forms of life insurance was administered on an assessment basis. Under this plan the surviving members of a group would be assessed so that a certain amount could be paid to the beneficiary of a deceased member of the group. This form of life insurance had inequities as well as practical limitations. Obviously, it was often difficult, and sometimes impossible, to collect an assessment from all members. With the development of mortality tables, it became possible to charge a more equitable premium based upon the probability of death of an individual within his own age group.

Since many individuals found an increasing premium objectionable, the level premium concept was introduced. Today most life insurance is sold on a level premium basis under which the annual premium remains constant. Under this plan, the amount of the premium is based upon an assumed interest rate, and upon the frequency of deaths according to the mortality table used by the insurance company. The premiums collected, after deducting benefits and other costs each year, are accumulated at interest. This accumulation, when combined with future net premiums and future investment income should generate a sum sufficient to pay the claims resulting from the deaths of the members of the insured group. The liability which corresponds to this fund is referred to as the "policy reserve." See page 24, "Premiums," for a further discussion of this subject.

Life insurance companies may also issue policies on some or all of the lives in a particular group—such as employees of a company. The accounting for group policies differs in a number of respects from that required for policies on individual lives. Much of the record-keeping for some group policies is handled by the insured groups and transactions are reported periodically to the insurance company. Premiums are often adjusted based on experience.

Life insurance companies also write annuity policies, on either an individual or a group basis, under which the insured (annuitants) receive fixed payments over varying periods. A recent innovation in the field of annuities is the "variable annuity" under which amounts paid in during the "accumulation period" are invested in common stocks with the annuity payments based, in part, on the investment performance of such stocks.

Another major line of business for the life insurance industry is health insurance (accident and health). This type of insurance takes many forms, and can be on an individual or group basis. Generally speaking, the broad coverages of accident and health insurance are for loss of income and for hospital and medical expenses.

Types of Organizations

The following are the principal types of life insurance organizations:

Stock Companies. A stock company is a corporation organized to earn profits for its stockholders by performing services for the benefit of its policyholders and their beneficiaries. Generally, the stockholders are not liable in case of bankruptcy or impairment of capital. In most states, stock companies may issue both participating and nonparticipating policies. Participating policies are those under which a portion of the earnings arising from those policies are returned to policy owners in the form of dividends. Nonparticipating policies are those under which the policyowners have no right to share in the earnings of their policies.

Mutual Companies. A mutual company is an incorporated entity without private ownership interests which operates for the benefit of its policyholders and their beneficiaries. With limited exceptions, mutual companies issue only participating policies. In a mutual company, participating policyholders have the right to vote for members of the company's board of directors or trustees. In some states, the insurance laws provide that upon liquidation of a mutual insurance company, the net assets are distributed among the existing policyholders of the company, and the prior policyholders have no claim against such assets.

Fraternal Benefit Societies. A fraternal benefit society resembles a mutual insurance company in that, although incorporated, it does not have capital stock, and it operates for the benefit of its members and their beneficiaries. Policyholders participate in the earnings of the society and the policies stipulate that the society has the power to assess its members should the legal reserves become impaired. Management of a fraternal benefit society is a representative form of government whereby members elect delegates to a national convention which in turn elects the officers and directors. Fraternal benefit societies operating under a lodge system are exempt from federal income taxation.

Assessment Companies. An assessment company is an organized group with similar interests such as a religious denomination or a professional group. Assessment companies represent only a minor segment of the industry. In many states no new assessment companies can be organized; most such existing companies have reorganized on a "legal reserve assessment company basis" which means that they charge a fixed premium and maintain the re-

serves required by law, but retain the right to call for additional premiums. These companies are required by law to charge no less than the required minimum rates and also to have an assessment clause only until such time as they accumulate surplus in excess of the legal minimum requirement.

The types of organization may vary, depending upon specific state regulations.

Operating Organizations

The internal organizations of companies are generally divided into two broad segments—home office and field operations.

Home Office. The business of a typical home office of a life insurance company may be departmentalized according to the following functions:

- Agency department—responsible for sales promotion, supervision of field forces and sales training.
- Underwriting department—responsible for the evaluation of risks and the issuance of policies.
- Policy service department—responsible for servicing changes in policies pertaining to such items as address, beneficiary and mode of payment; for notification and collection of premiums due; for conserving business; and for payment of benefits and claims. (In many companies these functions are performed by other departments.)
- Actuarial department—responsible for determining premium rates, nonforfeiture values, calculating and verifying the adequacy of policy reserves, determining dividends on participating policies, designing new policies, analyzing experience and assisting in long range planning.
- Investment department—responsible for managing the company's investments.

In addition to the above, there will usually be other functions typical of business operations in general.

Field Operations. For field operations most companies employ either the general agency or branch office system or some combination thereof and may, in addition, rely on brokers to sell life insurance.

The distinction between a general agent, a branch office salesman and a broker is based on the nature of their relationship to the insurance company. In all cases, they submit applications for insurance to the company for acceptance or rejection. A general agent usually is an independent contractor. A branch office salesman may be an employee of the insurance company, an independent contractor, or an employee of the general agent. A broker is an independent agent who places business with various companies. The vested rights to renewal commissions depend on contractual agreements. General agents and brokers commonly have vested rights to commission; however, branch office salesmen may not have vested commission rights.

General agency—A general agency is often granted an exclusive territory in which to produce business for the company, although this practice varies among companies and frequently does not apply to those companies operating in metropolitan centers. General agents agree to promote the company interest, pay their own expenses (except as reimbursement may be provided for by contract), maintain a satisfactory agency force and secure sub-agents. They perform services in connection with securing applications for insurance and the issuance of policies. General agents are compensated primarily on the basis of a percentage of the premiums they produce plus certain allowances. This may be a gross percentage out of which the general agents pay the sub-agents whom they appoint or the brokers from whom they secure business or it may be a specific overriding commission, with sub-agents' commissions paid directly by the company.

Branch office—The branch office is operated by a manager who is usually a salaried employee of the company, and whose compensation may be partly based on production. Branch office salesmen are often called field underwriters. Expenses of the branch office are usually paid by the home office.

Brokers—Insurance brokers are independent agents who solicit business and place it with various companies. They submit applications for acceptance or rejection directly to the company, through a general agency or its sub-agents, or through other brokers.

Other field operations—Some companies sell debit (or account) insurance in small amounts through door-to-door salesmen; these

policies may be issued on either ordinary or industrial policy forms. Premiums on such insurance are generally collected on a weekly or monthly basis. Some companies obtain new business through mail order solicitation, personal referrals, news media advertising, telephone, and other methods.

Reinsurance

Life insurance companies insure a great many persons and collect from them amounts expected to be sufficient in the aggregate to meet all benefits and expenses as they become payable. To accomplish this purpose, the company must insure a large enough number of persons for the law of averages to operate. Frequently, however, an insurance company may write a policy on a risk for an amount which is either beyond its financial capacity to absorb or in excess of an amount it is willing to absorb. Therefore, it will reinsure a part of the risk with another insurance company retaining only as much as it can or is willing to absorb. Most companies usually set a limit on the amount of risk they will retain. This limit is called their retention and may differ depending on a person's age or whether that risk is standard or substandard. The company transferring the risk is called the ceding company, and the company to which the risk is transferred is called the assuming company or the reinsurer.

The term reinsurance also applies to the "sale" of all or a part of a company's insurance in force to another company. In this case, the policy service responsibility (collection of premium, etc.) is transferred to the assuming company and all relations with the writing company are terminated. Such a transaction may arise upon the insolvency or liquidation of a company or may be instituted by management decision (with regulatory approval) to sell a portion of the business.

The principal types of reinsurance agreements are discussed on page 22.

Regulation

State. The insurance industry is a business vested with the public interest; an insurance company acts in a fiduciary capacity and thus requires regulation. Statutes in all states provide for the organization and maintenance of an insurance department

charged with the responsibility of supervising insurance companies and enforcing their compliance with the law.

While statutes vary, their principal objective is the development and enforcement of measures directed toward solvency, fair dealings with policyholders and uniform financial reporting.

The statutes generally restrict insurance companies to certain types of investments; prescribe methods of valuation of securities and other assets; require maintenance of minimum reserves, capital, and surplus; and define those assets not permitted to be reported as "admitted assets" in annual statements filed with insurance departments. (See page 41, "Nonadmitted Assets.")

Usually the statutes also provide for certain standard provisions to be incorporated in policies and for the insurance department to review and approve the various forms of policies. Agents, brokers and salesmen must qualify for licenses granted by the insurance department before they may solicit insurance business.

The statutes provide for the filing of annual or other periodic statements, in prescribed form, with the insurance departments and for the examination of insurance companies by the insurance departments at stated intervals. Annual statements are required to be filed on a calendar year basis.

In the majority of states, organization of insurance companies may not be undertaken without the authorization of the insurance department. In those states where such authorization is not required, approval of the insurance department is usually necessary for the completion of organization.

Most insurance departments consist of an insurance director, commissioner or superintendent-in-charge having one or more deputies, staffs of examiners, actuaries, attorneys, and clerical assistants. A commissioner is usually given many discretionary powers and authority to issue rules and regulations necessary to assure compliance with the statutes he is required to enforce.

National Association of Insurance Commissioners. The commissioners of the various states organized the National Association of Insurance Commissioners (NAIC) which meets semiannually to deliberate on various subjects of interest to insurance regulatory authorities. The Association has a number of standing committees that meet throughout the year to develop various plans and proposals for submission at the semiannual meetings of the commissioners. Although the findings of the Association

are not in themselves binding on any state, its recommendations for new rules or procedures or for changes in the old ones are usually accepted and adopted by the states in the form of appropriate legislation or regulations.

Important activities of the NAIC include financial reporting and examination. Special committees have developed and are maintaining a uniform annual statement and an examiner's manual which is in the nature of an audit program.

To minimize duplication of examinations, the NAIC designed uniform "association examination" procedures. For this purpose, the country is divided into six zones with one state commissioner in each zone designated as chairman of that zone. Whenever a domiciliary state decides that an insurance company within its jurisdiction is subject to association examination, it notifies the executive secretary of the NAIC who advises the chairmen of all the zones, designating those zones eligible to participate on the basis of the writings within the zone. The chairman of each zone eligible to participate designates one of the states within his zone to represent the zone in the examination. The examining staff, therefore, consists of the domiciliary state examiner, who supervises the examination, and also of representatives of all or some of the zones in which the company transacts business. The report of the association examination is filed with the chairman of each zone. The association examination generally satisfies the statutory examination requirements of each state in which the company transacts business, thereby eliminating the duplication which would occur if each state conducted its own examination of all companies within its jurisdiction. The auditor should review the report on examination for company compliance therewith.

Securities and Exchange Commission. Despite certain exemptive provisions of the Securities Exchange Act of 1934, the shares of a number of stock life insurance companies are registered with the Securities and Exchange Commission. Some companies that have registered under the 1934 Act have done so in connection with the listing of their shares on a national securities exchange. Others have been required to register under the 1934 Act because they have formed holding companies, which are not life insurance companies and, as such, do not qualify for exemption from registration under the 1934 Act. Companies, including life

insurance companies, registered under the 1934 Act must comply with annual and periodic reporting requirements and are subject to the proxy solicitation and insider trading rules. Life insurance companies making public offerings are required to register such offerings under the Securities Act of 1933 and must thereafter undertake to comply with the annual and periodic reporting requirements of the 1934 Act; however, these companies are not under the proxy solicitation or insider trading rules of such Act so long as they meet the attendant requirements for exemption therefrom. Reports submitted to the Commission, including prospectuses and proxy statements, must generally be in accordance with the applicable published rules and regulations of the Securities and Exchange Commission, including those for form and content of financial statements prescribed by Article 7A of Regulation S-X.

At present, life insurance financial statements are exempt from certification in reports or registration statements filed under the Securities Exchange Act of 1934. Form 10 is the general form for registration of securities pursuant to Section 12 of the 1934 Act and Form 10-K is the general form for annual reports thereunder. The Securities and Exchange Commission in May 1971 issued a notice of a proposed amendment to delete this exemption for insurance companies from certification; however, the exemption was retained in order to permit the accounting profession, in collaboration with the insurance industry, to develop and promulgate accounting guidelines for life insurance companies which will enable the financial statements of such companies to be certified in accordance with generally accepted accounting principles. This exemption is not available under the Securities Act of 1933. Thus, the financial statements of a life insurance company are required to be certified when they are included in registration statements for the offering of its own securities for sale under Form S-1, for example, or for the offering of securities for sale under Form S-6 by its separate account business for variable annuities or other separate account business for which the life insurance company is acting as sponsor.

Mechanics of Recording Transactions

Most life insurance companies maintain their general ledger on a cash basis but prepare their statutory financial statements

on a modified accrual basis. These statements vary from generally accepted accounting principles as defined in Part II. The adjustments necessary to convert the accounts from a cash to an accrual basis are not usually recorded on the books. Instead, these are usually recorded on working papers.

One reason for the use of cash basis accounting by life insurance companies is that a life insurance company generally conducts its business on a cash basis. Another reason is that certain of the exhibits contained in the annual statements filed with regulatory authorities require details of income and expense items on a cash basis with only the totals being adjusted to an accrual basis. Since the accounts underlying the income and disbursement pages of the annual statement (usually referred to as the "convention blank" or the "Association statement") do not reflect all financial transactions which occur during the period, the trial balance taken from a life insurance company's general ledger is incomplete compared to the usual commercial enterprise.

Because of the use of cash basis accounting for recording purposes and accrual basis accounting for reporting purposes, assets are referred to either as "ledger assets" (those assets recorded on the books, such as cash, bonds and stocks, mortgage loans, furniture and fixtures, etc.) or as "non-ledger assets" (those assets not recorded on the books, generally consisting of premiums deferred and uncollected, investment income due and accrued, adjustments for unrealized appreciation or depreciation from cost to market values, etc.).

Some items recorded in the general ledger, such as furniture and fixtures and certain agents' balances are considered "non-admitted" assets for statutory purposes and are, therefore, excluded from the statutory balance sheet.

In addition to "ledger assets" and "non-ledger" assets, there are "ledger liabilities" and "non-ledger liabilities." For most life insurance companies, "ledger liabilities" consist of liabilities arising directly from cash transactions, such as payroll deductions, remittance and items not allocated, etc., while "non-ledger liabilities" consist of liabilities that do not arise as a direct result of cash transactions, such as policy reserves, claims liabilities, etc.

For financial statement purposes, and for the statutory Association statement, a life insurance company must maintain records of claims pending, paid, compromised, or resisted. A "claim register" is usually maintained to provide a record of claims and their

disposition. Since the disbursement journal will only record the actual cash paid, the claim register will be the usual source for the auditor to verify the exposure of the company for pending or disputed claims, and the effect upon the inventory of policies entering into the computation of the life reserves at year end.

The reserve for life insurance and other contracts, which is normally the largest liability of the insurance company, does not usually appear on the general ledger, but in a subsidiary record. The policy reserve file, in spite of its importance and size, is not part of the bookkeeping system and is not under general ledger control; thus, it must be inventoried at the reporting date. (See "Liabilities," page 45, for a discussion of auditing procedures.)

The typical life insurance company will record most of its assets on its books, since most of its assets normally arise from cash transactions. However, it will record very few of its liabilities, since very few of its liabilities are the direct result of cash transactions. Therefore, the auditor will normally find an account on the books entitled, "Excess of assets over liabilities," "Balance account," or some similarly entitled account. This account is usually the balancing figure between ledger assets and ledger liabilities and will include ledger capital for those companies where ledger capital is not separately stated on the books. It is only in combination with the year-end inventories of non-ledger assets and non-ledger liabilities that the "Balance account" has any meaning for financial statement purposes.

Insurance Operations

Revenue from insurance operations generally consists of premiums and revenue produced through reinsurance agreements. Considerations for supplementary contracts and dividends left to accumulate at interest are included as income in life insurance company annual statements but are not true revenue since they are merely a reapplication of funds arising from policy proceeds and dividends.

Types of Policies and Contracts

Policies and contracts usually issued by a life insurance company may generally be designated by the following broad classifications:

1. Life insurance policies.
2. Annuity contracts.
3. Accident and health contracts.

In addition, certain life insurance companies may issue policies which incorporate features of two or three of the broad categories shown above (e.g., an insurance-with-annuity policy). Each of the types of policies is commonly issued both on a participating and on a nonparticipating basis.

Life Insurance Policies. Life insurance coverage consists of the following basic classes:

1. Whole-life.
2. Endowment.
3. Term.
4. Other.

Whole-life policies provide insurance over the insured's entire life and the proceeds (face amount) are paid only upon death of the insured. A level premium is usually paid for policies of this type; and the premium may be paid in annual or more frequent modes. An ordinary-life (straight-life) policy stipulates that premiums are to be paid during the life of the insured. A limited-payment policy is one for which premiums are payable over a stipulated period of time (10, 20, 30 years, etc.). A single-premium policy requires a lump-sum payment at the inception of the policy.

Endowment policies provide insurance protection over the term of the endowment (i.e., from inception of the policy to the maturity date). Such contracts stipulate payment of the face amount of the policy to a beneficiary if the insured dies during the endowment period. However, if he is still living at the maturity date, the insured will receive the face amount of the policy. Endowment contracts can mature at a specified age of the insured or at the end of a specified period of time. The premiums for contracts of this nature are usually payable over the endowment period, but the premiums can be on a single-payment or limited-payment plan.

Both whole-life and endowment policies contain nonforfeiture or similar clauses which provide for a value in cash or some other form of insurance to be available in the event of failure to continue the required premiums.

Term policies provide insurance over a specified period of time. If the insured dies during this term, the face amount of the policy will be paid to his beneficiary. Policies for term insurance which are written for relatively short periods of time commonly grant the policyholder the right to renew for an additional period or periods up to a maximum age, such as 60 or 65, without requiring additional evidence of insurability. Rights to convert to whole-life or endowment contracts may also be included in the contract. Term contracts may also be made for a period which will end when the insured reaches a certain age (for example, age 60 or 65). Since the premium for term insurance provides

for neither maturity benefits nor higher death rates at advanced ages, such policies do not usually accumulate cash surrender values. Collection of premiums for individual insurance may be by mail, where a notice of premium due is sent to the payor, or may be on the debit basis whereby an agent regularly calls at the home of the insured to collect small premium amounts. Usually, the more popular plans of debit life insurance are industrial plans paid up at age 65 or 70 or 10-pay or 20-pay life. Ordinary plans may also be administered on the debit basis.

In addition to individual policies, life insurance companies offer group life insurance, which insures lives of a group of persons under a single master contract. Insurance of this type is customarily written on a yearly renewable term basis although some permanent group life is sold.

In addition to the policies and contracts for life insurance mentioned above, there are other life insurance contracts which are becoming more prominent, such as credit life insurance. This form of insurance is generally issued in connection with the issuance of credit to an individual by a bank, retailer, finance company, or other similar organizations. This type of insurance most often protects the creditor to the extent of the unpaid balance of the loan in the form of decreasing term insurance; however, some credit life insurance is sold on a level-term basis.

In addition to the wide variety of whole-life and endowment policies which are available from life insurance companies, the basic policies can be supplemented by the use of riders which are attached to and made a part of the contract. It is fairly common to provide for waiver of premiums through the use of a rider in the event of disability of the insured or for an accidental death benefit. The typical accidental death benefit is often referred to as double indemnity which means that the company will pay twice the amount of the policy if the insured dies through accidental means.

Annuity Contracts. An annuity contract is an arrangement whereby an annuitant is guaranteed to receive a series of stipulated amounts commencing either immediately or at some future date. Annuity contracts are issued to individuals or to groups. Group annuities are often the vehicle used to provide for a company's pension obligations to its employees.

The main types of annuities are the following:

Straight-life annuity—The straight-life annuity provides for periodic payments to the annuitant as long as he lives. Death of the annuitant constitutes completion of the contract and no further payments are made by the insurance company.

Life annuity with a period certain—The life annuity with a period certain works essentially the same way as the straight-life annuity, except that if the annuitant dies before the end of the specified period, payments are continued to a beneficiary until the specified number of payments is completed.

Refund annuity—The refund annuity is similar to the annuity certain. There are two variants of this type of annuity. Under the cash refund annuity, a lump-sum payment is made at the death of the annuitant equal to the excess, if any, of the purchase price of the annuity over the sum of the annuity payments made to date of death. The installment refund annuity provides that annuity payments are to continue to a beneficiary after the death of the annuitant until the sum of all payments made equals the purchase price.

Joint and survivorship annuity—The joint and survivorship annuity provides for the continuation of payments after the death of one of the annuitants during the lifetime of the surviving annuitant.

Variable annuity—At present, variable annuities for individuals or groups are being introduced throughout the life insurance industry. A variable annuity is an annuity which includes a provision for benefit payments which vary in accordance with investment experience. The considerations for a variable annuity are usually invested in a separate account in which the value of the contract share varies according to the performance of the separate account before the commencement of annuity payments as well as after. Some variable annuities provide for a guaranteed minimum death benefit during the annuity consideration accumulation period.

Accident and Health Insurance Contracts. There is a great variety of accident and health contracts which life insurance companies may issue, but most contracts can be generally categorized as follows:

1. Protection against loss of income through partial or total disability.
2. Reimbursement of expenses
   a. Hospital expenses, laboratory services, drugs, and so forth.
   b. Surgical or medical expenses.

Much of the above coverage is currently being furnished under group contracts. Coverage furnished under individual contracts can be further subdivided according to the insured's right to continue his policy and the limitations on the insurer's right to increase premiums.

Underwriting Procedures

Selection of Risk. Underwriting procedures involve the selection of risks; applicants for insurance can be classified as standard risks at standard rates, as substandard risks at special rates, or as risks which are considered as uninsurable. Uninsurable risks are rejected and are not written by the insurance company.

Experience shows that more than 90% of the applicants for life insurance will fall under the classification of risks that are insurable at standard rates. Approximately 5 or 6% of the applicants fall into the classification of substandard risks, and the balance of applicants are considered uninsurable risks.

An application for life insurance requires information such as the applicant's age, sex, occupation, and marital status. It also includes other basic information, most of which relates to historical information about the applicant. The application should also contain comments by the agent which might have an effect upon the insurability of the applicant or the class in which he may fall for insurance rating purposes.

A medical report may be completed before the risk is submitted to the life insurance company for review. This report usually has two parts. The first part contains questions related to medical history, which the applicant answers with the assistance of a medical examiner designated by the company. If the

medical history does not appear routine, the medical examiner will probably request additional information from the applicant's physician. The second part of the medical report is a summary of the examining physician's findings. A medical examination may or may not be required depending on the amount of insurance applied for, the age of the applicant or other factors. Each company has its own guidelines in this regard; in any event, the application is likely to include health questions.

Another source of financial and personal information about the applicant is the inspection report which, for larger policies, is usually obtained from an independent agency.

Based on the information contained in the application, the medical report, and the inspection report, the applicant is rated as a standard or substandard risk or as uninsurable.

Issuance of the Policy. If an applicant is an insurable risk, a policy (contract) is prepared for insurance. This is generally done at the company's home office where a policy number is assigned to each policy and where overall numerical control of policies is maintained. After a policy is prepared and a policy number assigned, the policy is usually transmitted to the applicable general agent or branch office for delivery to the policyholder. The initial premium is collected at this time unless it was received with the application. Close control must be exercised over policies delivered but not paid for by the policyholders. Generally, the agent must remit the collected premium or return the prepared policy to the company within a specified period of time.

Reinsurance, Ceded and Assumed

In addition to any excess risk over the company's retention, which will be ceded to another insurance company, some life insurance companies will assume insurance risks from others.

Reinsurance can be effected through agreement arranged on the following bases:

1. Facultative reinsurance—Each risk or portion thereof is reinsured individually, the reinsurer having the option to accept or reject it.
2. Automatic reinsurance—An agreed portion of business written is automatically reinsured, thereby eliminating the necessity

for submitting each risk to the reinsurer for acceptance or rejection.

The following are the most usual types of reinsurance agreements, though many variations exist:

1. Yearly Renewable Term (YRT)—This is also called Annual Renewal Term (ART) and Risk Premium Reinsurance (RPR). When reinsurance is ceded on this basis, the principal company purchases from the reinsurer one-year renewable term insurance for the net amount at risk (face less reserve) on the portion of the policy reinsured, at annual premium rates published by the reinsurer. Regardless of the original plan of insurance, the reinsurer sets up one-year term reserves on the net amount at risk, and the ceding company takes a corresponding reserve offset. The YRT method transfers only the mortality risk to the reinsurer.

2. Coinsurance—When reinsurance is ceded on a coinsurance basis, the ceding company pays the reinsurer the gross premium at the ceding company's rate on the portion reinsured. The reinsurer reimburses the ceding company for its commission outlay and usually pays an additional amount toward the ceding company's expenses. The reinsurer is liable for its share of policyholder dividends (as declared by the ceding company), surrender values, death claims, and any other benefits covered by the premium. Thus, the reinsurer sets up reserves on the original plan basis and the ceding company takes a corresponding reserve offset. The effect of coinsurance is to transfer the surplus drain of the reinsured portion of new issues to the reinsurer (in addition, of course, to the mortality risk and risk of loss from early lapse).

3. Modified coinsurance—May be described most simply as coinsurance with mean reserves held by the ceding company. In addition to the transactions required by coinsurance, a "reserve adjustment" payment between reinsurer and ceding company is made each year. The reserve adjustment is calculated as the increase in mean reserves from one December 31 to the next less an interest element, and may be positive (payable to the principal company) or negative (payable to the reinsurer).

The legal rights of the insured are not affected by reinsurance. The company issuing the insurance policy remains liable for payment of policy benefits.

Most ceding companies have a separate reinsurance unit or department that maintains reinsurance records. The reinsurer usually bills the ceding company monthly. Reinsurance premiums are paid by the ceding company on an annual basis without regard to the mode of payment selected by the policyholder.

Generally, the accounting entries for reinsurance ceded transactions are the opposite of the entries that arise from direct writing business, and the amounts for reinsurance transactions are usually netted against the related accounts in financial statements. (For example, the premium account is decreased for premiums related to insurance ceded.)

Premiums

There are two types of premiums calculated by life insurance companies: gross premiums and net premiums.

The gross premium is the premium charged the insured; it represents the actuary's judgment of the amount which must be charged to the policyholder to be competitive with other insurers and at the same time accumulate a fund which, together with interest, will be adequate to provide for all the policy benefits, acquisition costs and other expenses, margins for contingencies, and the desired level of profits.

The net premium for a policy is associated with calculation of the statutory reserve liability and is based on the assumptions as to mortality and interest used in calculating the statutory reserves. These assumptions must lie within certain limits prescribed by state insurance laws and thus do not necessarily bear any relationship to the mortality and interest rates assumed in computing the gross premium.

The difference between the gross premium and the net premium is referred to as the "loading." The term loading is a misnomer since this difference is a hypothetical figure and does not necessarily represent an allowance for expenses and profit. In fact, some companies have gross premiums for some plans and issue ages that are equal to, or less than, the net premium, thus producing zero or negative loadings.

Generally, companies that write participating business charge

more than for a comparable policy sold on a nonparticipating basis. However, most, if not all, of the extra amount may be returned to the policyholder in the form of dividends. For a discussion of dividends to policyholders, see page 28, "Benefits Under Policies and Contracts."

Policyholders may elect to pay life insurance premiums in annual, semiannual, quarterly, or monthly modes. However, an additional charge is made if an annual premium is not paid because of the insurer's increased collection expenses, loss of interest, and, in some cases, extra mortality cost in the year of death.

Usually, the agent selling the policy is empowered by the company to collect the premium that is initially due. However, after the initial premium has been paid, it is customary for the policyholder to be billed by the company. This procedure, of course, does not hold true in the case of debit life insurance for which the agent usually collects premiums at the policyholders' homes on a weekly, biweekly, or monthly basis.

An increasingly popular form of collecting premium payments is the automatic check plan. Many companies now give the policyholder the option to authorize checks to be automatically drawn against his account on a monthly basis for the payment of premiums. Under such plans, the policyholder need not write a check; at the specified time during the month the company will simply draw a check on the policyholder's account.

If premiums are not paid by the due date there is a grace period (perhaps 30 or 31 days) during which the premium may still be paid and the policy will not lapse. However, if a premium has not been paid by the end of the grace period and any additional time granted, the policy may be lapsed. When this occurs, the nonforfeiture option selected by the insured will go into effect. The policyholder may at some point request reinstatement, which may require evidence of insurability. Many policies provide for payment of unpaid premiums by an "automatic premium loan" (a) to the extent that the cash surrender value of the policy permits such a loan and (b) if, as provided by some policies, the insured has indicated that he wants this option to take effect any time that premiums have not been paid.

One of the basic assumptions generally made in calculating the statutory policy reserve is that the net annual premium for each policy has been collected on the anniversary date of the policy regardless of the actual payment mode elected by the policy-

holder. To balance this overstatement of liability on policies on which the full yearly net premium has not yet been paid, a net deferred and uncollected net premium asset is set up. Therefore, the premium income for a life insurance company should include the equivalent of one net annual premium for each life insurance policy that is in force and on which premiums are still being paid. (See page 42, "Life Insurance Premiums and Annuity Considerations Deferred and Uncollected.")

In addition to premiums, insurance companies include considerations for supplementary contracts and dividend accumulations as revenues. Supplementary contracts are options exercised by beneficiaries relating to the disbursement of policy proceeds (e.g., death benefits) in other than a lump-sum payment. For example, a beneficiary may elect to receive periodic payments over a period of time.

The statutory accounting for supplementary contracts requires a charge to benefits or some other appropriate disbursement account and a credit to revenue representing the consideration for a supplementary contract. For contracts without life contingencies a reserve is established at year end for the remainder of the sum not yet paid to the beneficiary. As a result, the transaction is treated as though a lump-sum death benefit was paid initially to the beneficiary and then returned in the form of a payment for a supplementary contract. For contracts with life contingencies actuarially determined, reserves are required.

Similar accounting results when a policyholder elects to have dividends accumulate or have them applied to buy additional insurance. In such cases, dividend expense is charged and consideration for dividend accumulations or premiums for additional insurance are credited. A liability for accumulated policyholders' dividends or a reserve for additional insurance purchased is established at each year end, with a corresponding charge to operations.

Commissions

Agents are compensated by commissions on business written. The first-year commission rate is usually much higher than the renewal commission rates. The commission is usually limited to a specified period even though the policy may remain in force beyond that time. After a period of 10 or 15 years, many com-

panies pay smaller nonvested renewal compensation known as "service fees."

The commission scale differs with each type of policy. Accident and health policies usually pay smaller commissions the first year than life insurance policies; renewal commissions are paid over a similar period of time. One example of the rate of commission on an ordinary life policy would be 55% of the premium in the first year and 5% in the succeeding nine years. In order to compete for agents, some companies pay substantially higher first year and renewal commissions. An example of the rate of commission on an accident and health policy would be 40% of the premium in the first year and 10% for the next nine years.

Some companies permit all or a part of the renewal commissions to vest with the agent even though he may withdraw from his agency contract before the renewal commission period has terminated. Other companies do not permit renewal commissions to vest with the agent; consequently, the agent loses his rights to further commissions upon termination of his agency contract.

Additional compensation is provided by some companies to supplement the commissions to agents. Such compensation is usually based on the amount of business written by the agent and on other factors such as persistency of the written business. It is also common for companies to have agreements with general agents for reimbursement of certain expenses. Certain states have statutes that limit the amount of expenses that may be reimbursed under such agreements; these statutory limitations are usually complex and are normally based on premiums, insurance in force, etc. Many companies provide pension and other fringe benefits for their agents similar to those provided for employees.

It is often difficult for a new agent to earn enough commissions early in his career to provide adequate income. Accordingly, many companies make advances to new agents to supplement commission income. In many companies the advances are made against future commissions and must be repaid to the company out of such future commissions. If an agent leaves a company before his advances are repaid, he usually has an obligation to repay these advances. As a practical matter, all or a part of these obligations are often not collected by the company except to the extent of future commissions which would otherwise have been paid to the terminating agent. Consequently, all states require

that agents' advances be classified as nonadmitted assets. Agents' credit balances, however, must be included in liabilities.

Benefits Under Policies and Contracts

Types of Benefits. Death benefits under life insurance contracts are paid in a lump sum or under other arrangements which may be elected by the policyholder or the beneficiary. Once it is established that the death claim is proper, payment of the death benefit is made. In addition to the face amount of the benefits, life insurance companies may pay interest on the proceeds from date of death to the date the amount is disbursed.

Other benefits such as matured endowments, annuity payments, surrender payments, policyholder dividends, and disability benefits may involve a greater aggregate dollar amount than death benefits. These benefits may be paid to the insured or to someone that the policyholder has designated. If the insured lives to the maturity of an endowment insurance contract, the stipulated proceeds are paid at maturity. If the insured dies before the endowment matures, the company will pay a death claim in the normal fashion.

Annuity payments are made by the life insurance company to the designated person in accordance with the terms of the annuity contract.

Surrender or loan values usually accrue under whole-life or endowment contracts and are paid, or are available, on surrender of, or borrowing on, the policy.

Mutual companies and many stock companies write participating contracts. Many life insurance companies compute the dividends allocable to a particular policy according to dividend formulas that are based on asset share studies or other forms of analyses. These studies or analyses are intended to identify the accumulated earnings considered applicable to blocks of policies. As the funds accumulated on these policies exceed the amounts determined to be required to meet expenses and benefits according to their terms, dividends are declared and thus constitute a refund based on actual emerging experience.

Disability benefits include waiver of premium during the disability period and also loss of income benefits. Health insurance policies, offered by many life insurance companies, may provide hospital, surgical, medical, or loss of income coverage.

Processing Procedures. The processing procedures for payments of benefits generally involve a determination that the contract is in force and that such payments are being made in accordance with the contract.

In the case of disability payments, there is a medical question as to whether the insured has, in fact, been disabled. In this regard, life insurance companies generally obtain statements from physicians and/or hospitals to satisfy themselves that the person has been disabled. In addition, disability payments do not commence until a required minimum period of disability has been completed. Of course, if the disability is not permanent, the payments are contingent on the continuance of disability.

When death claims are presented, they should be entered in the claim register. A claim number is usually assigned sequentially to each claim as it is registered and a claim file is initiated. It must be determined whether the policy or policies under which the claim was submitted were in force at the time of death.

If the policy was in force at the time of death, the company obtains proof of death if such proof of death was not received with the claim. Documents used to substantiate the insured's death usually consist of a certificate of death and a statement from a physician.

The statement from the physician may be very important if the policy is in the contestable period, usually within two years of its issuance. If death occurs during this period and there is a material misstatement by the insured in the application, the company is usually not legally required to pay the face amount of the contract. However, in such cases, premiums paid are usually returned.

After determining that the policy had been in force and that the death of the insured has occurred, the company proceeds to determine that provisions of the contract have not excluded the risk which caused the death. For example, the policy may have stipulated that the contract did not provide coverage in the event the insured died while piloting a private plane. If death is by suicide occurring within the suicide exclusion period (usually one year from the date of issue), premiums are returned, but the payment is recorded as a death benefit. Cause of death is also a most important consideration in the interpretation of contract provisions for double indemnity benefits.

The next important phase in processing is for the company to determine the amount to be paid to the beneficiary. If a policy loan is outstanding on the contract, the amount of the loan will be deducted. Conversely, any amount of advance premiums on deposit, dividends left at interest, additional insurance purchased by dividends, and any terminal dividend credits are usually added to the face amount together with interest on the proceeds.

The policy under which the death claim has been submitted may involve reinsurance. If so, information regarding the policy will be supplied to the reinsurance department so that proper reimbursement will be received from the reinsurer.

Increase in Policy and Contract Reserves

The life insurance company's summary of operations will include a charge for the aggregate increase in the actuarially determined reserves for policies and contracts with life contingencies, for supplementary contracts without life contingencies, for dividend accumulations, and for accident and health policies.

General Expenses and Taxes

General expenses and taxes are usually recorded on a cash basis during the year with appropriate accruals being made at year end. Most general expenses and taxes represent items normally encountered in other types of business enterprises. Expense account classifications are prescribed by regulatory authorities.

Certain expenses and taxes are allocated to investment operations and are deducted from gross investment income.

Rent expense includes a charge for occupancy of a company's own buildings, the contra to which is included in investment income. The cost of furniture and equipment may be either charged to expense or capitalized and depreciated over the useful lives in the normal manner. If costs are capitalized and depreciated, the undepreciated balances are usually required to be treated as nonadmitted assets; an exception is usually made for EDP equipment when the cost exceeds a stipulated amount.

Taxes (other than federal income taxes), licenses, and fees include the following:

1. Real estate taxes.
2. State insurance department licenses and fees which are charged by various insurance departments including cost of

examinations made by the insurance departments for licensing of agents.

3. State taxes on premiums which are based on premiums received on lives within the borders of each taxing authority in which the company is licensed to do business. Tax rates vary among states, averaging about 2%. In some cases, counties and municipalities also levy taxes based on premiums. These taxes are generally considered to be in lieu of other state and local franchise and income taxes.

4. Payroll taxes.

Outline of Auditing Procedures

For this and the other areas of auditing discussed in this guide, the auditor must study and evaluate internal control to establish a basis for reliance thereon in determining the nature, extent, and timing of audit tests to be applied in his examination. An example of a supplementary internal control questionnaire intended to assist an auditor in his study and evaluation of the internal control of a life insurance company is presented in Appendix D.

The audit procedures applicable to premiums and other considerations, commissions, and policy benefits are somewhat interrelated and it is important that the auditor understand these relationships at the outset of his work. Since most of the auditing of these accounts constitutes a test of procedures, much of this work can usually be performed at an interim date.

A general outline of a program for the audit of premiums, commissions, benefits, and expenses is presented in the following sections.

Premiums and Other Considerations. A number of policy files should be selected and examined to determine that the company's accounting records and procedures are adequate and proper.

As part of his audit procedures involving the underwriting department, the auditor should satisfy himself, through tests, that safeguards surround the issuance of policies. In most life insurance companies policies are not prenumbered, but they are assigned policy numbers at the home office. Accordingly, other controls must be established for policies; for example, the auditor should determine that policies delivered to agents but not issued

to policyholders have been accounted for by the company. Some companies control this by billing the agent upon delivery of the policy.

As to reinsurance, the auditor should read the company's by-laws and minutes to ascertain the limits to be retained on various types of risks. Retention limits may also be shown in the reinsurance treaties and in correspondence with reinsurers. The auditor should also determine whether the company has assumed any reinsurance from other companies. In connection with reinsurance transactions, the auditor should obtain copies or abstracts of reinsurance treaties or agreements. During the tests of premiums and benefits, it should be determined that transactions are being recorded in accordance with applicable reinsurance agreements. The auditor may also consider it appropriate to confirm reinsurance transactions or balances directly with reinsurers. When a company has reinsured a significant portion of its risks, the auditor should satisfy himself that each assuming company is financially sound.

In addition to the procedures mentioned above involving underwriting and policy issue, the auditor should test premium billing and accounting. Such tests should include renewal premiums as well as first-year premiums. For selected policies in force, the auditor should check the calculation of the related premiums to the appropriate premium rate tables. He should also determine that appropriate premium amounts are billed, accounted for, and subsequently collected.

Premiums received but not yet applied are usually maintained in a suspense account. The auditor's tests should be designed to determine that the company is properly clearing these items from suspense on a timely basis.

It may also be appropriate to select in-force policies for confirmation directly with policyholders of premium amounts, date to which premiums are paid, policy loans, accumulated dividends, etc.

Tests of premiums can be correlated with audit tests of premiums paid in advance, premium deposit accounts, policy loans, dividends, commissions, surrenders, claims, and reserves.

Commissions. Prior to beginning specific auditing of commissions, the auditor should develop a thorough understanding of the relationships between premiums paid and commissions

earned. He should obtain copies of the various agreements with agents regarding compensation and expense reimbursement. A test of specific commission transactions can be related to the premium tests mentioned above. Alternatively, a number of commission transactions may be selected independently for testing. The auditor should determine that the commission transactions selected have been calculated in accordance with the provisions of the specific agreement. He should also determine that aggregate commissions are being properly recorded and subsequently disbursed. Consideration should be given to confirming commissions paid and balances unpaid as of a specific date.

The auditor should determine that agents' expense reimbursements are made in accordance with agreements with agents and the applicable state insurance law. The auditor may also wish to review expense reports and supporting details periodically submitted by agents.

Benefits Under Policies and Contracts. Death claims should be tested by reference to the related claim files. Each file selected should be reviewed to determine that it contains appropriate support such as a certificate of death, statement from a physician, the returned policy, etc. The file should also indicate that the company has determined that premiums on the policy were paid through date of death, whether there were any policy loans, whether the risk which caused death was covered, and whether there was recoverable reinsurance, etc. It is necessary to test whether the policies which matured, were surrendered, or terminated by death (for which claims have been paid or are pending payment) have been deleted from the listing of policies used in calculating reserves. If pending claims have not been deleted from the reserve listing, the reserves thereon should be deducted from the amount of the pending claim.

For death claims submitted under group life insurance contracts, the auditor may consider visiting the group administrator's location in order to verify the validity of the death claims in those cases where the records are maintained by the administrator.

Matured endowments should be tested to determine that payment is subject to a precontrol of all endowments maturing within the year. The tests should determine that all such pay-

ments are in accordance with the contract and have been properly approved.

Cash surrenders should be tested to determine that the amount paid is in accordance with policy terms and that the policy has been surrendered and cancelled.

Benefits paid under accident and health contracts should be tested to determine that the policy was in force, that proper support exists for the payment, that the benefits paid are in accordance with the terms of the contract, and that the claim data are properly recorded.

The aggregate amount of dividends that may be paid to policyholders should be compared with the amount approved by the board of directors. The auditor should determine that benefits are properly allocated and applied to the participating policies.

Consideration should also be given to direct confirmation of benefit payments with policyholders or beneficiaries, especially where payments are made to agents for delivery.

General Insurance Expenses, Taxes, Licenses, and Fees. The auditing procedures for general expenses and taxes should be generally the same as those applied in other business enterprises except that the auditor should bear in mind that accruals for such items are usually not under general ledger control but are in most cases, inventoried at financial statement date.

The auditor should make tests of the state coding for premium receipts to determine that premiums are being allocated to the proper state for premium tax purposes.

Investment Operations

The investment operations of a life insurance company, while physically distinct, are an inseparable part of the life insurance concept and the overall operations.

Premium rates are determined with the assumption that preminums less current costs will be invested and will produce an estimated yield.

In the statutory statement of operations, investment income is reported net of related expenses, taxes, and depreciation.

Insurance statutes regulate the investments of insurance companies by giving the supervisory authorities the power to designate what types of investments may be acquired or held. State insurance laws prescribe the types of bonds, stocks, and mortgages which may be acquired by the companies, as well as the limitations on amounts of specific investments and aggregate costs of investments.

Investments of life insurance companies generally consist of bonds, mortgage loans, stocks, real estate, collateral loans, and policy loans; such investments are valued for regulatory reporting purposes at prescribed values which can generally be described within the following designations:

Bonds

Investments in bonds are generally made with the intention of holding the securities until maturity; therefore, bonds are

usually carried at original cost reduced by amortization of premiums or increased by accrual for discounts. However, if a bond is in default as to principal or interest, values published by the NAIC must be used. Amortization is usually calculated by either (1) the straight-line method or (2) the level-yield method required by many states. In the case of bonds purchased at a premium which are subject to call before maturity, the premium is usually amortized to the call date.

Amortization of the premiums and accrual of the discounts are recorded as adjustments of interest income of the period.

Mortgage Loans

Mortgage loans are usually valued at their unpaid balances (or at amortized value if acquired at a value other than par). Such mortgage loans are considered admitted assets only if they are first liens. Second liens may be considered as admitted assets if the company also holds the first lien. The original amount of each mortgage loan is limited to a percentage (varying from state to state) of the appraised value of the underlying property.

Stocks

Investments in stocks are reported at values published by the NAIC. Common stocks are generally reported at market quotations. Preferred stocks in good standing, as determined by the NAIC, are reported at cost or, if held at December 31, 1964, the company has the option to value at association value as of that date. Preferred stocks not in good standing are valued at market.

Stocks of subsidiary, controlled, or affiliated companies are reported at values approved by the state (upon recommendation by the NAIC) on an individual basis.

Real Estate

Real estate properties may include those occupied by the company, those held for investment, and those acquired by foreclosure. These assets are usually carried net of any encumbrances at the lower of cost (less accumulated depreciation) or market value. Some states will permit or require certain real estate to be carried at appraised values.

Collateral Loans

Occasionally life insurance companies make collateral loans. The collateral securing the loans usually must be such that it would be an admissable asset if owned by the insurance company. The original amount of such loans is usually restricted to a percentage of the value of the collateral.

Policy Loans

Life insurance companies generally must permit borrowing against the cash values of policies. Policy loans are carried at their unpaid balances including accumulated interest but not in excess of cash surrender values or in excess of policy reserves. Many policy contracts require the company to initiate an "automatic premium loan" to pay delinquent premiums.

Other Investments

Other investment assets may include premium notes, certificates of deposit, accruals for interest, dividends, rent, and other investments permitted by law. The accruals may include dividends on preferred stocks or on common stocks payable on or before the balance sheet date but which were not received; dividends payable on common or preferred stock in the subsequent period are included in the accrual if the stock was being quoted ex-dividend at year end.

The excess of admitted asset value of investments over book value and interest, dividends and real estate income due and accrued are usually not recorded on the general ledger and, accordingly, are reported as non-ledger assets.

Outline of Auditing Procedures

The principal objectives in the audit of investments are to determine existence, ownership, the legality of the investment, the basis of valuation and the accounting for related income and gains and losses. Schedules A, C, and D of the annual statement provide a detailed listing of real estate, collateral loans, and bonds and stocks, respectively, at the end of the year, as well as details concerning acquisitions and disposals during the year, and income on individual investments. These schedules, or their underlying details, may be useful in the audit tests for investments.

The legality and admissibility of investment holdings should be tested by reference to applicable state laws and the NAIC valuation book. Securities owned, including securities held as collateral, should be inspected or confirmed with custodians or other holders as of the audit date. Tests should be made of the amortization of bond premium or discount. Consideration should be given to the need for a valuation allowance if collection of bonds at par is questionable. Committee minutes authorizing transactions should be examined.

Mortgage loans should be confirmed with mortgagors and, in some cases, with mortgage servicing agents. Underlying documents such as mortgages, deeds, and insurance policies should be examined on a test basis. The auditor may obtain audited financial statements of the servicing agents or some other appropriate evidence of the agents' financial condition. The existence of escrow funds for taxes and insurance should be determined. There should be some evidence that the servicing agent is adequately bonded and has adequate insurance protection. For new mortgage loans, appraisal reports should be examined on a test basis to assure the auditor that mortgage limitations have not been exceeded.

The valuations for stocks may be compared with quotations listed in financial publications. The method of determining valuations for stocks of other insurance companies and for subsidiaries should be reviewed, and it should be determined that the value is approved by the state.

The audit of investments in real estate involves the application of the usual steps associated with fixed assets.

Security transactions and interest and dividend income should be appropriately tested. Significant outside income from real estate investments should be tested by reference to source data.

Policy loans should be confirmed on a test basis; the interest should be compared to rates prescribed by the policy and the related income tested. The test should include a check that unpaid interest on policy loans is added to principal. A comparison of the policy loan including unpaid interest, if any, and the related cash surrender value for selected policies should be made to ascertain that the loan amount has not exceeded the related surrender value. As a practical matter, comparison with the related policy reserve could be acceptable for this purpose. Formal notes on file, if any, may be examined on a test basis.

Other Assets

Other assets may include some or all of the following:

1. Life insurance premiums and annuity considerations deferred and uncollected.
2. Accident and health premiums due and unpaid.
3. Amounts recoverable from reinsurers.
4. Miscellaneous admitted assets.
5. Nonadmitted assets.

Life Insurance Premiums and Annuity Considerations Deferred and Uncollected

The category includes uncollected premiums on life insurance policies still in the grace period; these represent premiums due as of the current statement date. It may also include uncollected premiums on policies up to 60 or even 90 days beyond the grace period where the company has not yet processed the policy and removed it from the premium-paying in-force file. Most insurers delay the processing of lapses 60 to 90 days beyond the grace period because of the frequency of reinstatements during this period.

In addition, this category includes deferred premiums which result from the assumption, generally made in the calculation of statutory life reserves, that all premiums are paid annually on

the anniversary date of the policy. Since many premiums are, in fact, paid on a monthly, quarterly, or semiannual basis, a calculation must be made to arrive at an amount to compensate for the annual mode assumption used in calculating the reserves. The amount of gross premiums to be used in arriving at the deferred premium amount can be determined by reviewing each premium-paying policy in force and (a) determining the anniversary date of the policy, the mode of premium payment, the date to which the premium is paid and whether it is a first-year or renewal premium; and (b) adding the gross amounts of such premiums that become due between the paid-to date and the next anniversary date of the policies.

After the total gross deferred and uncollected premiums are determined, a calculation is made to reduce such premiums from "gross" to "net." Gross premiums are the amount of premium paid by policyholders. Net premiums are the hypothetical premiums involved in the statutory policy reserve calculations. In many cases, net valuation premiums are listed in published actuarial tables.

Accident and Health Premiums Due and Unpaid

This item is identical in nature to uncollected premiums on life insurance policies previously discussed. However, for accident and health (A & H), with the exception of certain premiums due from ceding reinsurers, only those uncollected premiums due within three months of the reporting date may be included as an asset. Where premiums are payable more frequently than quarterly, only one premium may be included as an asset. So that profit will not be anticipated on the uncollected A & H premiums, a calculation is made to estimate the amount of commissions and other expenses that will have to be paid if the premiums are collected. This estimated amount is recorded as a liability.

Amounts Recoverable From Reinsurers

Amounts recoverable from reinsurers, which are carried as an asset, represent recoveries due from reinsurers on paid losses on life and accident and health insurance. Similarly, amounts recoverable on unpaid losses are deducted from the applicable claim reserve in the liability section of the statement of condition.

Miscellaneous Admitted Assets

Miscellaneous admitted assets may include investment in electronic data processing equipment (EDP), certain types of furniture and fixtures (dependent upon state regulations), bills receivable, and net foreign exchange adjustment.

Nonadmitted Assets

Nonadmitted assets include all assets other than those permitted to be reported as admitted assets in the annual statement. The principal nonadmitted assets are the following:

- Agents' debit balances.
- Furniture and equipment (except EDP equipment).
- Automobiles.
- Advances to officers and employees.
- Accrued income on investments in default.
- Excess of amounts loaned over stipulated percentages of related collateral.
- Prepaid and deferred expenses.
- Goodwill and similar intangible assets.
- In a few states, amounts recoverable from unauthorized reinsurers, unless covered by amounts due to such reinsurers. (In other states, a separate liability is required to be established for such amounts.)
- Excess of book value over admitted asset value of stocks and other investments.

Most of the preceding nonadmitted assets are self-explanatory. In general, receivables, other than those due from policyholders, should be classified as nonadmitted assets unless they are collateralized. Companies maintaining accounts for furniture and other equipment, and charging operations with depreciation are generally required to treat undepreciated balances as nonadmitted assets; however, some states permit furniture and equipment to be treated as admitted assets in amounts up to stipulated percentages of the aggregate of all other assets.

Unauthorized investments and investments in excess of

amounts authorized by statute are nonadmitted. In many states, insurance companies are not permitted to own their own stock; loans collateralized by such stock are also classified as nonadmitted assets.

The cost of blocks of insurance in force purchased is usually charged off when incurred. Some states may permit such an item to be capitalized and amortized. The unamortized cost of such a purchase is, however, nonadmitted.

Separate Account Assets

Separate account assets and liabilities are found in the annual statement and represent summary totals of details contained in the separate account association blank. Separate accounts constitute a separate record of fiduciary responsibility for the assets which fund the liability to variable or fixed-benefit annuity contractholders, pension funds, and others.

Assets usually consist of stocks, bonds, cash, dividends receivable, and amounts due from brokers. Investments of variable annuity accounts are valued at market values.

The annuity considerations received by the separate account usually are net of charges levied on gross dollars received by the life insurance company. The amounts retained by the life insurance company are usually to pay commissions, premium taxes, and underwriting costs. In addition to annuity considerations, income is derived from dividends, interest, and capital gains and losses. Charges against income usually take the form of investment advisory fees, service charges, increases in reserves, and annuity benefit payments.

Outline of Auditing Procedures

Life Insurance Premiums and Annuity Considerations Deferred and Uncollected. Audit procedures relating to life insurance premium and annuity considerations deferred and uncollected should include tests to determine that

1. Policies listed as having uncollected premiums are in force and the premium is actually due.
2. Amounts included in the deferred premium tabulation apply to policies in force and the data are correct with regard to

gross premium, mode, anniversary date, and whether first year or renewal.

3. Annualization of gross premium by mode compares to premium income for the period.
4. Policies included in the deferred computations are also included in the actuarial reserve computations.
5. Factors used to reduce the gross premium to net are appropriate. For renewal premiums, comparison of such factors can be made with those in previous years.
6. Net premium factors are consistent with the reserve assumptions; most accountants will need to utilize the services of a qualified actuary for this audit procedure. (See page 97, "Utilization of Actuaries.")

Accident and Health Premiums Due and Unpaid. Determine by a test basis that the listed premiums are uncollected and that the related policies are in force.

Amounts Recoverable From Reinsurers. Audit procedures for amounts recoverable from reinsurers include confirmation of amounts due and verification of subsequent collection as well as testing of selected claim payments to ascertain whether or not reinsurance applies.

Miscellaneous Admitted Assets and Nonadmitted Assets. The auditing procedures for assets in these classifications will be dependent upon the nature of the assets. The auditing procedures will be similar to those utilized in the performance of an audit of any other type of business. The auditing procedures would include confirmation, calculation, examination, and any other procedure that should be applied to satisfy the auditor.

Separate Account Assets. Since separate account assets consist principally of investments, the auditing procedures to be applied will be similar to those used for other investment accounts.

Liabilities

Aggregate Reserve for Life Policies and Contracts

The aggregate reserve for life policies and contracts is an amount which is considered adequate to provide future guaranteed benefits as they become payable under the provisions of the insurance policies in force. The policy reserve is the aggregate result of an actuarial computation on each policy or group of policies. Theoretically, the policy reserve represents the present value of future guaranteed benefits reduced by the present value of future net premiums.

There are several policy reserving methods currently in use; the most common are the "net level" and "modified or preliminary term" methods. Under the net level method, the valuation net premium is a level percentage of the gross premium. The modified or preliminary term method provides a smaller increment to reserves in the first year to offset some of the higher first-year expense on a policy.

The two most significant factors in determining the policy reserves are the mortality and interest rate assumptions. Published reserve factors, based on various interest rates and mortality tables, are available for most plans of insurance. Aggregate reserves must at least equal those which would be determined according to the statutory minimum standard, which is expressed in terms of mortality tables and maximum interest rates. Given the plan

of insurance, age of the insured at issue, and the date of issue, it is often possible to go to published tables for the appropriate reserve factors. Where such tables are not available, alternative procedures will be required. In any event, the auditor should satisfy himself that the life insurance reserves are fairly presented. A broad outline of auditing procedures to be followed in the examination of policy reserves is described below.

In addition to the basic reserves for future death benefits, the aggregate reserve for life policies usually includes amounts applicable to other contract benefits such as disability waiver of premium, disability income benefits, and additional accidental death benefits. The factors to be used for computing the policy reserves for these benefits may be incorporated in the basic published table used by the company or in separate published tables.

The aggregate reserve for life policies and contracts will also include annuities and supplemental contracts with life contingencies. As with life contracts, the policy reserves are determined by the use of approved, applicable tables.

The aggregate reserve for life policies is presented net of reserves ceded under reinsurance arrangements.

The liability for supplementary contracts without life contingencies and dividend accumulations is reflected separately in the annual statement and represents the present value of amounts not yet paid to beneficiaries or policyowners.

Outline of Auditing Procedures. Since the "inventory" of insurance policies in force is not under general ledger control, a careful study of internal control over the inventory is essential. Such a review should highlight the kind of errors more likely to occur so that the auditor can then direct his attention to those areas.

The audit tests necessary to satisfy the auditor that the aggregate reserve is a fair presentation of the company's life reserve liabilities can be divided into three main areas.

1. The inventory of policies in force must be tested for the inclusion and exclusion of all applicable policies and for the accuracy and completeness of the information included for each policy (i.e., plan, year, age, sex, policy riders, etc.).
2. The propriety of the actuarial factors used in computing the reserve must be examined.

3. The determination that the factors in step 2 have been correctly applied to the inventory of policies in force and the results have been accurately accumulated.

In smaller companies, the auditor can often obtain a detailed list of all the insurance policies in force. In larger companies, or in smaller companies where this listing is not available, the auditor must be able to obtain details supporting the accumulation of selected blocks or cells in the client's inventory.

After the auditor has obtained sufficient details of insurance policies in force, he should test the data to and from sources independent of the inventory such as cash receipts, the billing file, and the policy register to satisfy himself that all policies have been included in the inventory that should be included. He should also test to and from the lapse file, the claim register, and cash disbursements to assure himself that the proper deletions have been made to the in-force or inventory file. The auditor should also select items from the inventory in-force records of the prior year, or apply alternative procedures to satisfy himself as to the propriety of additions or deletions. The auditor should also perform tests to satisfy himself that the paid up policies (e.g., 10- and 20-pay policies on which no further premiums are being collected) are still included in the insurance in force and that the cutoff for the company's inventory of policies in force is consistent with the cutoff for the premium collections. The accuracy of coding shown on the detail of the insurance in force should be tested by comparing such coding with data shown on the original policy applications for which premium calculations have been tested by comparison with appropriate rate books. All of the aforementioned tests may be performed on the basis of statistical sampling techniques.

The determination that the factors have been correctly applied can be performed in the same way as any other test of clerical accuracy.

For policies in force in the prior year, a comparison should be made of the current factors and tables to the factors and tables used in the prior year.

Auditors will need to utilize the services of a qualified actuary for certain of the foregoing audit procedures. (See page 97, "Utilization of Actuaries.")

Aggregate Reserve for Accident and Health Policies

The aggregate reserve for accident and health policies consists of the (a) "active life reserve" which is that portion of due and collected premiums which has been set aside to be recognized as earned in the future and which includes the unearned portion of the current premium, "additional" reserves and reserves for rate credits, and (b) "claim reserves" which consist primarily of the present value of amounts not yet due on claims. Provision is made in both the active life and claim sections for a reserve for future contingent benefits.

The unearned portion of the current premium is computed for most types of accident and health coverages on a pro rata basis using either actual due dates and premium modes or one-half of the last modal premium. That portion of the unearned premium reserve applicable to credit A & H business is generally computed on the pro rata basis or the sum-of-the-years' digits method.

"Additional" reserves apply to policies which provide for the payment of level premiums for a risk the cost of which increases with the age of the insured. The reserve is similar in principle to the reserve on life insurance policies, with the further need to take into account the appropriate morbidity assumption.

Many accident and health policies provide for a "deferred maternity benefit" whereby medical expenses incurred in childbirth are covered for approximately nine months after the cessation of premium payments. The reserve for future contingent benefits represents current premiums set aside for such coverage and is generally equal to maternity benefits paid over the most recent nine months and adjusted for increases in business and claim cost. Provision for other future contingent benefits might be included.

The present value of amounts not yet due relates to that portion of the liability for claims incurred on or before the valuation date which has not been accrued as of the valuation date. The reserves are usually computed by the application of actuarially determined factors based on mortality, morbidity, interest, and policy limitations. Also included are reserves for unaccrued benefits on incurred but unreported claims.

Outline of Auditing Procedures. Unearned premium reserves and additional reserves are computed from inventories of acci-

dent and health policies in force which, like life policies, are not under general ledger control. Therefore, the studies of internal control and audit testing described under the heading, "Aggregate Reserve for Life Policies and Contracts" are virtually the same for these liabilities.

Likewise, the reserves for present value of amounts not yet due on claims and future contingent benefits are akin to reported and incurred but not reported claim liabilities, respectively. See "Policy and Contract Claims," below for a discussion of appropriate auditing procedures.

Policy and Contract Claims

This liability represents amounts due on life and accident and health claims that have accrued as of the statement date but have not yet been paid. Included are accrued benefits on incurred but unreported claims. The liability is reduced by that portion of the policy and contract claims which is recoverable from reinsurers.

Outline of Auditing Procedures. The portion of the policy and contract claim liability that has been reported at the statement date can be verified by (1) comparing the items the client has included in the liability to the claim register, (2) reviewing claim disbursements subsequent to the statement date, and (3) reviewing the claims files and year-end cutoff procedures.

The adequacy of the incurred but not reported portion of the liability can be reviewed by an examination of the claim register through the latest date available, extracting those claims that have an incurred date before the statement date, but a reported date after the statement date. In this connection, it should be recognized that the lag between incurred dates and reported dates is a critical factor in determining the adequacy of these reserves. The total of these claims should then be compared to the amount provided for incurred but not reported claims at the statement date. It should be noted, however, that in most cases all the claims will not have been received at the date the audit is completed; therefore, the auditor must analyze the past years' experience and project it to the future after considering various modifying factors, such as premium volume and claim frequency and severity. A development through the current date of the prior years' incurred but not reported reserves can be of great

assistance to the auditor in this projection. Also, the assistance of a qualified actuary will usually be required. (See page 97, "Utilization of Actuaries.")

Dividends to Policyholders on Participating Policies

Participating policies generally provide for the payment of annual dividends after the policy has been in force for two or three policy years. Annual dividends are generally payable on policy anniversaries. The board resolution authorizing the payment of dividends is usually made annually for policies reaching policy anniversaries within a certain calendar period. The amount apportioned for distribution to policyholders as annual dividends is commonly called "divisible surplus" and represents the excess of the funds on hand over the amount which the company determines it should hold to meet future needs. The company must determine that the level of its surplus and other company goals can be satisfied before determining the final amount of divisible surplus. Some companies also pay termination dividends. Such dividends may be payable when a policy terminates by maturity, surrender, or death. Termination dividends are paid from the funds which have been accumulated in excess of the reserve or cash value and which are released upon termination of the policy.

Annual dividends on individual policies are generally determined from formulas based on the classic contribution method, asset share method, experience premium method, or fund method. These methods are designed to provide a basis whereby a company's divisible surplus may be prorated to the various classifications of individual policies in proportion to the net total contributions to surplus arising from actual experience as compared to assumed mortality, interest, withdrawals, expense, and sometimes other factors such as provision for experience fluctuations or abnormal costs. Capital gains or losses may be considered in the determination of divisible surplus and in the dividend formulas, usually through an adjustment in the interest factor. Techniques based on experience are also used in calculating dividends for health insurance and group insurance.

A legal consideration may affect the aggregate amount of distribution. For example, in Illinois no more than 10% of the profit on participating business issued by a stock company can inure

to the benefit of the shareholders. New York State has, in addition to restrictions on earnings from participating business, maximum and minimum surplus requirements, depending upon when a company was organized.

Dividends can be (1) paid in cash, (2) applied to pay premiums, (3) applied to provide paid-up additions, (4) applied to shorten the endowment or premium-paying period, or (5) left on deposit. Items (3) and (4) are reserved for directly in the policy reserves, while item (5) is included as a part of the liability for supplementary contracts without life contingencies and dividend accumulations. There are a number of other dividend options available.

The aggregate dividends must be approved by the board of directors, and the dividend must be formally declared before any legal liability exists. When declared, the liability for dividends must be recorded for the amount so declared.

The liability for dividends due and unpaid refers to dividends payable prior to the end of the accounting period but not yet paid. As a separate item, a liability is established for dividends payable beyond the end of the accounting period if a commitment to pay such dividends has been made by board resolution. Some states require a life company to set up a liability for a full year's dividends whether or not they have been declared.

Outline of Auditing Procedures. The procedures followed in determining the amount of policyholders' dividends should be reviewed for reasonableness and for compliance with policy terms and/or statutory requirements. The factors involved should be compared to other audited data and calculations should be tested. Auditors will need to utilize the services of a qualified actuary for these audit procedures. (See page 97, "Utilization of Actuaries.")

The recording of dividends among cash payments, dividends accumulated at interest, dividends applied against premiums, and dividends applied to provide additional paid-up insurance should be tested. If not tested as a part of cash disbursements, dividend payments should be tested separately. Consideration should also be given to confirming dividends directly with policyholders.

The minutes of the board of directors' meeting should be reviewed to ascertain their approval of the dividend declarations.

Premiums Paid in Advance and Premium Deposit Funds

Life insurance premiums and annuity considerations paid in advance represent, for the most part, premiums paid for one or more years in advance which are discounted at a guaranteed interest rate to the specified due date and which are recorded as liabilities (sometimes classified as premium deposit funds) and recognized as income as they become due. Premium deposit funds are often recorded as ledger liabilities. Premiums paid immediately in advance of the next anniversary, without discount, are initially recorded as premium income but income for which a liability (classified as advance premiums) must be established with a corresponding reduction of premium income. Such liability is established by estimate or by inventory. Accident and health premiums paid in advance are similarly treated, but there usually is no discount associated with such premiums.

The payment of premiums in advance is encouraged by most life insurance companies because of the greater probability of higher persistency of policies for which premiums have been paid for a period well into the future.

Premium deposit funds are accounted for so that premiums are credited to income when due and interest is credited annually to the deposit account.

Outline of Auditing Procedures. Receipt of premiums paid in advance and premium deposit funds should be tested. Calculations of discount, interest, and premiums charged against the liabilities should also be verified by test. Consideration should be given to confirming balances directly with policyholders.

Advance premiums established by estimate or by inventory should be reviewed and tested as appropriate. The basis for establishing unearned premiums for accident and health policies should also be reviewed and tested.

Other Reserves

In addition to the reserve and liability items already mentioned, there may be miscellaneous reserves or liabilities which should be provided. Life insurance companies may voluntarily provide such reserves, or state insurance departments, upon examination, may also require them.

It is possible that reserves, based on the usual mortality or morbidity tables may not encompass all benefits so that special reserves may be required. For example, special retirement options may require reserves beyond those in the insurance or annuity section of the regular reserves. Reserves might also be required for extra mortality after conversion of term insurance.

Another miscellaneous reserve item might be required for accident and health policies which, while not guaranteed renewable or noncancellable, may be administered in such a way as to be very similar to policies with such renewability clauses. In such cases companies have, voluntarily or upon request of insurance departments, provided an additional reserve on policies which are described as "nonrenewable for stated reasons only."

A liability may also need to be established in respect of the extra costs of future supplementary contracts arising from overly liberal settlement option provisions in outstanding policies.

Outline of Auditing Procedures. The auditor should review all miscellaneous reserves for propriety. The basis for these reserves should be determined and appropriate tests made of their calculation.

Most auditors will need to utilize the services of a qualified actuary for these audit procedures. (See page 97, "Utilization of Actuaries.")

Other Liabilities

Other liabilities consist of accrued expenses, taxes, licenses, and fees, as well as the following items peculiar to the insurance industry:

- *Commissions to agents due or accrued* are applicable to premiums which have been collected but for which the applicable commissions have not been paid.
- *Amounts withheld or retained by the company as agent or trustee* include payroll withholdings and amounts held for payment of taxes and insurance under mortgage loans.
- *Amounts held for agents* generally represent credit balances in agents' accounts.
- *Remittances and items not allocated* are premium cash clearing accounts and other suspense accounts.

Outline of Auditing Procedures

1. *Accrued expenses*—tests should be made to determine that all liabilities are properly included at the close of the year in the annual statement. The auditor should test the calculations of those accruals that lend themselves to such treatment; other accruals should be reviewed as to reasonableness and the consistency of their development.

2. *Taxes, licenses, and fees*—tax returns should be examined on a test basis in support of payments and adequacy of accruals for the various state taxes and sufficient tests made to determine that the taxes have been properly calculated and the allocable credits taken.

3. *Commissions*—contracts should be reviewed to determine that proper rates were used. Calculations should be tested. The auditor should determine that the commission cutoff is consistent with that of premium income.

4. *Amounts withheld*—the auditor should review support for items in this account and verify by confirmation, recalculation, or subsequent payment review.

5. *Amounts held for agents*—this account should be tested in connection with tests of balances due from agents.

6. *Remittances not allocated*—the auditor should review an aging of this account and investigate old, large, or unusual items by references to supporting data.

Federal Income Taxes

Life insurance companies are taxed under the Life Insurance Company Income Tax Act of 1959. In some of its provisions, the Act gives recognition to the uncertainty of the determination of period income because of the long-term nature of the life insurance contract by allowing deferral of taxation on a portion of the apparent income until the untaxed amount is identified as income by payment of dividends to shareholders or by other action which attributes the amount to shareholders. See Appendix C.

Outline of Auditing Procedures. The auditor should analyze the liability account for the year and vouch payments to copies of the tax return. The most recent revenue agent's report should

be reviewed and the current status of any revenue agent's examination in process should be discussed with the clients. Provision for federal income tax for the current year should be recalculated. The auditor should review the accrual and also those returns that have not been examined but are not closed by the statute of limitations.

Mandatory Securities Valuation Reserve

The mandatory securities valuation reserve is reported as a statutory liability. One of the effects of the statutory reserve is to stabilize the statutory surplus of the company against fluctuations in the market value of securities. Another effect is to provide, on a formula basis, for a valuation allowance against collection of bonds at par.

The reserve is developed through annual charges to surplus equal to formula percentages of admitted asset security values at the end of the year, and realized and unrealized capital gains during the year; the reserve is reduced by all realized and unrealized capital losses. The reserve development is generally structured to reach its maximum amount, with respect to a particular security, at the end of 20 years (longer in the case of the common stock component) exclusive of the effect of capital gains and losses.

Outline of Auditing Procedures. The auditor should obtain a copy of the NAIC form used for calculation of the mandatory securities valuation reserve and read the applicable instructions and ascertain that the company is complying therewith. The company's classification of the securities in the reserve classifications should be tested by the auditor and calculations should be rechecked on a test basis.

Separate Account Liabilities

Separate account liabilities usually consist of reserves for variable annuity contractholders, amounts due the investment adviser and administrator (the life insurance company), and amounts due brokers. (See page 43, "Separate Account Assets.")

Capital and Surplus

Capital and surplus of a life insurance company consists of capital stock, paid-in or contributed surplus, special surplus funds, and unassigned surplus. Special surplus refers to amounts of unassigned surplus set aside to provide for contingencies, such as mortality fluctuation reserves and group contingency reserves.

In the case of stock companies, the amount of capital stock required to be issued and maintained is governed by the respective state insurance laws. The law usually prescribes the minimum value of the shares that may be issued. In addition to the minimum capital stock requirements, there is usually a provision for the payment of an additional amount, in the form of surplus, equivalent to a prescribed percentage of the minimum capital stock. Some state laws permit dividends to be paid out of surplus regardless of the source as long as the minimum statutory surplus amount is maintained.

In lieu of capital stock, mutual companies are organized with prescribed minimum surplus which varies among states. Such surplus may take the form of guaranty funds, guaranty capital, or other permanently designated funds subject to the payment of interest and subject to repayment under conditions prescribed by the respective state laws.

In addition to the gain or loss from operations and dividends paid, surplus transactions include the following, which are peculiar to the insurance industry.

Net Unrealized and Realized Capital Gains or Losses

Unrealized capital gains or losses originate as a result of the prescribed method of valuation of investments. The change in the difference between book value and prescribed value occurring between reporting dates is credited or charged to surplus as unrealized capital gains or losses.

Realized capital gains or losses from sale or other disposition of investments in the reporting period, net of applicable federal income taxes, are also credited or charged to surplus.

Changes in assets and liabilities during the year due to the change in foreign exchange rates are also included in the net unrealized and realized capital gains or losses.

Changes in Nonadmitted Assets

As previously discussed, certain assets are excluded from the balance sheet when reporting to the regulatory authorities. The net change between such nonadmitted amounts during the year is charged or credited to surplus.

Change in Mandatory Securities Valuation Reserve

Any increase or decrease in the amount of the mandatory securities valuation reserve between reporting dates is charged or credited to surplus.

Change in Reserve on Account of Change in Valuation Basis

The company may strengthen (or decrease) its policy reserves by changing its actuarial assumptions. A change to the net level basis from the preliminary term basis or a lowering of the interest assumption will result in a larger reserve requirement. The surplus account is charged for the amount necessary to bring reserves accumulated in prior years to the requirements under the new assumptions.

There may be other surplus transactions in addition to those listed above.

Outline of Auditing Procedures

Except for the need to check the statutory minimum capital and surplus requirements applicable to the lines of business written by the company, the audit of capital and surplus is the same as that of other industries.

In view of the tendency to accumulate all types of surplus in one account, it is frequently necessary to analyze the account to determine the sources of surplus. The applicable state laws should be reviewed to ascertain compliance with restrictions on surplus, and the validity and propriety of any miscellaneous surplus items should be ascertained.

PART II

Application of Generally Accepted Accounting Principles

Principles of Accounting

Many life insurance contracts provide for the performance of services which may extend a generation or more into the future. The financial results of any specified group of policies cannot be known with certainty until the contracts have been terminated or have matured. The results reported for any accounting period are highly dependent upon actuarial assumptions involving estimates of future developments with respect to mortality, investment yield, expenses, and withdrawals and upon the variance from these estimates. While such estimates are usually based on experience, each of these elements has had periods of adverse experience in the past and there can be no assurance that estimates made for the future will, in fact, be realized.

The actuarial assumptions and estimates used in determining annual revenue and costs applicable to life insurance contracts are extremely significant and involve considerable judgment. Many accounting problems of a long-term nature such as accounting for pension costs, long-term leases, construction projects, depreciation, and amortization involve similar judgment, but accounting for life insurance contracts generally involves longer periods of time and substantially more material amounts than those encountered in similar judgments in other businesses.

Conservatism in valuing assets and liabilities and in accounting for revenue and costs is necessary because of the uncertainties inherent in the use of actuarial assumptions and estimates for

contracts guaranteeing performance over long periods of time and the risk of unfavorable variations (adverse deviations) from such assumptions and estimates. However, as contemplated by generally accepted accounting principles, such conservatism must be reasonable and realistic.

The choice of actuarial assumptions and the disciplining of that choice are primary responsibilities of the actuarial profession. The related responsibility of the auditor is to form a judgment as to whether the actuary has been guided in his work by considerations which are consistent with generally accepted accounting principles. In this connection, it should be noted that the "Guides to Professional Conduct" published by the American Academy of Actuaries requires that "the member will exercise his best judgment to ensure that any calculations or recommendations made by him or under his direction are based on sufficient and reliable data, that any assumptions made are adequate and appropriate, and that the methods employed are consistent with the sound principles established by precedents or common usage within the profession."

At the time of publication of this audit guide, when the concept of generally accepted accounting principles as set forth in the guide has not yet been generally applied to the financial reporting of life insurance companies, there is a relative scarcity of published "precedents or common usage" to guide the actuarial profession in the choice of actuarial assumptions or the disciplining of the choices. The American Academy of Actuaries is examining these areas intensively and can be expected to provide more extensive guidance at an early date.

However, the actuary's choice of assumptions to be used in connection with general purpose financial statements is disciplined by the principles of his profession. His responsibility to use assumptions which are "adequate and appropriate" is consistent with the concept, under generally accepted accounting principles, that actuarial assumptions be characterized by conservatism which is "reasonable and realistic." The auditor should expect the actuary to be able to demonstrate that assumptions used in determining actuarial items in a general purpose financial statement meet such standards.

Under regulatory accounting practices, life insurance reserves are provided for death benefits and other similar contract benefits. Such reserves are actuarially computed and represent the present

value of future benefits reduced by the present value of future premiums. Under regulatory accounting practices, the interest rate used for discounting is subject to statutory limitation and may not be representative of the company's expected investment yield. Regulatory reserves are also calculated without regard to the effect of withdrawals. In addition, under regulatory practices, expenses, including the cost of acquiring new business, are charged against income as incurred and dividends are provided as paid or accrued. Some regulatory reserving methods are designed to partially offset the effect of charging such expenses as incurred.

The interests of policyholders and of the public in the financial integrity of the life insurance industry make it important and proper that the solvency of life insurance companies be demonstrated to regulatory authorities. Consideration of these interests, together with the uncertainties inherent in the future, has resulted in the conservative accounting practices prescribed or permitted by insurance regulatory authorities (regulatory accounting practices).[1] Solvency must be continuously demonstrated for a life insurance company to be permitted to offer its services to the public. Federal income taxation of life insurance companies is also based primarily on these insurance regulatory accounting practices. The use of generally accepted accounting principles, as discussed herein, should not be construed as an indication that such accounting principles should also be used in reporting to insurance regulatory or taxing authorities.

Statement on Auditing Procedure No. 33 states 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 regulated companies, including insurance companies. Regulatory accounting practices differ in some respects from generally accepted accounting principles. The purpose of this chapter is to discuss the difference between these two bases, and to set forth appropriate guidelines for accounting and financial reporting in conformity with generally accepted accounting principles for general-purpose financial statements. The object of such statements is to provide reliable financial information about economic re-

[1] Such practices have been prescribed by statute, regulation, or rule or have been permitted by specific approval or acceptance.

sources and obligations of a business enterprise and changes in net resources resulting from its business activities, measured as a going concern.

A summary of the major areas involving variances between regulatory accounting practices and generally accepted accounting principles is set forth below. Each of these areas is discussed later in this section:

Recognition of premium revenues
Recognition of costs
Loss recognition
Deferred income taxes
Valuation of investments and recognition of realized and unrealized gains (losses) thereon
Investments in subsidiaries
Special reinsurance agreements
Commitment fees
Stockholders' equity
Mandatory Securities Valuation Reserve (MSVR)
Nonadmitted assets

It should be recognized that regulatory accounting practices may result in other variations from generally accepted accounting principles. These include, but are not limited to, (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 and (4) transferring only the par value of stock to capital for certain stock dividends. Other adjustments or reclassifications may be required if they are material to the presentation of financial position or results of operations, in conformity with generally accepted accounting principles.

RECOGNITION OF PREMIUM REVENUES

Premiums are designed to cover benefits expenses, and profits on the basis of assumptions with respect to mortality, investment yield, withdrawals, and expenses. Premiums received in anticipation of future benefits and expenses provide investable funds. The investment of such premiums is recognized in the actuarial assumptions and in setting the premiums.

The following alternatives for the timing of recognition of premium revenues for insurance contracts were considered:

1. At the completion of the contract.
2. At sale or issuance of the contract.
3. During the life of the contract.

It was concluded that premium revenues should be recognized over the life of the contract in proportion to performance under the contract; accordingly, the first two alternatives were rejected. In general, the Committee agreed that if performance could be measured by one or more of the predominant functions or services, premium revenues should be recognized in direct proportion to such functions or services or by some method which approximates the measure of such functions or services.

The following functions and services were considered as bases for recognizing premium revenues:

1. *Premium collection*—recognition of premiums as revenues under traditional statutory practices.
2. *Costs incurred*—recognition of premium revenues in proportion to costs incurred (acquisition costs, benefits, and expenses).
3. *Invested funds*—recognition of premium revenues in relation to projected investment funds.
4. *Net amount at risk*—recognition of premium revenues in proportion to
   a. Gross amount at risk reduced for cash surrender values.
   b. Net amount at risk weighted for probability of death.
5. *Insurance in force*—recognition of premium revenues in proportion to the amount of insurance in force.

Life and Endowment Contracts

Whole-Life Contracts. After consideration of the aforementioned bases, it was concluded that there was no predominant function or service which provided a measure of the composite of all functions and services with respect to whole life contracts; therefore, a level recognition of premium revenue over the lives of individual contracts was considered an appropriate method of recognition of revenues in proportion to performance. This level recognition of premium revenues for whole-life contracts is satisfactorily accomplished by recognizing premiums as revenues when due. It should be noted, however, that such revenue

recognition does not necessarily result in a level profit recognition for the reasons discussed below.

It has been suggested that life insurance is a risk undertaking as opposed to a service function. The Committee concluded that the risk undertaking of a life insurance company consists of the pooling of individual risks under which the principal risk is that actual experience will be more adverse than the basic assumptions underlying premium rates. Such assumptions have been referred to as "most realistic," "best estimate," or "expected value" rates as to mortality, interest, withdrawal, and expense. In each accounting period, a company realizes actual experience with respect to these assumptions; in the process, a portion of the risk of adverse experience is removed. The process of assuming these risks and gradually being relieved from such risks represents an essential function or service performed by a life insurance company. The risks of adverse deviations from which the company is relieved during an accounting period, therefore, constitute an important measure of performance that should be recognized in determining the timing of the recognition of premium revenues and related costs. The inclusion of a provision for the risk of adverse deviations in arriving at reasonably conservative assumptions will cause some profits to emerge over the life of the contract as risks are eliminated in that

1. In the absence of adverse deviations in mortality, some profits will emerge in relation to the net amount at risk.

2. In the absence of adverse deviations in the investment yield, some profits will emerge in relation to invested funds or investment income.

3. In the absence of adverse deviations in withdrawal rates, some profits will emerge in relation to the excess of (a) the difference between the benefit reserve less unamortized acquisition expenses over (b) the related cash value.

4. In the absence of adverse deviations in estimated expenses, some profits will emerge in relation to expenses incurred.

5. Any profit in the premium in excess of provisions for adverse deviation will emerge in relation to premium revenues. Profits emerging as a level percentage of premiums give recognition to the importance of the sales effort as a source of profit. Margins allocated to this function, however, must not be at

the expense of providing for the risk of adverse deviations in the mortality, investment yield, withdrawal, and expense assumptions.

Limited Payment Contracts (Other Than Term Contracts). As in the case of whole life contracts, revenues should be recognized in relation to performance under the contract. The level of performance under limited payment contracts is significantly greater during the premium-paying period than after such period, since all the sale and conservation services necessary to establish and retain the pooling of individual risks, many of the investment services, and other services, such as revisions of coverage, are generally greater during the shorter premium-paying period. If, after providing for mortality, withdrawals, expenses (including higher maintenance expenses and amortization of acquisition costs during the premium-paying period), and the risk of adverse deviations (all based on assumed investment yield), there is any remaining gross premium in excess of the valuation premium, it is properly recognized over the premium-paying period in recognition of the higher level of services and functions performed during that period. Because of the provision for risk of adverse deviation from estimates of mortality, withdrawals, investment yield, and expenses over the life of the contract, this method should provide operating results that are both reasonable and conservative.

Term Contracts

A wide variety of term insurance contracts are issued. The clearly predominant service provided by many such term contracts is protection. Examples of term contracts where the predominant service is protection, include credit life insurance and other types of single or limited payment contracts of a relatively short duration. Gross premium revenues on such contracts should be recognized in proportion to the amounts of insurance in force. Expressed otherwise, written premiums should be recognized as earned during each year that a policy is in force in proportion to the ratio of the amount of insurance in force each year to the total of the annual amounts in force over the life of the policy.

In instances where premiums are collected throughout the life of the term contract and where the contract is of sufficient duration as to make it unclear as to the relative significance of the

protection service as opposed to the sales, collection, investment and conservation services necessary to establish and retain the pooling of individual risks, it may be appropriate to recognize premium revenues in the same manner as previously discussed for whole-life insurance contracts. However, the risks of adverse deviation with respect to the mortality and withdrawal assumptions are more significant than is the case with whole-life contracts.

Annuity Contracts

The reasoning underlying the accounting described for recognition of premium revenue from whole-life and limited payment life insurance contracts also applies to annuity contracts; therefore, annuity considerations should be recognized as revenue when due.

Accident and Health Contracts (Health Insurance)

Accident and health contracts generally fall into three categories: (1) individual, (2) group, and (3) credit.

Key features of these contracts are as follows:

1. Individual Accident and Health
   a. Renewable at the option of the company (also referred to as cancellable)—premiums may be step-rate or level; but, for contracts which are expected to be renewed, rates are adjustable.
   b. Collectively renewable—similar to (a) above but the company cannot cancel individual policies without cancelling all policies in the particular group or all like policies within a state.
   c. Guaranteed renewable—renewable at the option of the insured for a specified period; premium rates are adjustable, typically only for all like policies within a state.
   d. Noncancellable—same as guaranteed renewable except premium rate is guaranteed.
2. Group Accident and Health
   Usually annual renewable term although companies may guarantee rates for two or three years; usually cannot be cancelled unless participation requirements are not met; experience rating provisions are common.

3. Credit Accident and Health (Group and Individual)
   a. Single premium—term of the contract ranges from several months to several years. Maximum premium rates are stipulated by the states.
   b. Monthly outstanding balance—similar to regular Group Accident and Health.

The accounting for accident and health insurance policies, which are expected to be in force for a reasonable period of time and for which elements of expense or benefit costs are not level, should follow the same principle of accounting as followed for whole-life insurance. Accordingly, premium revenues should be recognized over the premium-paying period. For other kinds of health insurance, gross premiums should be recognized as revenues on a pro rata basis over the period covered by the premium except in those cases of credit accident and health where the coverage decreases by passage of time. For the latter type contracts, gross premiums should be recognized as revenues over the stated period of the contract in reasonable relationship to the anticipated claims.

RECOGNITION OF COSTS

Having determined the manner in which premium revenue is to be recognized, it is necessary to consider the manner in which costs (benefits and expenses) should be associated with premium revenue. The association is dependent upon the assumptions and methods used in accounting for annual costs.

Life Insurance Other Than Short Duration Term Contracts

Annual charges for costs in conformity with generally accepted accounting principles should be determined using methods which include assumptions for interest, mortality, withdrawals, expenses, and other benefits. The cost of acquiring new business should be deferred and other non-level costs should be provided for in order to charge operations in proportion to premium revenue. The assumptions used, including provision for the risk of adverse deviation, must be reasonably conservative.

The basic assumptions and methods and considerations related thereto are discussed below.

Acquisition Expenses. Regulatory accounting practices require that commissions and other expenses in connection with acquiring new business be charged against income as incurred. In

many instances, commissions and other acquisition expenses will exceed related premiums during the initial year that policies are in force. In a period of increasing production, the results of operations are depressed because acquisition expenses are charged against income currently, whereas related premiums will be recognized as income in later years. Conversely, in a period of decreasing production, the results of operations are benefited by premiums being taken into income, whereas related acquisition expenses were charged against income in prior periods. Accordingly, acquisition expenses should be deferred and charged against income in proportion to premium revenues recognized. Reference is made to Appendix B for a discussion of the considerations involved in the method to be used for amortizing acquisition costs.

Only those acquisition expenses which both vary with, and are primarily related to, the production of new business should be deferred. These should include renewal commissions based on a descending commission scale even though such expenses are incurred subsequent to issue. The inclusion of any indirect expenses in acquisition expenses requires judgment on the part of both the company and the auditor with overriding considerations being those of reasonable conservatism, consistency, and recoverability.

Generally speaking, there are two broad types of acquisition expenses. The first is related to the actual sale of insurance, for example, commissions. The second is related to the processing of business submitted by agents and the setting up of the necessary records.

In some companies virtually all "sales" expense is composed of compensation paid to agents. Such compensation relates directly to the amount of business produced by an agent. In other companies considerably less compensation will be paid to agents; however, additional sums will be paid to salaried employees, such as to branch office managers and employees or to field representatives who call on and assist the agents. There are also companies that do not sell through agents. Some companies employ a salaried sales force. Other companies operate on the mail-order plan and, in order to acquire business, these companies incur costs for brochure design and printing, postage, advertising, and other direct solicitation expenses. Regardless of the method used by a particular company to sell insurance, an acquisition expense should

be deferred only if the expense both varies with and is primarily related to the production of new business.

Issue, as opposed to sales, expenses are generally incurred in the home office of a company. In some companies, issue functions are partly performed in regional or branch offices. Issue costs which may be deferred are those expenses of the underwriting and policy issue departments which are primarily related to and vary with new business.

After determining whether an acquisition expense is to be deferred, it is usually necessary to allocate such expenses by line of business and by type of business (e.g. permanent and term) or by some other classification in order to associate them with the related premium revenue. These resulting factors for expenses should be measured against the expense assumptions used in setting premiums as a test of the reasonableness of the allocations.

Actual acquisition expenses, as distinguished from those assumed, should be used in the calculations as long as it can be shown that the gross premiums charged are sufficient to cover the actual expense. However, as a practical matter, most actuarial techniques require the use of estimates to calculate the amounts to be deferred. Such estimates are made before the costs are actually incurred. As in the case of variances from standard costs in other businesses, it may not be necessary to adjust such estimates to actual if they do not vary significantly from actual acquisition expenses.

Policy benefits and unrecovered acquisition costs may be accounted for by means of a single valuation reserve using factors expressed as amounts per thousand dollars of insurance in force. Such valuation represents the present value of all benefits and expenses related to policies in force reduced by the present value of that portion of gross premiums necessary to cover such benefits and expenses. Many assert that this single valuation reserve is also the most appropriate basis for financial statement presentation. Those who hold this view believe the interdependent relationship between benefits and expenses related to policies in force and the premiums expected on such policies require the net valuation reserve to be presented as a single amount in the balance sheet.

Policy benefits and unrecovered acquisition costs may also be accounted for separately. Many assert that such separate ac-

counting is also the most appropriate basis for financial statement presentation. Those who hold this view believe that there is a significant difference in the nature of acquisition expenses already incurred, which must be recovered from the expense portion of future premiums, and the liability representing the benefit portion of premiums collected, which are being held to meet future benefits. They believe that this difference requires separate presentation of such amounts in the balance sheet.

Each method accomplishes a reasonable association of costs with related revenues and should produce the same net income and stockholders' equity.

The deferral and amortization of acquisition costs represents a significant change in accounting practices for life insurance companies. Such deferral and amortization will generally represent a substantial portion of the difference between stockholders' equity and net income presented in conformity with generally accepted accounting principles and such amounts presented in accordance with regulatory practices. The magnitude of deferred acquisition costs and their effect on reported earnings will be of significant interest to the users of life insurance company financial statements. In light of these facts, the Committee has concluded that, because of the magnitude of such amounts, complete disclosure requires their separate presentation and that, because of their nature, fair presentation requires classification of unamortized acquisition costs as a deferred charge.

Other Expenses. If an expenditure has substantial future utility, and is clearly associated with and recoverable from future revenue, it may be considered for separate deferral in line with practices followed in other industries. An example of such an expenditure might be computer systems costs. If separately deferred, the expense should be amortized in a systematic and rational manner.

Non-level expenses, such as termination or settlement expenses, and expenses after the premium-paying period must be provided during the premium-paying period.

A portion of a life insurance company's expenses, such as policy maintenance and general overhead, are not associated directly with acquiring new business nor are they appropriate for separate deferral. As in the case of other business enterprises, such expenses should be charged to operations in the period in-

curred. Therefore, level renewal expenses in the premium-paying period do not require a reserve to be provided, but the expense portion of the gross premium must be adequate to cover such expenses as well as deferred costs. In addition, all renewal expense assumptions should take into account the possible effect of inflation on these expenses.

Interest (Return on Funds Invested). The rate of interest used in an actuarial valuation is an expression of a composite yield rate assumed on the funds invested or to be invested to provide for the future benefits and expenses. Since in most instances the investments include equity securities and real estate as well as debt securities, the yield rate includes dividends, rental income and interest. Such yield rate should be net of investment expenses.

Actual yields will tend to significantly influence the interest assumption. The influence of actual yields on the interest assumptions will usually be reflected more frequently and more currently in the rates charged for insurance than is the case for the statutory maximum interest limitation, used for computing statutory reserves. Statutory interest assumptions are frequently lower than actual or expected yields. The use of such lower interest assumptions tends to defer the recognition of income. Over the lives of any specified group of policies, the total income earned is the same regardless of the interest assumption used for accounting purposes. However, the annual incidence of income recognition will vary with the assumptions used. The use of a low reserve interest assumption initially places a greater portion of the gross premium in the reserve annually than does the use of a higher assumption. Thus, the use of low reserve interest assumptions tends to reduce the amount of income that might otherwise be reported in the early policy years, while income in later policy years tends to be benefitted when high reserves are released upon death and surrender.

To the extent that the statutory interest assumptions differ significantly from the average yield rate that can be expected on the funds invested or to be invested, more realistic assumptions should be considered. The selection of such an interest assumption is a subjective judgment which must be made by the company in light of the long term nature of life insurance, the contractual obligations under life insurance policies, and the inherent inability to forecast the future with certainty.

The interest assumption for each block of new issues should

not be inconsistent with such factors as actual yields, trends in yields, portfolio mix and maturities, and a company's overall investment experience generally. Since life insurance involves long-term obligations and investment risks, the assumed interest rate should include provision for the risk of adverse deviation from such estimates. Generally, the interest assumption to be used in computing reserves in conformity with generally accepted accounting principles should be based on the estimate of future interest expected at the time that the policies are issued.

To the extent that subsequent yields exceed the interest rate assumed in establishing policy reserves, such excess interest should be reported as income as it is earned. Periodically adjusting the reserve interest assumptions for in-force business to reflect changed conditions prospectively is not considered appropriate since the inherent fluctuations in investment yields make it impracticable to determine the proper timing and the extent to which such adjustments should be made.

Mortality. Minimum legal standards for statutory reserves are based on mortality tables prescribed by the various states as recommended by the National Association of Insurance Commissioners. At present, the minimum standard for reserves on ordinary issues is the Commissioner's 1958 Standard Ordinary Table. Under regulatory accounting practices, no change can be made in the reserves for existing insurance in force which would cause the reserves to be less than the minimum standards in effect when the policies were issued.

The mortality assumption to be used in determining annual reserve additions in conformity with generally accepted accounting principles should be based on realistic estimates of expected mortality. As in the case of other estimates, provision for adverse deviations should be included. For any blocks of business which are subject to little or no underwriting selection, the use of ultimate-only or aggregate mortality tables will be appropriate. Where there is adequate medical underwriting, a select table should be used.

Withdrawals. Under regulatory accounting practices, no specific provision for the liability for withdrawals (terminations for reasons other than death or maturity) is required because cash sur-

render values or other nonforfeiture benefits on an individual policy basis rarely exceed statutory reserves.

Reserves provided on the basis of reasonably conservative assumptions as to interest and mortality may be less than expected nonforfeiture benefits so that a provision should be made for anticipated nonforfeiture benefits. In addition, withdrawals affect anticipated premiums and death benefits; therefore, the reserve computations should include appropriate provision for withdrawals, using anticipated withdrawal rates and contractual nonforfeiture benefits. An assumption for withdrawals is necessary even for term insurance policies which contain no withdrawal benefits, because of the effect of withdrawals on anticipated premiums and death benefits.

The present value of expected nonforfeiture benefits will usually be less than the aggregate cash values of all policies outstanding. Reserves determined in conformity with generally accepted accounting principles may be less than aggregate cash value, since, on a going concern basis, it is unrealistic to assume that all policies will be surrendered for cash.

Withdrawal rates used in computing reserves in conformity with generally accepted accounting principles should vary by plan, age, mode of premium payment, duration, and other factors. If composite rates are used, they should be representative of the company's actual mix of business.

As in the case of interest and mortality estimates, provision for the risk of adverse deviation from such estimates should be included.

Policy Dividends. Regulatory accounting practices for dividends on individual participating policies generally require a provision for dividends expected to be paid over the annual period subsequent to the date of the financial statements. Because of the impact of high initial policy acquisition costs, many companies issuing participating policies do not provide for or declare any dividends until two full annual premiums have been collected. For such companies there is no charge in the financial statements for a dividend provision in the first year that a participating policy is in force. Furthermore, undistributed earnings on participating business are included in unassigned surplus without regard to the fact that all such earnings may not inure to the benefit of the shareholders.

To determine the appropriate accounting in conformity with generally accepted accounting principles for participating business, it is necessary to consider any restrictions on the amount of earnings of participating policies which can inure to the benefit of shareholders. Such restrictions may be imposed by law, charter, or contract or they may be self-imposed as demonstrated by company policy or practice.

For those companies for which there are no earnings restrictions and who use dividend scales that may be unrelated to actual earnings, the specified policy dividends (based upon dividends anticipated or intended in determining gross premiums or as shown by published dividend projections at the date policies are issued) should be provided for ratably over the premium-paying period. The specified dividend may be considered as a planned contractual benefit in computing reserves. However, it may be necessary to identify the amount of such dividends in order to calculate deferred income taxes in those cases where there is a question as to whether or not the dividend provision in the reserves, together with dividends declared or paid, may exceed the amount of dividends otherwise deductible for federal income tax purposes in the "with-and-without" calculations described in Appendix C.

For those companies for which there are limitations on the amount of earnings which may inure to stockholders, the policyholders' share of earnings on such business which cannot be expected to inure to stockholders, should be excluded from stockholders' equity by a charge to operations and a credit to an appropriate liability account in a manner similar to the accounting for earnings applicable to minority interests. Dividends declared or paid should be charged to the liability account. Dividends declared or paid on such business, in excess of the liability account, should be charged to operations.

In establishing provisions for policyholders' share of earnings, consideration must be given to whether earnings applicable to policyholders and to stockholders are determined based on earnings or whether they are determined on a basis unrelated to earnings. In those instances where earnings applicable to policyholders and stockholders are determined based on earnings before provision for policyholders' share, adjustments to conform to generally accepted accounting principles create

timing differences between the inclusion of items in income and expense in adjusted financial statements and statutory statements. For the purpose of computing a provision for the policyholders' share of earnings, these timing differences should be considered in the same manner as timing differences between financial statements and tax returns are considered in calculating provisions for deferred income taxes. For example, a company, either by law or by intent, may determine that 90% of earnings on participating policies must inure to the benefit of participating policyholders. If earnings before dividends on its participating business, determined in conformity with generally accepted accounting principles, are $1 million, provision should be made for policyholders' share of earnings by a charge to operations for $900,000 (90% of $1 million). Actual dividends should be treated as previously described.

A second example relates to the legal restriction which limits the amount which may inure each year to stockholders from certain participating business to the greater of (1) 10% of the statutory earnings before policyholder dividends or (2) fifty-cents-per-thousand of participating life insurance in force.

For a company whose statutory earnings on participating business is subject to the 10% limitation and which is expected to continue to be in that situation, timing differences and their reversal will affect policyholders' and stockholders' share of participating earnings. For a company whose statutory earnings on participating business is subject to the fifty-cents-per-thousand limitation, and which is expected to continue to be in that situation, timing differences and their reversals will not affect the amount of earnings which can inure to stockholders. In the former case, a provision for policyholders' share of participating earnings should be made by a charge to operations based on 90% of reported predividend earnings. In the latter case, a provision should be made by a charge to operations for all reported predividend income in excess of fifty-cents-per-thousand.

Financial statements prepared in conformity with generally accepted accounting principles may reflect predividend income which would produce an apparent basis of calculation of policyholders' share of participating earnings that differs from the basis used in statutory statements. Such a change in basis of calculation should only be recognized if circumstances indicate that the

timing differences which create the change in basis are likely to produce the same results for statutory purposes when such timing differences reverse.

A third example relates to stock companies which issue participating policies that are substantially similar to participating policies of mutual companies in that all, or substantially all, of the earnings on such policies inure to the benefit of policyholders. As in the other examples, earnings which cannot inure to stockholders should be excluded from stockholders' equity by a charge to operations and a credit to a liability account.

It should be noted that for participating business for which all, or substantially all, of the profits inure to policyholders or for which amounts that may inure to stockholders are limited to fifty-cents-per-thousand, adjustments to conform to generally accepted accounting principles will not affect net income or stockholders' equity. However, they will affect individual items within the financial statements. The auditor must determine whether the adjustments to individual items within the financial statements are necessary for a fair presentation of financial position and results of operations.

Other Benefits. Other guaranteed benefits, such as coupons, annual endowments and conversion privileges under term insurance contracts should also be provided for ratably, as opposed to being recognized only as such benefits become payable or mature.

Short Duration Term Life Insurance Contracts

Where gross premium revenues for short duration term life insurance contracts are recognized in proportion to the amounts of insurance in force, acquisition costs should be amortized in proportion to the amount of premium revenue recognized in each accounting period. Death and other benefits should be recognized in the period incurred, unless future premium revenues are not expected to be sufficient to cover such benefits and to recover unamortized acquisition costs. In such case, the resulting anticipated future losses should be recognized in the period when such losses become apparent. (See "Loss Recognition" on page 86.)

Alternatively, companies may establish benefit reserves in ac-

cordance with generally accepted accounting principles and defer sufficient premium revenues so that the aggregate liability approximates the amount of premium revenues which would be deferred as a result of application of the method set forth under "Recognition of Premium Revenues—Term Contracts" on page 69. In either case, acquisition costs should be deferred and amortized as described above.

Annuity Contracts

Immediate Annuities. A reserve for future annuity payments and expenses should be provided in an amount approximating the consideration less acquisition costs. Since all of the consideration is invested immediately at a known rate of interest when the reserve is set up and the flow of investment cash can be matched very closely to the flow of benefits, little provision for adverse deviation in investment results is necessary. Consequently, an interest rate based on the new money rate of the company in the year of issue may frequently be appropriate. The mortality assumption in annuity reserves involves the most significant risk of adverse deviation. It should be recognized that conservatism in providing reserves for annuity benefits means, in the case of the mortality assumption, a lower assumed death rate, since ordinarily the annuitant is paid an income throughout his lifetime and the effect of improved mortality is to diminish or, in some cases, eliminate annuity profits. Provision should be made for future expenses and deferred acquisition expenses should be amortized during the premium-paying period. Withdrawals under single premium immediate annuities are quite uncommon, the immediate benefit usually being limited to the present value of any guaranteed payments under the contract. As a result, withdrawals can generally be ignored in reserving for these plans.

Deferred Annuities. Deferred annuities, both the single premium and annual premium types, may be considered in two separate segments. The first segment is the accumulation or deferred period, during which there is relatively little risk to the company except failure to earn the guaranteed net interest rate. Net premiums are accumulated at interest, and much like a savings account, the cash surrender value may be withdrawn. The second segment is the pay-out or liquidation period, during

which annuity income payments are made to the annuitant and the mortality risks described above are introduced.

For both types of deferred contracts, reserves should be based on the accumulation of a maturity value equal to the estimated initial reserve required at the time the annuity becomes income-paying. This maturity value will generally be larger than the initial reserve for current immediate annuities, particularly in the case of annual premium deferred annuities. This result follows from the difference in the timing of the cash flow and consequent investment. Under single premium deferred annuities, all of the net cash is invested immediately. However, some of the funds are usually reinvested and therefore, some recognition of the possibility of adverse deviations in the investment income is appropriate. For annual premium contracts, the factors affecting the choice of an investment income assumption are similar to those for life insurance. Accordingly, the considerations for the provision for adverse deviation are similar to those for life insurance.

Individual Variable Annuities. Under an individual deferred variable annuity contract, the contractholder's payments, after deduction of specified sales and administrative charges, are used to purchase units of a separate investment account. The units may be surrendered for their current value, although there is often a small surrender charge, or be applied to purchase annuity income. The contractholder bears the investment risk while the insurer guarantees mortality and maximum expense charges. Deferred contracts provide a death benefit during the deferred period under which the beneficiary usually receives the greater of the sum of premiums paid or the value of total units to the credit of the account at time of the contractholder's death.

Immediate variable annuity contracts are similar to matured deferred variable annuity contracts. The contractholder bears the investment risk and his income varies with the unit value adjusted for the investment return assumed in determining his initial income. The insurer guarantees mortality and maximum expense charge.

Individual variable annuity contracts provide two sources of income to offset expenses; namely, deductions from considerations or sales charges and asset charges or management fees. Except for acquisition costs, expenses are fairly level and should

be matched with deductions from considerations. Sales charges will normally be used as the sole revenue base for matching acquisition costs. If they are insufficient to recover commissions and other acquisition costs, it may be appropriate to match certain acquisition costs against a portion of asset charges if there is sufficient margin in future asset charges. Any one-time fee charged at the time a contract is sold should be subtracted from related acquisition costs in determining the net amount to be amortized. These costs should be amortized over the period in which revenue is recognized.

Asset charges are intended to cover investment management, certain administrative expenses, mortality, and expense risks assumed by the insurer. Adjustments for matching purposes should not be required unless sales charges are insufficient to recover acquisition costs.

Accident and Health Contracts

Long-Term Contracts. Long-term individual and group accident and health contracts include noncancellable, collectively renewable, and guaranteed renewable contracts. Contracts which are renewable at the option of the company (cancellable contracts) may also be considered to be long-term when it can be demonstrated that such contracts are likely to remain in force for a reasonable period of time, similar to guaranteed renewable contracts.

Costs (including acquisition expenses) should be allocated to premiums recognized over the current and expected renewal period. Accordingly, in addition to liabilities provided for incurred claims, reserves should be provided on the same principle as the reserves used for ordinary life insurance. Such reserves represent the present value of future costs less the present value of expected future valuation premiums, calculated using actuarial assumptions which, as for life insurance, make reasonable provision for the risks of adverse deviation. For guaranteed renewable, collectively renewable, and long-term cancellable contracts, estimates of future premiums should, in some cases, consider anticipated premium increases and their effect on lapses and anti-selection (the tendency for higher persistency of poor risks).

Short-Term Contracts. For accident and health contracts of a short duration, acquisition costs should be deferred and amortized in proportion to premiums recognized. Liabilities are required only for claims incurred, provided that there are no expected increases in the ratio of claims to premiums earned.

Assumptions and Estimates. Assumptions and estimates used in determining annual revenue and cost must properly reflect the unique characteristics of various types of accident and health coverage.

It is generally appropriate for companies to use the assumptions developed by the actuary. The auditor should expect the actuary to demonstrate the adequacy and appropriateness of the assumptions used in determining actuarial items.

In determining the reasonableness of the assumptions, the adequacy of the gross premium must be considered. The basic test of gross premium sufficiency is whether the benefit reserves plus the present value of expected future gross premiums is at least equal to the amount of unamortized acquisition costs plus the present value of future benefits and expenses. Any right to increase premiums and the right not to renew policies should be considered in this determination.

If a company has adequate and meaningful claim experience, it should use factors derived from such experience. Otherwise it would be appropriate to use recognized morbidity tables, adjusted for the effect of selection and variations in individual company underwriting practices.

Whereas the risk of adverse deviation with respect to interest may be most significant in a whole-life contract, the morbidity and lapse risks will likely be more significant in an accident and health contract. Anti-selection in renewal years or external trend factors, such as economic conditions and medical developments, may create higher rates of morbidity by policy duration than are provided in statutory tables or industry experience tables. The risk of anti-selection should be considered in the choice of morbidity assumptions.

Morbidity. Claim cost assumptions normally have a significant effect on the level of reserves. The claim cost assumptions used in the calculation of reserves should be based on realistic estimates of expected claim cost experience at the time premiums are

established, or revised, or policies are issued. Consideration should be given to the level and incidence of claims for various types of coverage (e.g., noncancellable, guaranteed renewable, cancellable) and for such other factors as occupational class, waiting period, sex, age, and benefit period. Where company experience is unavailable or inadequate, an appropriate basis for claim cost assumptions would be industry experience adjusted for expected experience for a specific coverage.

Lapse Rates (Withdrawals). Lapse rates will have a material effect on the level of reserves. The guidelines mentioned previously should be considered in establishing lapse rate assumptions for individual and group accident and health insurance. Since lapse experience may vary sharply between types of contracts, the mix of business must be considered. It should be noted that for coverages which have increasing claim costs, it is not conservative to assume high lapse rates in renewal years.

Interest. As in the case of life insurance, where the effect of adjusting interest assumptions to a more appropriate rate would have a material effect on the financial statements, such an adjustment should be made. (See page 75, "Interest (Return on Funds Invested).")

Retrospective Commission or Experience Refund Arrangements

In those cases where retrospective commission or experience refund arrangements exist, care should be exercised to see that profits in any period do not include any amounts that are expected to be paid to the agent or other party in the form of experience refunds or additional commissions. A separate liability, based on experience, should be provided for such amounts.

Summary

In determining the provisions for risks of adverse deviation, it will be necessary to consider the individual assumptions; however, the provisions must be reasonable in relation to the total valuation premium.[2] Conservatism in determining such

[2] The valuation premium as used here represents that portion of the annual gross premiums required to provide for all benefits and expenses.

provisions should also be considered in relation to the effect of the provision on recognition of profit. Conservatism with respect to individual assumptions will not necessarily result in conservative recognition of profit. For example, a conservative provision for mortality could result in deferral of profit on ordinary whole-life contracts but could result in acceleration of profits on endowment contracts and on decreasing term contracts. In addition, because of the interrelationship of assumptions, conservatism with respect to one assumption may have the opposite effect on the results produced by other assumptions.

In determining the reasonableness of the assumptions, either individually or as composite factors, the adequacy of the gross premium must be considered. If the valuation premium exceeds the gross premium, a loss is indicated. Such loss should be recognized currently as discussed in the section "Loss Recognition."

In order to use a valuation premium less than the gross premium, the company must demonstrate the reasonableness of the assumptions used based on historical results, current operations, trends, and all other necessary factors to be considered in such judgments. Therefore, the valuation premium based on the assumptions to be used for a block of business should be tested in comparison to the gross premium.

A company should not arbitrarily use the gross premium as the valuation premium if its demonstrated experience and future outlook indicates that such practice is unduly conservative. For companies with narrow profit margins or companies with little experience, however, the use of the gross premium as the valuation premium may be most appropriate.

LOSS RECOGNITION

It is anticipated that the original assumptions will continue to be used ("locked-in") during the period in which reserves are accumulated so long as reserves are maintained at a level sufficient to provide for future benefits and expenses. This approach results in variances from original estimates being recognized in the accounting periods in which such variances occur.

It is possible that actual experience with respect to expenses, interest, mortality, morbidity, and withdrawals may be such as to indicate that accumulated reserves, together with the present

value of future gross premiums, will not be sufficient (a) to cover the present value of future benefits and settlement and maintenance expenses related to the block of business and (b) to recover the unamortized portion of deferred acquisition expenses. The computation of such deficiency would take the following form:

Estimated gross premium reserve at valuation date:	
Present value of future payments for benefits and related settlement and maintenance expenses, computed using revised assumptions based on actual and anticipated experience	$ xx
Less present value of future gross premiums, computed using revised assumptions based on actual and anticipated experience	xx
Gross premium reserve	xx
Less reserve at valuation date, reduced by deferred acquisition expenses	xx
Reserve deficiency	$(xx)

This deficiency represents a loss which, in conformity with generally accepted accounting principles, should be recognized immediately by a charge to earnings to increase reserves and/or reduce deferred acquisition expense. Future annual reserve additions should be based on the revised assumptions. No charge should be made to record an indicated loss currently which will result in creating an apparent profit in the future. Gross premium reserves should be computed periodically for comparison with the actual reserves, and particularly when the company has experienced or anticipates adverse deviations from original assumptions that could materially affect the reserves.

While the computation can be made only by individual blocks of business, a provision for reserve deficiency may be required only if the aggregate reserves on an entire line of business are deficient. In some instances, the reserves on a particular line of business may not be deficient in the aggregate, but circumstances may be such that profits will be recognized in early years, and losses in later years. In such situations, appropriate adjustments should be made to reserves to eliminate the recognition of losses in later years.

Adjustments should always be made at a time losses first become apparent.

DEFERRED INCOME TAXES

Life insurance companies are not required to provide for deferred income taxes under regulatory accounting practices. Life insurance companies presenting financial statements in conformity with generally accepted accounting principles, however, must follow Accounting Principles Board Opinions Nos. 11, 23, and 24.

Life insurance companies are taxed under provisions of the Life Insurance Company Income Tax Act of 1959. The Act contemplated taxation of total income, but the computation of tax is complex because of the manner in which total income is segmented between taxable investment income, taxable gain from operations, and taxable policyholders' surplus (gain from operations previously excluded from tax) and the inter-relationship of these elements. Further details concerning life insurance taxation and methods of computing deferred income taxes are discussed in Appendix C.

VALUATION OF INVESTMENTS AND RECOGNITION OF REALIZED AND UNREALIZED GAINS (LOSSES) THEREON

Under regulatory accounting practices, investments in common stocks are carried at quoted market values, preferred stocks are generally carried at cost and bonds at amortized cost. Changes in the carrying values of common stocks representing unrealized appreciation or depreciation and realized gains or losses are charged or credited to unassigned surplus.

Except in the cases of securities brokers and dealers and investment companies, carrying bonds at amortized cost has been considered a generally accepted practice. Proper accounting for equity securities has been considered at length by the AICPA Insurance Accounting and Auditing Committee, by the Accounting Principles Board, and by other interested groups. However, no conclusions have been reached.

At the present time, most industrial and commercial companies account for investments in equity securities classified as current assets at the lower of cost or market. Gains and losses from the disposition of such assets and losses from writing down investments to market have been included in the income statements of such companies. Insurance companies, securities brokers and dealers and investment companies generally use special methods of accounting for investments in equity securities. With the ex-

ception of preferred stocks owned by life insurance companies, these methods account for equity securities in the balance sheet at market value. Gains or losses on disposition of such investments and changes in market values have generally been accounted for by one of the following methods:

1. Some fire and casualty insurance companies follow the statutory form and include realized gains and losses on investments in determining net income in annual reports to stockholders and report unrealized gains or losses as direct increases or decreases in a special stockholder's equity account.
2. Some fire and casualty insurance companies present realized and unrealized gains and losses on equity securities and realized gains and losses on bonds in a separate statement in a format similar to that presently set forth in the AICPA publication entitled *Audits of Fire and Casualty Insurance Companies.*
3. Most life insurance companies follow the statutory form and include realized and unrealized gains and losses on all investments in unassigned surplus.
4. Securities brokers and dealers generally include realized and unrealized gains or losses on all investments in income as proposed by the AICPA Committee on Stockbrokerage Accounting and Auditing in its proposed publication, *Audits of Brokers and Dealers in Securities.*
5. Investment companies present realized and unrealized gains and losses on all investments in a separate statement.
6. Some insurance companies that are subsidiaries of noninsurance companies have restated investments in equity securities from market to cost for purposes of consolidation and recognize in income the realized gains and losses on sales of securities.

Because of the variety of alternative practices, life insurance companies may follow any of the foregoing, except alternative (4), until such time as generally accepted accounting principles for investments are more clearly defined by an authoritative opinion of the Accounting Principles Board or its successor.

Regardless of the method followed, realized and unrealized gains or losses, together with related income taxes, should be prominently displayed in the financial statements. Unrealized investment gains, net of related income tax, should be shown as

a separate stockholders' equity account. When realized gains or losses are excluded from the income statement, the last item in that statement should be designated as "Income, excluding realized investment gains or losses."

INVESTMENTS IN SUBSIDIARIES

Under regulatory accounting practices, life insurance companies are not permitted to consolidate subsidiaries. For regulatory reporting purposes, investments in subsidiaries are required to be valued using one of the following bases prescribed in the valuation manual published by the NAIC Subcommittee on Valuation of Securities:

1. The value of only such assets as would constitute lawful investments (admitted assets) for the insurer.
2. The net worth determined in conformity with generally accepted accounting principles if the financial statements of the subsidiary have been audited by an independent certified public accountant.
3. Book value as defined in the manual.
4. Cost adjusted for subsequent operating results determined in conformity with generally accepted accounting principles.
5. Market value of the common stock of the subsidiaries if such stock is listed on a national securities exchange.
6. Any other value which the company can substantiate to the satisfaction of the staff of the Subcommittee as being reasonable.

On whichever basis the investment is valued, the change in value each year is charged or credited directly to surplus as part of the capital gains and losses on investments. Accordingly, the income of subsidiaries is included in the parent's investment income only to the extent that dividends have been received.

For life insurance companies preparing financial statements in conformity with generally accepted accounting principles, investments in subsidiaries should be accounted for as purchases or poolings of interest in accordance with the provisions of Accounting Principles Board Opinion No. 16 and any cost in excess of net assets arising in purchase transactions should be accounted for in accordance with the provisions of APB Opinion No. 17.

For life insurance companies or life insurance holding compa-

nies whose subsidiaries consist of other life insurance companies and/or companies engaged in diverse financial activities, consolidated financial statements may be more meaningful than separate financial statements. However, consideration should be given to the presentation of separate financial statements of significant subsidiaries or operating groups. The presentation of financial statements for such companies reporting under the requirements of the Securities and Exchange Commission are set forth in Rule 4-07 of Regulation S-X. Where more than one financial activity is involved, separate statements for each significant financial subsidiary or each significant group of financial subsidiaries will be required to be presented.

The publication of consolidated statements may require approval of insurance regulatory authorities. In some cases, consolidation may be permitted only if separate statements are also presented.

Investments in unconsolidated subsidiaries, corporate joint ventures and controlled companies should be carried on the equity method prescribed by Accounting Principles Board Opinion No. 18.

The financial statements of all consolidated and unconsolidated subsidiaries should, of course, be presented in conformity with generally accepted accounting principles.

SPECIAL REINSURANCE AGREEMENTS

In addition to the usual reinsurance of excess risk described on page 22, some life insurance companies enter into special reinsurance agreements (usually of the coinsurance type) for the purpose of increasing their statutory surplus position to meet minimum capital and/or surplus requirements or to create enough taxable income to avoid the loss of an operating loss carryforward for tax purposes. To accomplish this, a company will seek another company with sufficient surplus or taxable income that is willing to assume a portion of the risk on a large block of business. Under regulatory accounting practices, such reinsurance agreements result in current income to the ceding company representing recovery of acquisition costs and an element of profit. The corresponding amount is treated as current expenses by the assuming company.

In order to account for such special reinsurance contracts in conformity with generally accepted accounting principles, it is

necessary to determine whether the agreement is constructed so as to shift the economic risk. Many reinsurance agreements of the coinsurance type entered into for "surplus relief" may in essence be financing arrangements rather than reinsurance contracts. Agreements of the financing type often result in little, if any, shift in economic risk. Such agreements usually call for the ceding company to agree that the contract will not be cancelled until such time as the assuming company has recovered all monies advanced, and may provide that in the event of cancellation, the ceding company must refund the amount of "surplus relief" together with interest. These agreements frequently call for a large provisional commission and accomplish the desired payback through subsequent adjustments of the provisional commission based on experience.

In presenting financial statements in conformity with generally accepted accounting principles, net credits arising from financing, type reinsurance agreements should be treated as a deferred credit or liability by the ceding company. In the adjusted financial statements of the assuming company, net charges arising from these agreements should be treated as deferred charges or receivables.

Under generally accepted accounting principles for special reinsurance agreements which are constructed so as to shift a significant part of the economic risk from one company to another, that portion of the proceeds from the transaction which represents recovery of acquisition costs should be charged with the applicable unamortized acquisition costs. If the ceding company has agreed to do all the servicing of the business without adequate compensation, a liability should be provided for estimated future servicing costs under the agreement. Any gain or loss, if material, should be appropriately disclosed. The net cost to the assuming company should be treated as acquisition expense to be amortized over the premium-paying period on a basis consistent with that used for acquisition expense of other business.

COMMITMENT FEES

Insurance companies sometimes obtain commitment fees in connection with the placement of mortgage loans and recognize such fees as income in the period the commitment is made. In presenting financial statements, in accordance with generally accepted accounting principles, commitment fees which exceed

normal charges for such commitments are considered as adjustments of the effective interest rates of permanent financing. After reduction of direct costs and related expenses, normal fees (those fees currently being charged for commitments within the industry) should be recognized as income over the commitment period and excess fees should be recognized as an adjustment to the effective interest rate over the period of the mortgage loans. However, in instances where the mortgage loan is not ultimately taken down, the unamortized commitment fee should be recognized as income at the time the company's obligation ceases.

STOCKHOLDERS' EQUITY

Stockholders' equity accounts are discussed on page 57, "Capital and Surplus." The equity accounts for a stock life insurance company are similar to those of other corporate enterprises.

In order to present life insurance company equity accounts in conformity with generally accepted accounting principles, it will be necessary to reclassify the regulatory accounts to show, as applicable, (1) capital stock (including disclosure of all pertinent data); (2) capital in excess of par value; (3) retained earnings, showing restricted and unrestricted amounts separately; and (4) unrealized investment gains or losses. Disclosure requirements related to statutory surplus and restrictions on retained earnings or stockholders' equity, as appropriate, are described on page 57, "Capital and Surplus" and on page 111, within the section titled "Disclosure Requirements."

MANDATORY SECURITIES VALUATION RESERVE (MSVR)

In most states, life insurance companies are required to establish, as a liability, a mandatory securities valuation reserve in accordance with a formula adopted by the National Association of Insurance Commissioners' (NAIC) Committee on Valuation of Securities. The reserve is established by a charge to unassigned surplus, and annual changes in the reserve balance are also charged or credited annually to unassigned surplus.

Under generally accepted accounting principles, valuation reserves for losses anticipated on assets such as receivables, inventories, and investments should be deducted from the assets to which they relate. There is a further requirement that such valuation allowances be provided by charges to earnings and that

when losses are realized, they will be charged to the reserves created for that purpose. The Mandatory Securities Valuation Reserve is not a valuation reserve, but is an appropriation of surplus which should be included in the equity section of the balance sheet.

NONADMITTED ASSETS

Certain assets designated as "nonadmitted assets" (principally furniture and equipment, agents' debit balances, and certain other classes of receivables) are eliminated from the statutory balance sheet by a charge to surplus. The treatment of furniture and fixtures varies in that they may be capitalized and depreciated by annual charges to income with the undepreciated balances charged against surplus for regulatory accounting purposes. Alternatively, furniture and fixtures may be charged to expense upon purchase. In presenting financial statements in conformity with generally accepted accounting principles, nonadmitted assets should be restored to the balance sheet where appropriate. Receivables, however, must be subjected to the usual review as to collectibility, and appropriate valuation reserves should be established by a charge to income.

Auditing Procedures

Auditing procedures applicable to accounts maintained in conformity with regulatory accounting practices are set forth in Part I following the description of each account described therein. The adoption of generally accepted accounting principles for financial reporting of life insurance companies requires additional auditing procedures, the most significant of which relate to reserves and acquisition expenses. These additional auditing procedures with respect to reserves and other accounts are set forth below. The discussion under reserves deals with acquisition expenses where such expenses are included as part of the reserving method. When acquisition costs are deferred and amortized separately, additional procedures will be required with respect to amortization of such costs. Such procedures would include those required to determine the appropriateness of the method followed and the accuracy of its application. They would not be significantly different from auditing procedures with respect to amortization of other deferred charges so as to require additional comment herein.

RESERVES

General

To determine whether adjusted reserves calculated in conformity with generally accepted accounting principles are fairly presented, the following basic audit procedures should be followed:

1. The inventory of policies in force should be reviewed and tested for completeness and accuracy.
2. The reasonableness of assumptions and propriety of the actuarial factors used in reserve calculations should be reviewed and tested.
3. The application of the actuarial factors to the inventory should be tested.

The principal change in auditing reserves calculated in conformity with generally accepted accounting principles as compared with auditing statutory reserves relates to the determination of the reasonableness of assumptions and the propriety of the actuarial factors.

If a complete inventory of policies in force is used in the reserve computation, the tests of such inventory for completeness and accuracy will be the same as those performed in the audit of the statutory reserves. If a model of the inventory is used to determine the adjusted reserves, the auditor should be satisfied as to the propriety of the model.

When using models, the derivative reserve factors for key plans are extended to other plans that can be properly placed in the same category. An appropriate model would include those plan and age groupings and durations required to make the model appropriately sensitive to material changes in the plan and age distribution. The auditor must at least be satisfied that the model effectively reproduces the statutory results as to insurance in force, gross premiums, expenses and reserves. In most cases, he will want to see the model tested under varying conditions to determine whether it is properly responsive.

Unlike statutory reserves for which the factors for many plans are published, 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. The auditor must be satisfied as to the following:

1. The reasonableness and appropriateness of the basic underlying assumptions entering into the calculations of the reserve factors, including the reasonableness of the provision in the factors for the risk of adverse deviation.

2. The appropriateness of the actuarial formulas.
3. The accuracy of the factors resulting from the application of the formulas to the assumptions.

Assumptions can be classified in terms of their applicability to the established company and to the new company. Each assumption must be determined individually even though such assumptions may be applied in the aggregate in the computation of adjusted reserve factors. Documentation of the individual assumptions will facilitate the measurement of variances from each of the assumptions in future years to determine whether reserve differences exist. Such measurement will probably be made by comparing revised valuation premiums with actual gross premiums. Should the revised valuation premiums exceed the actual gross premiums by a material amount, a loss should be recognized as described earlier in the chapter.

Utilization of Actuaries

The professional qualifications required of the independent auditor are those of a person with the education and experience to practice as such. They do not include those of a person trained for or qualified as an actuary. Although the independent auditor may be informed in a general manner about matters of an actuarial nature, he does not purport to act in the capacity of an actuary. Therefore, auditors will need the advice of a qualified actuary[1] in such matters.

The work done by the auditor necessitates close coordination and cooperation with consulting actuaries, company actuaries, or, possibly, insurance department actuaries. The auditor should utilize the expertise of an actuary in much the same manner as he uses the expertise of attorneys or those in other areas of specialization in forming a judgment in his own area of expertise, namely, expressing his opinion on the fairness with which overall financial position and results of operation are presented. The auditor is responsible for obtaining sufficient competent evidential matter as a basis for forming his opinion. The education and professional experience of the independent auditor and/or his

[1] Currently, not all jurisdictions specify qualifications for actuaries. Membership in the American Academy of Actuaries, a comprehensive organization of the profession in the United States, is generally considered to be acceptable evidence of professional qualifications.

staff will dictate the extent to which he must utilize the services of a qualified actuary in obtaining competent evidential matter and in forming an opinion. An auditor who is sufficiently experienced in auditing life insurance reserves may be able to form an opinion by working with the qualified actuary who was responsible for calculating the reserves, or with insurance department actuaries when they verify the reserves. In other cases, the auditor may need to utilize the services of a qualified consulting actuary to assist him in auditing life insurance reserves.

Normally, a company will not compute required reserves for individual life, noncancellable and guaranteed renewable accident and health policies or other benefits that require actuarial reserves on each individual policy, but will summarize insurance in force at statement date by policy plan, year of issue, and age at issue. The actuary works with these summaries in determining that appropriate reserve factors have been used according to the terms of the insurance policies and the actuarial assumptions made. He also determines the effect of changes in basis of reserve factors applied where the effects of such changes are reported as charges or credits to surplus in the annual statement filed with regulatory bodies. As it relates to statutory reporting, his responsibility is to see that such reserves are adequate and in accordance with statutory requirements.

Reserve assumptions used in computing reserves in conformity with generally accepted accounting principles will require the actuary to look at the reserving method from a different perspective. His judgment will extend to the reasonableness of the reserves, determined on a basis which is in conformity with generally accepted accounting principles, and the consistent application of factors used in calculating the reserves. Although an actuary has been involved in these determinations, perhaps even to the extent of testing clerical accuracy, it is incumbent upon the auditor to be satisfied that reserves are fairly stated on a consistent basis. To the extent that independent actuaries (i.e., outside experts) are utilized in the process of reviewing amounts established for reserves, the auditor should plan his work with the consulting actuary to insure a coordinated program to achieve the objectives of the audit. Such coordinated review should enable the auditor to restrict the extent of his testing of reserve factors, in-force records and clerical accuracy of listings from that which

would otherwise be required absent the utilization of the consulting actuary.

Actuaries are not practicing auditors; they are not specifically trained in auditing procedures, nor are they governed by generally accepted auditing standards. Therefore, there is no justification for the auditor to omit all audit procedures or to perform only token procedures as to the reserves reviewed by the consulting actuary unless the terms of the engagement contemplate a qualification or denial of opinion by the auditor.

The foregoing guidelines for using the assistance of qualified actuaries should also be applied to premiums deferred and uncollected, policyholders' dividends and other actuarially determined amounts, the auditing procedures for which are described elsewhere in this guide.

The auditor should obtain a written opinion from the qualified actuary who calculated the reserves or who verified the reserves, the same as he would obtain letters from counsel on legal matters and other representations from management on various matters.

If the auditor has any substantial doubt as to any assertion of material significance (such as the life reserves and the changes therein), he must refrain from expressing an opinion until he has obtained sufficient evidential matter to remove such substantive doubt, or he must express a qualified opinion or disclaimer of opinion.

Audit Guidelines for an Established Company

In his review of the reasonableness and appropriateness of the assumptions entering into the calculations of the reserve factors, the auditor will find the following guidelines helpful. However, he must remember that the factors will include provisions for the risk of adverse deviations that must be taken into account in determining the reasonableness of the factors.

Interest. For current issues, the company's current and historical portfolio yield, trends in such yield, new money rates, and cash flow projections for the particular mix of the investment portfolio should be considered in estimating expected yields. Some companies may use a level interest assumption, while other

companies may employ scaled down or graded interest assumptions since it is difficult to estimate yields so far into the future. Any anticipated effect of economic conditions on the interest assumption should be similarly considered for expense assumptions.

For policies issued in previous years, gross premiums or asset share studies, if available, should be reviewed as a part of the test of the reasonableness of interest rates and yields experienced at the time the policies were issued.

In testing the interest assumption, the adequacy of the gross premium should be considered, as discussed previously. As a test of the interest assumption, the auditor might consider the average new money rate (the net investment yield attributable to new investments made each year) or the average portfolio yield rate for some reasonable period of time, such as 20 years.

For companies not having sufficient experience, the auditor could substitute the average rate on long-term U.S. Government bonds, or some similar high-quality investment, for its new money rate and the industry yield for the portfolio rate for each year for which the company did not have any experience during the period being considered.

While it is not possible to establish a precise limitation or a guideline that will apply in all circumstances, the auditor should be satisfied that the rate used is reasonable and conservative. The auditor has an additional burden when the rate used varies significantly from historic rates measured as described above. The auditor should consider the facts and circumstances and make a professional judgment as to the reasonableness and conservatism of the rate used.

Expenses. Unit costs per policy or per thousand should be developed, based on cost studies. Such studies should segregate acquisition costs from costs that are attributable to the maintenance of policies. The audit of such cost studies should be the same as would be conducted in auditing any cost system.

As discussed earlier in this chapter, these cost studies should also isolate development and other similar expenses so that a determination can be made as to whether any of such costs should properly be deferred. The deferral of development or similar expenses requires judgment on the part of both the company and the auditor with an overriding consideration as to

future benefit, consistency, amortization period, and the probability of recovery. (See page 86, "Loss Recognition.")

If data necessary to develop unit costs based on cost studies are not available for policies issued in previous years, it will be necessary to estimate acquisition costs. Data used in the gross premium determination or asset share studies at the time policies were issued could be used. In addition, data related to commissions may be available so that estimates will be limited to other acquisition costs. Renewal expense assumptions should recognize the possibility of inflation.

Mortality. The auditor should ascertain that the company properly considers its underwriting practices in its selection of assumed mortality rates.

For current issues, the company should use its own experience, if such experience is credible or, if appropriate, data from recently published tables.

For policies issued in previous years, the company's experience or published experience used in the gross premium calculations should be used, provided that subsequent gross premium calculations do not result in reserve deficiencies requiring adjustment.

Withdrawals. To determine the reasonableness of withdrawal assumptions used, the auditor should review historical lapse rates and recent data or studies of the company's termination rate experience. The auditor should also ascertain whether there have been significant changes in underwriting practices which might affect the validity of historical data.

Companies should use published withdrawal tables such as Linton or Moorhead only if the results produced by the use of such tables are comparable with the company's actual withdrawal experience.

Different types of business such as short-term endowment, life policies and long-term endowment, level-term, and other term contracts have different termination characteristics. In addition, non-annual mode business often experiences higher termination rates than annual mode business. Therefore, consideration should be given to the mix of business and the mode of premium payments in determining the reasonableness of withdrawal assumptions. In all cases, the auditor should request adequate documentation to support conclusions on the part of a company.

The auditor should also determine that the company's actual cash value scale is used in the reserve calculation.

Policy Dividends. The auditor should make tests to determine that the dividends provided are in accordance with such regulation, charter, contract, or published or intended dividend scales as are appropriate. He must be satisfied that net income and retained earnings are not being increased by participating policy earnings which will not be likely to become available or can never become available to shareholders. In the case of companies with no restrictions as to participating policy earnings, it will be necessary to determine that an appropriate provision is made for dividends where current dividends or expected future dividends vary significantly from the dividend scale anticipated when the policies were issued. (See page 86, "Loss Recognition.")

Audit Guidelines for a New Company

Because of the lack of reliable experience for a new company, the auditor will have difficulty in forming an opinion as to the reasonableness of assumptions to be used in calculating adjusted reserves and as to the related recoverability of acquisition costs to be deferred. In some instances, the auditor may use industry data or data for companies similar to that being audited as a test of the reasonableness of the assumptions and recoverability of costs. Such data should be used only as a test and should not be used as a substitute for professional judgment. In exercising his judgment about new companies, the auditor will probably need to be more conservative than he would be with an established company. If he cannot be satisfied as to the adequacy of reserves and recoverability of acquisition costs, he may feel compelled to qualify his opinion or to disclaim an opinion.

The auditor may be satisfied if the company uses very conservative provisions for adverse deviations, principally for interest and mortality, so as to make the valuation premium approximate the gross premium until the company has demonstrated consistent experience for a reasonable period of time. In such instances, the auditor will still need to review projections and be satisfied that the implicit factors for interest, expenses, mortality, withdrawals, dividends, and other benefits resulting from the use of gross premium as the valuation premium, are capable of being attained by the company.

In order for a new company to depart from regulatory practices or to use a valuation premium which is less than the gross premium, the auditor should consider each of the assumptions as described below. In considering these assumptions, the assistance of a qualified actuary should be utilized.

Expenses. As for all companies, only those acquisition expenses which are recoverable should be deferred and amortized. In a new company, additional conservatism may be required in testing recoverability of expenses to be deferred. For example, it may only be appropriate to defer the most directly variable expenses such as commissions and medical examination fees. In any event, the auditor should be satisfied that the company can retain a sufficient volume of business to recover such costs.

Interest. For companies having little or no investment experience, the auditor may find it helpful to compare the interest rate used by the company with benchmarks such as the current average industry yield rate or average rate on long-term U. S. Government bonds or similar high-quality investment for some reasonable period of time. In some instances, the auditor may be satisfied if the company uses the maximum rate permitted by the state in which the company is domiciled.

Mortality. The auditor may be satisfied with the use of an accepted published table if it is representative of the company's experience and underwriting practices. In some cases, the auditor may only be satisfied with the use of commissioner's tables or other more conservative tables.

Withdrawals. For a company with little experience, the auditor should review industry data or data for companies similar to the one being audited. He may be satisfied with the use of published tables if such tables are conservative and produce results which are not more favorable than industry experience or the company's experience to date.

OTHER ACCOUNTS

General

Auditing procedures with respect to investments, other than investments in subsidiaries, and mandatory securities valuation

reserves do not require any auditing procedures in addition to those described in Part I. Additional auditing procedures with respect to other accounts described in this section are set forth below.

Deferred Income Taxes

The initial procedure for auditing deferred income taxes for life insurance companies is to determine the existence and the amount of timing differences which enter into the determination of deferred income taxes. This procedure is complicated by the fact that the Life Insurance Company Income Tax Return does not include a reconciliation of income per books with income per tax return. Accordingly, auditors must reconcile income per the annual statement filed with the state and with any additional differences between the annual statement and financial statements presented in conformity with generally accepted accounting principles with income tax per the tax return.

When all timing differences have been identified, their proper inclusion in a with-and-without calculation must be verified, following the computational techniques described in Appendix C. All facts and circumstances should be reviewed and evaluated in those cases where it has been determined by the company that timing differences will not produce tax effects when they reverse.

Investments in Subsidiaries

The financial statements of consolidated subsidiaries should be subjected to the same auditing procedures as applied in other industries. Where material, such financial statements may require examination to the same extent as the parent company.

Auditing procedures with respect to corporate joint ventures and controlled companies should follow the requirements of Statement on Auditing Procedure No. 51.

Special Reinsurance Agreements

All reinsurance agreements should be examined as indicated in Part I. However, for companies reporting in conformity with generally accepted accounting principles, additional procedures are required to determine whether any of these reinsurance agree-

ments are of the type requiring special accounting treatment described under "Special Reinsurance Agreements" on page 91.

Commitment Fees

Additional auditing procedures are required with respect to commitment fees to determine whether normal fees are being recognized as income over the commitment period, and whether any such fees exceed normal fees (those fees currently being charged for commitments within the industry) which should be recognized as an adjustment to the effective interest rate over the period of the mortgage loan.

Stockholders' Equity

Stockholders' equity accounts must be examined to determine the proper classification of such accounts in conformity with generally accepted accounting principles. Such accounts should also be examined to determine whether they include transactions which should be reflected in net income to conform to generally accepted accounting principles and as to whether stock dividends have been properly accounted for.

Nonadmitted Assets

Nonadmitted receivables which are restored to the balance sheet must be subjected to the usual auditing procedures necessary to determine their existence and collectibility.

Furniture and fixtures should be subjected to the usual auditing procedures for additions and disposals and depreciation thereon.

Disclosure Requirements

Statement on Auditing Procedure No. 33 states that "the fairness of presentation of financial statements, apart from the relationship to generally accepted accounting principles, is dependent upon the adequacy of disclosures involving material matters." APB Opinion No. 22 also states that ". . . a description of all significant accounting policies of the reporting entity should be included as an integral part of the financial statements." This chapter deals only with those disclosures peculiar to life insurance company financial statements presented in conformity with generally accepted accounting principles. A description of matters requiring disclosure and the illustrative notes are presented below.

Recognition of Premium Revenue and Related Expenses

Disclosure of principles relating to the recognition of premium revenues and related expenses might be worded as follows:

> Premiums are reported as earned when due or, for short duration contracts, over the contract period. Benefits and expenses are associated with earned premiums so as to result in recognition of profits over the life of the contracts. This association is accomplished by means of the provision for liabilities for future benefits and the amortization of acquisition costs.

Deferred Acquisition Costs

Unamortized acquisition costs should be presented in the balance sheet as a deferred charge. The nature of the costs deferred, the method of amortizing such costs, and the amount of amortization charged to income for the period should be disclosed in a

note to the financial statements. An example of such a note for a company issuing principally life insurance contracts is set forth below.

> The costs (principally commissions) of acquiring new business, certain expenses of the policy issuance and underwriting department (such as medical examination and inspection report fees) and certain variable agency (field office) expenses all of which vary with, and are primarily related to, the production of new business have been deferred. These deferred acquisition costs are being amortized over the premium-paying period of the related policies in proportion to the ratio of the annual premium revenue to the total premium revenue anticipated. Such anticipated premium revenue was estimated using the same assumptions as were used for computing liabilities for future policy benefits. Amortization charged to income for the years ended December 31, 197X and 197X amounted to $xxxxx and $xxxxxx, respectively.

The note should be appropriately modified for those companies that issue a material amount of contracts other than life contracts.

Policy Liabilities

The methods employed and the assumptions used in calculating policy reserves should be disclosed in the financial statements along the following lines.

> Liabilities for future policy benefits have been computed by the net level premium method based upon estimated future investment yield, mortality and withdrawals. The composition of the policy liabilities and the more material assumptions pertinent thereto are presented below:

Ordinary Life Insurance in Force	Amount of Policy Liability	Years of Issue	Bases of Assumptions: Interest Rates	Mortality	Withdrawals
$	$	19—	X% or X% to Y%	Tables or Company's Experience	Tables or Company's Experience
$	$				

Similar information should be disclosed for annuities, accident and health insurance, or other material lines of business.

Participating Policies

The relative amount of participating business in force, the method of accounting for dividends and the amount thereof should be disclosed in a note similar to the following.

> Participating business approximates X% of the Company's ordinary life insurance in force.
>
> The amount of dividends to be paid is determined annually by the Board of Directors. Amounts allocable to participating policyholders are based on (legal requirements), (Company charter or other contractual obligation), (Company practice), or (published dividend projections or expected dividend scales).

Where amounts allocable to participating policyholders are based on earnings on such policies, the following additional disclosure is required.

> $xxx was allocated to participating policyholders representing approximately Y% of total earnings on participating policies for the year.

Stockholders' Equity

The auditor must be cognizant of statutory requirements for surplus and/or capital. The ability to meet statutory requirements and to avoid statutory impairment or insolvency is critical in connection with the fair presentation of the financial statements.

The significance (possible impairment and effect on ability to pay dividends to stockholders), as well as the amount of statutory surplus should be disclosed. Although stockholders' equity presented in conformity with generally accepted accounting principles may substantially exceed statutory capital and surplus, the amount which is restricted by statutory requirements should be disclosed. Examples of the application of this disclosure requirement follow.

Example 1

A company issuing nonparticipating policies is domiciled in a state which permits the payment of dividends out of total capital and surplus provided that minimum capital and surplus of

$250,000 each is maintained. Its balance sheet shows the following:

Capital stock		$ 750,000
Capital in excess of par value		500,000
Net unrealized investment gains (losses)		250,000
Retained earnings:		
Statutory unassigned surplus	$350,000	
Retained earnings in excess of statutory unassigned surplus	400,000	750,000
Total stockholders' equity		$2,250,000

Under these circumstances, there is no legal limit on the amount of retained earnings available for distribution to stockholders. Since the amount of statutory surplus can be determined from the information disclosed in the body of the financial statements, no further disclosure is required if there is no evidence of imminent impairment.

Example 2

Capital stock		$200,000
Capital in excess of par value		500,000
Net unrealized investment gains (losses)		50,000
Retained earnings:		
Statutory unassigned surplus (deficit)	($200,000)	
Retained earnings in excess of statutory unassigned surplus (deficit)	300,000	100,000
Total shareholders' equity (Note X)		$850,000

Assuming the same minimum capital and surplus requirement of $250,000 each as in Example 1, a restriction would exist in the above situation. The minimum statutory capital and surplus requirement amounts to $500,000, and since capital, surplus and unassigned surplus on a statutory basis is only $550,000, only $50,000 of total stockholders' equity (the amount by which capital and surplus determined in accordance with regulatory practices exceeds minimum capital and surplus) shown above is unrestricted. This fact should be disclosed along the following lines:

> Under applicable laws and regulations, the Company is required to maintain minimum capital and surplus, determined in accordance with regulatory accounting practices in the aggregate

amount of $500,000. Accordingly, only $50,000 of the total stockholders' equity is unrestricted.

If, in addition to requiring minimum capital and surplus of $250,000 each, state law prohibits the payment of dividends from any source other than statutory unassigned surplus, total stockholders' equity would be restricted in Example 2 above. In this situation, the disclosure required would be changed to read as follows:

> Under applicable laws and regulations, the Company is required to maintain minimum capital and surplus, determined in accordance with regulatory accounting practices, in the aggregate amount of $500,000 and may not pay dividends to stockholders in the absence of statutory unassigned surplus. Total stockholders' equity exceeds the minimum capital and surplus required by law by $50,000. However, until the statutory unassigned deficit ($200,000) is eliminated, no dividends may be paid to shareholders.

A similar restriction in Example 1 would restrict the amount of stockholders' equity available for dividends to $350,000 and disclosure similar to the above would be required.

In the foregoing examples, it was assumed that no participating business was involved. In the case of companies issuing participating policies, stockholders' equity determined in conformity with generally accepted accounting principles should exclude any undistributed participating earnings. However, the amount of statutory unassigned surplus could include such amounts, since there is generally no statutory requirement to establish a liability for undistributed participating earnings. The amount of undistributed participating earnings included in statutory unassigned surplus should be considered in determining the amount of retained earnings or total stockholders' equity not available to stockholders.

In addition to the requirements for disclosure, as in the case of any other business, the auditor must be satisfied that the values at which the assets are shown can be realized in the ordinary course of business. There may be situations, as in Example 2 above, in which a company's ability to continue to do business may be deteriorating toward the point of statutory capital impairment or insolvency. In addition, realization of asset values in the ordinary course of business may be dependent upon such future events as profitable operations or the injection of new capital.

In some instances, a company's financial statements prepared in conformity with generally accepted accounting principles may show stockholders' equity when its statutory surplus is below the minimum required by law (or where surplus impairment is likely or imminent). While there may be evidence that such condition is only temporary, the auditor must determine what action, if any, is intended by regulatory authorities. Disclosure of the relevant facts should be made in the financial statements. There may be circumstances where the possible effect of the uncertainties is such that the auditor would need to consider qualification of his opinion or possible disclaimer of opinion on the financial statements taken as a whole.

When financial statements are presented on the basis of generally accepted accounting principles, it would be desirable, and in some cases it may be necessary in order to meet regulatory requirements, to include a reconciliation of net income and stockholders' equity determined under generally accepted accounting principles, with net gain from operations and capital and surplus determined under regulatory accounting practices. The reconciliation, in the form of either a note or supplemental financial statements, would include descriptions of differences in the two methods. Examples of such reconciliations are shown in Appendix A. In addition, it would be desirable, and in some cases it may be necessary in order to meet regulatory requirements, to include a condensed statutory balance sheet in a note to the financial statements.

Federal Income Taxes

Life insurance companies are taxed under provisions of the Life Insurance Company Income Tax Act of 1959 (See Appendix C). Because of the peculiarities of this Act, certain matters of disclosure relative to accounting for income taxes should be considered. These include, but are not necessarily limited to, the following:

1. The basis upon which current and deferred income taxes have been provided.
2. Disclosures relating to "Policyholders' Surplus" as defined in the Internal Revenue Code and as prescribed by Accounting Principles Board Opinion No. 23.

3. That portion of retained earnings in excess of statutory unassigned surplus upon which no current or deferred federal income tax provisions have been made and the reasons therefor.
4. Unused operating loss carry-forwards (described as operations loss deductions in the Code) including amounts and dates of expiration.

Reinsurance

Material reinsurance transactions and their effects on the financial statements should be disclosed.

PART III

Auditors' Reports

Auditors' Reports

Types of Reports

Financial Statements in Conformity With Generally Accepted Accounting Principles. The insurance laws of some states contain varying degrees of prohibitions against the publication by insurance companies of financial statements based on accounting practices differing from those used in the preparation of the annual statement filed with the state. In many cases regulatory authorities require that financial statements be prepared on the same basis as used in the annual statement filed.

The independent auditor must follow the requirement of paragraph 38, Chapter 10 of Statement on Auditing Procedure No. 33 which includes the following statement which is applicable when financial statements of life insurance companies are presented in conformity with regulatory practices:

> . . . material variances from generally accepted accounting principles, and their effect should be dealt with in the independent auditor's report in the same manner followed for companies which are not regulated. Ordinarily, this will require either a qualified or adverse opinion on such statements. However, an adverse opinion may be accompanied by a piecemeal opinion on the unaffected items in the statements or on any supplementary data furnished which are fairly presented in conformity with generally accepted accounting principles.

Independent auditors' reports which might be used in these instances are illustrated below. Examples of supplementary data which might be used to reconcile income and surplus on a regulatory basis to net income and stockholders' equity as determined in accordance with generally accepted accounting principles are given in Appendix A. The suggested language and format should, of course, be adapted to the particular circumstances.

Where acceptable to the state regulatory authority, the preferable method of financial statement presentation to avoid the need for qualification of the auditor's report is to present the financial statements in accordance with generally accepted accounting principles. In such cases, the independent auditor should follow the standard short-form report described in SAP No. 50. If financial statements are presented on this basis, it is desirable, and in some cases it may be necessary in order to meet regulatory requirements, to include a reconciliation of net income and stockholders' equity determined under generally accepted accounting principles with net gain from operations and capital and surplus determined under regulatory accounting practices.

Effects of Variances From Generally Accepted Accounting Principles Disclosed in the Financial Statements, Notes, or Supplementary Data.

Qualified opinion—when the financial statements of a life insurance company are prepared in conformity with regulatory practices, with disclosure of the effects of the variances from generally accepted accounting principles which are sufficiently material to require a qualified opinion, the auditor's report might be worded as follows:

> We have examined the balance sheet of X Life Insurance Company at December 31, 19. ., and the related statements of operations and changes in surplus 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.
>
> The Company presents its financial statements in conformity with accounting practices prescribed or permitted by the Insurance Department of the State of .... The effects on the accompanying financial statements of the variances between

such practices and generally accepted accounting principles are described in Note 1.[1]

In our opinion, except for the effects of the matters referred to in the preceding paragraph, the accompanying financial statements present fairly the financial position of X Life Insurance Company at December 31, 19.., and the results of its operations and 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.

If a statement of changes in financial position on a statutory basis is not presented, such an omission should be dealt with in accordance with SAP No. 50.

Adverse opinion—when the financial statements of a life insurance company are prepared in conformity with regulatory practices, and when the effects of the variances from generally accepted accounting principles are so material that, in the independent auditor's judgment, a qualified opinion is not justified, an adverse opinion will be required. Such an adverse opinion will usually be followed by an opinion on any supplementary data presented in conformity with generally accepted accounting principles. Under these circumstances, the independent auditor's report would include a scope paragraph, expanded to include references to supplementary data when such data are presented separately as opposed to being included in notes to the financial statements, and a second paragraph referring to the variances from generally accepted accounting principles which would be worded as in the example under "qualified opinions" above. The opinion paragraph might be worded as follows:

It is our opinion that, because of the materiality of the effects of the differences between generally accepted accounting principles and the accounting practices referred to in the preceding paragraph, the accompanying financial statements do not present fairly the financial position of X Life Insurance Company at December 31, 19.., or the results of its operations or changes in its financial position for the year then ended, in conformity with generally accepted accounting principles. It is our opinion, however, that the statements of adjustments to arrive at stockholders' equity and net income present fairly stockholders' equity at December 31, 19.., and the net income for the year then ended,

[1] If the effects of the variances are not described in a note, they should be set forth in this paragraph. The suggested wording for such a note is included in Appendix A.

in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.[2]

When the supplementary data are included in a note to the financial statements rather than in supplementary statements, the last sentence of the opinion would read as follows:

> It is our opinion, however, that the supplementary data included in Note .... present fairly the stockholders' equity at December 31, 19.., and net income for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Effects of Variances From Generally Accepted Accounting Principles Have Not Been Determined. When the financial statements of a life insurance company are prepared in conformity with regulatory practices, and the effects of variances from generally accepted accounting principles have not been determined, the auditor should ordinarily disclaim an opinion. In such instances his opinion might read as follows:

(Standard scope paragraph as on page 118)

> The Company presents its financial statements in conformity with the accounting practices prescribed or permitted by the Insurance Department of the State of .... The effects on the accompanying financial statements of the differences between such practices and generally accepted accounting principles have not been determined. Therefore, we do not express any opinion on the accompanying financial statements as to fair presentation of financial position or results of operations or changes in financial position in conformity with generally accepted accounting principles.

Even though the effects of the differences between regulatory practices and generally accepted accounting principles have not been determined, the auditor may be able to satisfy himself that such effects (a) would be immaterial so as to permit an unqualified opinion, (b) would be sufficiently material to require a qualified opinion, or (c) would be so material as to require an adverse opinion.

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[2] A suggested format for such statements of adjustments is illustrated in Appendix A.

Reports on Presentations in Conformity With Regulatory Practices. SAP No. 33 states the following:

> In instances where the financial statements of regulated companies purport to be primarily presentations in accordance with prescribed accounting regulations the independent auditor may also be asked to report upon their fair presentation in conformity with such prescribed accounting. There is no objection to the independent auditor's report containing such an opinion provided that the first standard of reporting is also observed by the issuance of a qualified or adverse opinion, as required by the circumstances.

When the auditor is asked to report in this manner, he may accomplish this in any of the foregoing circumstances by adding the following to the opinion paragraph:

> Also in our opinion, (It is our opinion, however, that) the accompanying financial statements present fairly the financial position of X Life Insurance Company at December 31, 19.., and the results of its operations and changes in its financial position for the year then ended in conformity with accounting practices prescribed or permitted by the Insurance Department of the State of ...., applied on a basis consistent with that of the preceding year.

Variances Not Affecting All Financial Statements. In those instances where the effects of variances from generally accepted accounting principles have been determined and are material to one or more but not all of the financial statements, the auditor's report need take exception to only the statements so affected and may include an unqualified opinion on the statements not so affected.

Comparability of Financial Statements. A change in financial reporting from a regulatory basis to the basis of generally accepted accounting principles is a change involving the generally accepted auditing standard of reporting as to consistency as described in SAP No. 53. Such a change requires disclosure in the opinion paragraph of the auditor's report. Ordinarily, the auditor should express his approval of a change for a life insurance company adopting generally accepted accounting principles. Examples of the disclosure required in the auditor's report under these circumstances are set forth in SAP No. 53.

Reliance on Actuaries

It has been the practice for some auditors to refer, in the opinion paragraph of their reports, to the role of the actuaries in various ways. In many instances, it has not been clear whether the auditor intended such reference as an indication of a division of responsibility (for example, as if between two auditors) or as an explanation of how the auditor had satisfied himself with respect to gathering of sufficient competent evidential matter related to policy reserves and other actuarially-determined amounts, referred to in this section collectively as "reserves."

As described in the section, "Utilization of Actuaries," on page 97, the auditor should avail himself of the competence of an actuary as he would use the expertise of other professionals. The auditor can not diminish his responsibility to satisfy himself as to reserves by referring in his opinion to actuaries.

The use of actuarial expertise is a fulfillment of the auditor's responsibility for obtaining sufficient evidential matter in accordance with generally accepted auditing standards. The auditor must be satisfied with the reserves, but there is no requirement to explain how he was satisfied or to elaborate upon the steps he followed, including use of varying forms of expertise, in performing such tests of the accounting records and such other auditing procedures as he considered necessary in the circumstances. Reference to the assistance furnished by actuarial expertise in the opinion paragraph of the auditor's report should not be made unless it is the auditor's intention not to render an opinion on the financial statements taken as a whole. If, in fact, the auditor is unwilling to express an unqualified opinion because he has not satisfied himself as to the reserves and the changes therein, reference to the responsibility for the amounts of the reserves may be appropriate. Normally, under such circumstances, because of the materiality of reserves, the auditor should disclaim any opinion as to the fairness of the financial statements taken as a whole.

Accordingly, so that there may be no misunderstanding as to the significance of the use of actuaries insofar as it relates to the degree of responsibility being assumed by the auditor expressing an opinion on overall financial position and results of operation, it is considered preferable not to refer to the utilization of actu-

arial expertise in the scope paragraph. Such disclosure of the use of actuaries may be interpreted as an indication that the auditor making such reference had performed a more thorough audit than an auditor not making such reference, thereby implying an additional degree of assurance.

Since the foregoing defines or establishes procedures which go beyond current practice, it is not intended to be retroactive with respect to opinions which have been issued previously. Accordingly, where comparative financial statements are presented, it may be necessary for auditors to continue to make reference to actuaries in reports on earlier periods, but to omit such reference in subsequent reports. However, in those cases where reference in prior reports was not required because the auditor had satisfied himself as to reserves, it is suggested that such reference be omitted for all years.

Appendices A-E

Appendix A

Illustrative Financial Statements and Supplementary Data

Financial Statements

The following financial statements are presented as suggested examples of the format of financial statements which might be presented by a life insurance company reporting in conformity with generally accepted accounting principles. Further experience in the implementation of this guide may result in new and improved presentations.

ABC LIFE INSURANCE COMPANY
BALANCE SHEET
December 31, 197X and 7Y

ASSETS	197X	197Y
Cash and investments:		
Cash	$.......	$.......
Bonds, amortized cost (market $.......)	....	....
Mortgages on real estate, amortized cost	....	....
Preferred stocks, cost (market $........)	....	....
Common stock, market value	....	....
Policy loans	....	....
Real estate, cost (less $..... accumulated depreciation)	....	....
Investment in affiliated companies (state basis)	....	....
Other investments (state basis)	....	....
Total	....	....
Accrued investment income	....	....
Accounts receivable and agents' balances (net of $....... allowance for uncollectible accounts)	....	....
Property and equipment, at cost:		
Land	....	....
Buildings	....	....
Furniture and equipment	....	....
	....	....
Less accumulated depreciation	....	....
Net property and equipment	....	....
Unamortized acquisition costs	....	....
Other	....	....
Assets held in separate accounts	....	....
Total assets	$.......	$.......

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

LIABILITIES	197X	197Y
Policy liabilities:		
Future policy benefits:		
Life and annuity	$.......	$.......
Accident and health	....	....
Other	....	....
Unpaid claims	....	....
Dividends	....	....
Premium deposits	....	....
Unearned premiums	....	....
Other	....	....
Total	....	....
Income taxes	....	....
Real estate mortgages payable	....	....
Note payable	....	....
Accrued expenses	....	....
Other	....	....
Dividends to stockholders	....	....
Deferred income taxes	....	....
Undistributed earnings on participating business (Note 3)	....	....
Liabilities related to separate accounts	....	....
Total liabilities	....	....
STOCKHOLDERS' EQUITY		
Capital stock—authorized .... shares of $.... par value issued and outstanding .... shares	....	....
Capital in excess of par value	....	....
Net unrealized investment gains	....	....
Retained earnings:		
Appropriated (describe purpose)	....	....
Unappropriated, including $........ in excess of statutory unassigned surplus	....	....
Total stockholders' equity	....	....
Total liabilities and stockholders' equity	$.......	$.......

ABC LIFE INSURANCE COMPANY
STATEMENT OF INCOME
For the Years Ended December 31, 197X and 197Y

	197X	197Y
Revenue:		
Premiums:		
Life and annuity	$.......	$.......
Accident and health	....	....
Other	....	....
Investment income (Net of expenses of $.......)	....	....
(Note 4)	....	....
Benefits and expenses:		
Death benefits	....	....
Annuity benefits	....	....
Accident and health benefits	....	....
Increase in liability for future policy benefits (Notes 1 and 4)	....	....
Other (detailed as appropriate)	....	....
Decrease (increase) in deferred acquisition costs (Note 1)	....	....
Provision for policyholders' share of earnings on participating business (Note 3)	....	....
	....	....
Equity in income (loss) of unconsolidated affiliates, net of related income taxes of $.......	....	....
Income before income taxes, realized investment gains and losses, and extraordinary gain (loss)	....	....
Provision for income taxes:		
Current	....	....
Deferred	....	....
	....	....
Income before realized investment gains and losses and extraordinary gain (loss)	....	....
Realized investment gains and losses, net of related income taxes of $....... (Note 2)	....	....
Income before extraordinary gain (loss)	....	....
Extraordinary gain (loss)	....	....
Net income	$.......	$.......
Per share:		
Income before realized investment gains and losses and extraordinary gain (loss)	$.......	$.......
Realized investment gains and losses	....	....
Income before extraordinary gain (loss)	....	....
Extraordinary gain (loss)	....	....
Net income	$.......	$.......

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

NOTES

1. The increase in liability for future policy benefits may be reclassified between death benefits, annuity benefits, and accident and health benefits. In such cases, the resulting amounts would be captioned "Provision for surrender and death (annuity) (accident and health) benefits." Acquisition costs incurred may be reclassified as an offset to appropriate expense accounts and amortization may be similarly charged or treated as a separate item.
2. Until generally accepted accounting principles for investment gains and losses are more clearly defined, some companies may wish to exclude realized investment gains and losses from income. In such cases, the last item in the income statement should be designated "Income excluding realized investment gains and losses."
3. This caption is only applicable when dividends are not considered as a benefit in determining the liability for future policy benefits. Where dividends are considered as benefits, the caption in the operations statement should be described as "Dividends to policyholders".
4. A modification of the income statement presentation would reduce net investment income and the increase in liability for future policy benefits by required interest on funds accumulated.

ABC LIFE INSURANCE COMPANY
STATEMENT OF STOCKHOLDERS' EQUITY
For the Years Ended December 31, 197X and 197Y*

	Capital Stock	Capital in Excess of Par Value	Net Unrealized Investment Gains	Retained Earnings		Total
				Appropriated	Unappropriated	
Balance, beginning of year	$					$
Proceeds of sale of .... shares of capital stock						
Net income						
Increase (decrease) in unrealized investment gains						
Income taxes applicable to increase (decrease) in unrealized investment gains						
Dividends to stockholders						
Addition to group contingency reserves						
Other (detailed as appropriate)						
Balance, end of year	$					$

The accompanying notes are an integral part of these financial statements.
* Similar data should be presented for all years reported.

ABC LIFE INSURANCE COMPANY
STATEMENT OF CHANGES IN FINANCIAL POSITION
For the Years Ended December 31, 197X and 197Y

	197X	197Y
Resources provided:		
Income before extraordinary item	$.......	$.......
Decreases (increases) in income not affecting resources:	....	....
Increase in liability for future policy benefits	....	....
Amortization of deferred acquisition costs	....	....
Deferred income taxes	....	....
Other (detailed as appropriate)	....	....
Resources provided by operations before extraordinary item	....	....
Extraordinary item	....	....
Resources provided by operations	....	....
Bonds sold or matured	....	....
Preferred stocks sold	....	....
Common stocks sold	....	....
Repayments on mortgage loans	....	....
Repayment on policy loans	....	....
Other (detailed as appropriate)	....	....
Total	$.......	$.......
Resources applied:		
Investment in bonds:	$.......	$.......
Long-term	....	....
Temporary (net)	....	....
Mortgage loans	....	....
Investment in preferred stocks	....	....
Investment in common stocks	....	....
Policy loans	....	....
Acquisition costs	....	....
Dividends to stockholders	....	....
Other (detailed as appropriate)	....	....
Net increase (decrease) in cash	....	....
Total	$.......	$.......

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

Supplementary Data

The following statements are illustrative of the form for supplementary data required to reconcile net income and stockholders' equity presented in financial statements prepared in accordance with regulatory practices to such amounts determined in conformity with generally accepted accounting principles. As an alternative, the necessary details may be set forth in a note to the financial statements or within the financial statements themselves as adjustments to the surplus and income statements.

Where a reconciliation of net income and stockholders' equity presented in financial statements prepared in conformity with generally accepted accounting principles to such amounts determined in accordance with regulatory practices is required by law or regulation, a similar format may be used.

Statement of Adjustments to Arrive at Net Income

	197X	197Y
Net gain (loss) from operations as shown in the accompanying Statement of Operations (Regulatory basis)	$.......	$.......
Adjustments (to be added or deducted as appropriate):		
Adjustments to policy reserves	....	....
Change in deferred acquisition costs	....	....
Adjustments arising from special reinsurance agreements	....	....
Deferred income taxes applicable to adjustments to policy reserves and deferred acquisition costs and special reinsurance agreements	....	....
Equity in undistributed earnings of unconsolidated subsidiaries, net of related income taxes $.......	....	....
Income, excluding realized investment gains and losses	....	....
Realized investment gains and losses, net of related income taxes of $.......	....	....
Net income	$.......	$.......
Per share:		
Income excluding realized investment gains and losses	$.......	$.......
Realized investment gains and losses	....	....
Net income	$.......	$.......

Statement of Adjustments to Arrive at Stockholders' Equity

	197X		197Y	
Capital stock and surplus as shown in the accompanying balance sheet (Regulatory basis)		$.......		$.......
Adjustments (to be added or deducted as appropriate):				
Adjustments to policy reserves	$.......		$.......	
Deferred acquisition costs	....		....	
Adjustments arising from special reinsurance agreements	....		....	
Nonadmitted assets	....		....	
Mandatory securities valuation reserve	....		....	
Deferred income taxes applicable to:				
Adjustments to policy reserves, deferred acquisition costs, and special reinsurance agreements	....		....	
Net unrealized gains on investments	....		....	
Other	....	....	....	....
Stockholders' equity		$.......		$.......
Consisting of:				
Capital stock		$.......		$.......
Capital in excess of par value		....		....
Unrealized investment gains or losses		....		....
Retained earnings:				
Appropriated for contingencies — prescribed or voluntary	$.......		$.......	
Mandatory securities valuation reserve	....		....	
Unappropriated	....	....	....	....
		$.......		$.......

Notes to Financial Statements

An illustrative note describing some of the common differences between regulatory practices and generally accepted accounting principles is as follows:

> The accompanying financial statements have been prepared in conformity with accounting practices prescribed or permitted by the Insurance Department of the State of .... which vary in some respects from generally accepted accounting principles. The more significant of these differences are as follows: (a) acquisition costs, such as commissions and other costs in connection with acquiring new business, are charged to current operations as incurred, whereas the premiums are taken into earnings over the premium paying period of the policies; (b) policy reserves are based on statutory mortality and interest requirements and without consideration of withdrawals, which may differ from reserves based on reasonably conservative estimates of mortality, interest, and withdrawals; (c) deferred income taxes are not provided for unrealized gains on investments, differences in reporting policy reserves, and other material book-tax timing differences; (d) a liability for undistributed earnings allocable to participating policyholders has not been recorded; (e) the mandatory securities valuation reserve is reported as a liability rather than as an appropriation of surplus; (f) certain assets designated as "nonadmitted assets" (principally furniture and equipment, agents' debit balances, and certain other classes of receivables) have been charged to surplus.
>
> The effects of these differences on stockholders' equity and net income are shown in the accompanying supplemental statements of adjusted net income and adjusted stockholders' equity.

Ordinarily, the effects of these differences on the statement of changes in financial position need not be disclosed because they will not affect the flow of funds.

In addition to those matters discussed in the foregoing illustration, other differences between regulatory accounting practices and generally accepted accounting principles may exist which will require disclosure. Among other things, such disclosure might include methods of accounting for investments in affiliates, prior service costs of pension plans, stock dividends, and reserve strengthening, or other matters related to financial statement classification or presentation. Other differences from generally accepted accounting principles may exist with respect to a particular company, but which may not be unique to the life insurance

industry. These, of course, will have to be dealt with by the independent auditor as they arise.

In those cases where the supplementary data are to be included in the notes, the concluding paragraph of Note 1 might read, "The effect of these differences on the financial statements is shown (below) in the accompanying tabulations." Such tabulations would be presented in the same form as the preceding examples of supplementary statements of adjustments to arrive at net income and stockholders' equity.

The foregoing material attempts to set forth the most significant differences which are peculiar to life insurance regulatory accounting. Further, it would be preferable to avoid stating the per share amounts based on regulatory statements where the auditor's opinion indicates that net income is not in accordance with generally accepted accounting principles.

Appendix B

Accounting for Unamortized Acquisition Costs

As indicated in Part II of this guide, acquisition expenses should be charged against income in proportion to premiums recognized. Examples of methods for amortizing such costs are set forth below.

Some techniques will tend to produce unacceptable results. For example, amortization of costs on the basis of "average policy life" involving a straight-line charge-off of a fixed sum per policy per year plus an immediate charge-off of the unamortized amounts attributable to terminated policies, will not result in a reasonable association of expenses with related revenues.

Assume 1,000 policies are issued with a total acquisition cost of $60,000 and that the "average life" of a policy was determined to be three years so that $20 per policy in force would be written off each year with the unamortized balances for each policy being charged off for those policies terminating. Under this approach amortization would occur as follows:

Year	Policies in Force Beg. of Year (1)	Terminations (2)	Policies in Force End of Year (3)	Annual Amortization For Policies in Force (Col 3 x $20) (4)	Write-off of Unamortized Balances on Policies Term. (5)	Total Amortization (6)	Expected Premium Income (7)
1	1,000	200	800	$16,000	(a) $12,000	$28,000	$100,000
2	800	200	600	12,000	(b) 8,000	20,000	80,000
3	600	200	400	8,000	(c) 4,000	12,000	60,000
4	400	200	200	—	—	—	40,000
5	200	200	—	—	—	—	20,000
						$60,000	

(a) 200 x $60; (b) 200 x $40; (c) 200 x $20

This method does not result in amortizing costs in proportion to premium revenue. It is also inconsistent with the concept that aggregate acquisition costs for each year's blocks of business are expected to be recovered from the aggregate premium revenue over the life of each block. Stated otherwise, the cost of *each* individual policy issued cannot be expected to be recovered from *each* policy's premium revenue, since it is known at the outset that terminations will begin almost immediately with respect to any year's block of business.

A more refined approach would involve the use of an amortization schedule adopted for each major category of business in the year of issue. Amortization would be prescheduled to coincide with the expected premium revenue as shown below:

Year	Expected Premium Revenue	Ratio of Annual to Total	Prescheduled Amortization	Ratio of Amortization to Premium Revenue
1	$100,000	33.3%	$20,000	20%
2	80,000	26.7	16,000	20
3	60,000	20.0	12,000	20
4	40,000	13.3	8,000	20
5	20,000	6.7	4,000	20
	$300,000	100.0%	$60,000	20%

This method results in amortizing costs in proportion to premium revenues. Some characterize this as the "sum-of-the-premiums" method. If the persistency experience differs from that expected, actual premium revenues will differ from those estimated. Accordingly, the amount of amortization in any year will be disproportionate to premium revenue. The method could be modified so that annual or periodic adjustments could be made to give effect to actual terminations. Because of the volume of schedules that would be required for each year's new business, this technique may be impractical.

Another method approximates the technique used by actuaries in the determination of reserve valuation factors under the single valuation reserve method. This method uses a "standard unamortized cost factor" or "expense reserve factor" which is applied to the insurance in force at the end of each period. Using the prescheduled amortization from the previous example, the "expense reserve factor" is determined as follows:

Year	Planned Amortization	Planned Unamortized Cost End of Period	Expected Insurance in Force End of Period (000)	Planned Unamortized Cost Per M of Ins. in Force
1	$20,000	$40,000	$800	$50
2	16,000	24,000	600	40
3	12,000	12,000	400	30
4	8,000	4,000	200	20
5	4,000	–0–	–0–	0
	$60,000			

Assume that actual experience emerges as follows:

Year	Actual Premium Revenue	In Force End of Period (000)	Planned Unamortized Cost Per M Ins. in Force	Unamortized Cost End of Period	Amortization	
					Amount	Ratio to Premiums Collected
1	$100,000	700	$50	$35,000	$25,000	25%
2	70,000	600	40	24,000	11,000	16
3	60,000	500	30	15,000	9,000	15
4	50,000	300	20	6,000	9,000	18
5	30,000	0	0	–0–	6,000	20
	$310,000				$60,000	

Under this method, if persistency is higher or lower than assumed, the unamortized cost factors (or "expense reserve factor") are multiplied by higher or lower in-force amounts. Thus, the method tends to provide some degree of self-correction in that it causes the rate of amortization to increase or decrease as actual persistency is lower or higher than initially estimated. If actual experience differs significantly from that assumed, the factors should be recomputed.

To be fully consistent with actuarial concepts, the rate of amortization should give effect not only to estimated persistency, but to the interest assumed in benefit reserve calculations. In the previous examples, an amount of $20 per thousand would have to be included in the gross premium in order to recover first-year acquisition costs based on expected persistency. This may be determined as follows:

Year	Policies Expected to Be in Force at Beginning of Each Year
1	1,000
2	800
3	600
4	400
5	200
Total expected premium payments	3,000
Acquisition costs	$60,000

Amount required per premium payment $60,000 ÷ 3,000 = $20

This $20 may be considered as the present value of expected future expense premiums. The premium actually calculated and charged should be increased by the time cost of the funds expended. An interest rate, which coincides with the basic interest assumption, is used to determine an annuity factor. This factor is used to determine the expense portion of the gross premium in the following tabulation:

Year (1)	Expected in Force Beg. of Year (2)	Interest: Rates (3)	Interest: Present Value Factor (4)	Present Value of 1 (Due at Beg. of Each Year) at the Beg. of Year 1 (2 x 4) (5)
1	1.0	.06	1.000	1.000
2	.8	.06	.943	.754
3	.6	.05	.890	.534
4	.4	.05	.848	.339
5	.2	.05	.807	.161
				2.788

The annuity for the premium paying period is 2.788 which, when divided into the initial acquisition cost of $60 per policy, gives an expense premium of $21.51. The total of $21.51 paid at the beginning of each year by the expected number of survivors is equivalent to $60 at the time of issuance of the policy plus interest thereon at the assumed rates for the collection period indi-

cated. This example demonstrates how premiums are theoretically determined and the basis upon which the expense portion of a single valuation premium factor would be determined. Any "worksheet" approach to amortization should be based on the fact that interest affects the rate of recovery of costs. This is a refinement of the previous example and results in a worksheet determination of an expense reserve factor which would be identical to the expense portion of the single reserve valuation factor. The following tabulation summarizes this method:

Year	Expected in Force Beginning of Year (1)	Interest Rate (2)	Unamortized Cost Beginning of Year (3)	Expense Premium Payment $21.51 x (1) (4)	Portion of Premium Representing: Interest [(3)−(4)] x (2) (5)	Portion of Premium Representing: Cost Recovered (4)−(5) (6)	Unamortized End of Year: Amount (3)−(6) (7)	Unamortized End of Year: Per in Force at End of Year (8)
1	1.0	6%	$60.00	$21.51	$2.31	$19.20	$40.80	$51.00
2	.8	6	40.80	17.21	1.41	15.80	25.00	41.67
3	.6	5	25.00	12.91	.60	12.31	12.69	31.72
4	.4	5	12.69	8.60	.21	8.39	4.30	21.50
5	.2	5	4.30	4.30	–0–	4.30	–0–	–0–
						$60.00		

The factors shown in column 8 would be applied to the insurance in force at the end of each year in the manner shown in the previous example. When amortization is determined by this method, a result is produced which is identical to the result that would be produced by a single reserve valuation factor used to determine a single sum representing the aggregate amount of policy benefits and unamortized acquisition costs.

Appendix C

Deferred Income Taxes

Life Insurance Taxation

Life insurance companies are taxed under provisions of the Life Insurance Company Income Tax Act of 1959. The Act contemplated taxation of total income, but the computation of tax is complex because of the manner in which total taxable income is segmented between investment income, gain from operations and policyholders' surplus (gain from operations previously excluded from tax) and the interrelationship of these elements. Total taxable income composed of those three elements, referred to as Phase I, Phase II, and Phase III income, is subject to tax in the same manner as other corporations, including alternative tax computation for capital gains, foreign tax credit, and investment credit. However, an operations loss deduction (the equivalent of a net operating loss carryover) is treated as a deduction from gain from operations in arriving at taxable income. The terms Phase I, Phase II, Phase III, and combinations thereof are frequently used to describe the specific situations in which companies are taxed. There is a lack of uniformity in the use of these terms; therefore, their use has been avoided in describing various taxable situations in this appendix.

Taxable investment income consists of that portion of invest-

ment yield (gross investment income less investment expenses) deemed not required to maintain reserves ("company's share") reduced by a proportionate share of tax exempt interest and dividends-received deduction. The portion of investment yield which is considered to be required to maintain reserves ("policyholders' share") is the sum of (1) the lower of the average or current earnings rate ("adjusted reserves rate") applied to mean life insurance reserves adjusted to reflect the effect of the difference between the adjusted reserves rate and the assumed rate actually used to calculate reserves, (2) the current earnings rate applied to mean pension plan reserves, and (3) interest paid during the year.

Gain or loss from operations consists of all income and cost, including investment income, with limitation on deductibility of dividends to policyholders and certain other special deductions described later herein. Investment income for this purpose is net of the policyholders' share computed using rates of interest assumed in calculating reserves as opposed to adjusted rates used in determining taxable investment income. However, this is offset in the reserve increase with no effect on income. Taxable income consists of taxable investment income and 50% of the amount by which gain from operations exceeds taxable investment income. If gain from operations is less than taxable investment income, the lesser amount is taxable income. If there is a loss from operations, there is no taxable income except to the extent of any reductions from policyholders' surplus.

The 50% portion of gain from operations which is excluded from taxable income, together with the amount of special deductions for certain accident and health, and group life insurance and nonparticipating contracts is added to the policyholders' surplus account until the total policyholders' surplus account equals a specified maximum. Reductions in this account are included in taxable income in the year when such reduction occurs. Reductions in this account arise when the company (a) makes distributions, in excess of shareholders' surplus, to stockholders as dividends or in redemption of stock in partial or complete liquidation, (b) accumulates policyholders' surplus in excess of the specified maximum, (c) elects to transfer amounts to shareholders' surplus, or (d) ceases to qualify as a life insurance company for tax purposes.

Dividends to Policyholders and Special Deductions

The Life Insurance Company Income Tax Act of 1959 provides deductions for dividends to policyholders and special deductions for certain accident and health and group life contracts, and nonparticipating contracts.

Deductions for dividends to policyholders generally enter into the determination of taxable income and pretax accounting income. Such deductions may represent timing differences when the amounts deducted in the financial statements differ from the amounts deducted in the tax return.

The special deductions for nonparticipating contracts and accident and health and group life contracts do not enter into the determination of pretax accounting income in any period. Deductions for nonparticipating contracts are based on a percentage of increase in reserves or a percentage of total premiums, whichever produces the larger deduction. When based on a percentage of increase in reserves, the deduction may be directly affected by other timing differences related to the calculation of reserves. However, when based on a percentage of total premiums, the deductions may be unaffected by other timing differences related to the calculation of reserves. Deductions for accident and health contracts are based on a percentage of annual premiums subject to a cumulative limitation. Such deductions are not directly affected by other timing differences.

Limitations have been placed on the aggregate of all the foregoing deductions which prevent the reduction of gain from operations to an amount which is less than taxable investment income minus $250,000. When gain from operations, computed without regard to such deductions, is less than taxable investment income, the aggregate of these deductions is limited to $250,000. When such deductions are limited, the unused deductions are not available in subsequent periods.

Categories of Taxation

If gain from operations, after deducting all dividends to policyholders and special deductions described above, is less than taxable investment income by more than $250,000, these dividends to policyholders and special deductions are limited to an amount which will not decrease gain from operations below this

level. As long as taxable income is $250,000 less than taxable investment income and all of the dividends or special deductions have not been used in arriving at taxable income, the tax base is taxable investment income less $250,000, not gain from operations. For a company which remains in this category, any timing difference affecting only gain from operations as a result of applying generally accepted accounting principles will have no tax effect when it reverses. This situation is described as category 1 on page 151.

If gain from operations, without regard to dividends to policyholders and special deductions, is less than taxable investment income, the aggregate of these special deductions is limited to $250,000. For a company which remains in this category, the tax base is gain from operations, and timing differences will produce tax effects which reverse. However, the unused special deductions may, in some cases, be used in calculating the tax effects of timing differences as described under "computational techniques." This situation is described as category 2 on page 151.

Gain from operations, without regard to dividends to policyholders and special deductions, may be less than taxable investment income, and the aggregate of these special deductions may be less than $250,000 so as not to be limited. For a company which remains in this category, the tax base is gain from operations, and timing differences will produce tax effects which reverse. This situation is described as category 3 on page 151.

Gain from operations, without regard to dividends to policyholders and special deductions, may be greater than taxable investment income and, if the aggregate of these special deductions does not reduce gain from operations to an amount which is less than taxable investment income or which is not $250,000 less than taxable investment income, these special deductions are not limited. For companies which remain in these categories, the tax base is gain from operations, and timing differences will produce tax effects which reverse. These situations are described as categories 4 and 5 on page 151.

Significant timing differences and their effects on special deductions in a "with-and-without" calculation could result in a current change in category. Methods for dealing with such a situation and for determining or dealing with the tax effects of timing differences in general are discussed under "Computational Techniques."

	Taxable investment income	Gain from *operations* before special deductions	Special deductions			Taxable income
			Total	Allowable	Unused	
Category 1	$1,000,000	$1,500,000	$1,200,000	$ 750,000	$ 450,000	$ 750,000
Category 2	1,000,000	900,000	1,200,000	250,000	950,000	650,000
Category 3	1,000,000	900,000	200,000	200,000	—	700,000
Category 4	1,000,000	3,000,000	1,200,000	1,200,000	—	1,400,000*
Category 5	1,000,000	2,100,000	1,200,000	1,200,000	—	900,000

* Taxable investment income		$1,000,000
Gain from operations after special deductions	$1,800,000	
Less taxable investment income	1,000,000	
Excess	$ 800,000	
50% of excess included in taxable income		400,000
Taxable income		$1,400,000

Nature of Timing Differences

While the usual timing differences, such as those resulting from depreciation methods, amortization of bond discount, and accrual of dividends and interest may exist for life insurance companies, the most significant timing differences result from the adoption of generally accepted accounting principles—principally from differences between adjusted life insurance reserves and those used for tax purposes and deferral and amortization of acquisition costs. Such timing differences affect only gain from operations.

The only transactions that give rise to timing differences with respect to taxable investment income would be those related to the timing of the inclusion of items of investment income or investment expense, such as cash vs. accrual basis of accounting for dividends and interest or accelerated vs. straight-line depreciation methods on real estate. While the inclusion of adjustments to life insurance reserves and deferral and amortization of acquisition costs resulting from the adoption of generally accepted accounting principles in a hypothetical tax return would indirectly affect taxable investment income, such effect is a permanent difference. These items affect only total assets or aggregate reserves, which amounts will, for income tax purposes, always be greater or less than comparable amounts for accounting purposes. Accordingly, amounts of such differences do not reverse in subsequent periods.

Computational Techniques

As stated in APB Opinion No. 11, "The tax effect of a timing difference should be measured by the differential between income taxes computed with and without inclusion of the transaction creating the difference between taxable income and pretax accounting income. The resulting income tax expense for the period includes the tax effects of transactions entering into the determination of results of operations for the period. The resulting deferred tax amounts reflect the tax effects which will reverse in future period." "With-and-without" computations for life insurance companies are more complicated than is the case in the normal tax return because of the complexities of the Life Insurance Company Income Tax Act of 1959. Accordingly, no

short-cut method of computing deferred income taxes is possible.

The differential tax effect tentatively determined in the with-and-without calculation must be further examined to determine whether such tax effect will reverse in the future. For example, as discussed previously, timing differences affecting only gain from operations may result in a current tax effect in such a with-and-without calculation which may not reverse in the future for companies who continue to be taxed on taxable investment income. Deferred taxes are not required to be provided for the current tax effect of timing differences if circumstances indicate that there will not be a reversal of such current tax effect in the future.

Although (1) certain special deductions never enter into the determination of pretax accounting income in any period and/or (2) the amount of dividends to policyholders and certain special deductions may be subject to limitation on the tax return so that unused deductions will not be available in subsequent periods, such deductions may be properly recomputed in the with-and-without calculation. For example, unused dividends to policyholders and special deductions may be used to offset timing differences which affect taxable income to the extent that the limitations on these deductions change when based on pretax accounting income, unless known or anticipated circumstances indicate that future taxable income resulting from such timing differences will not be offset by like deductions when they reverse. Similarly, in the case of provisions for dividends to policyholders, which are timing differences themselves, statutory limitations should not be applied so as to eliminate their current tax effect unless circumstances indicate that such dividends will be limited when they reverse.[1] Special deductions that are directly affected by timing differences should be recomputed in the with-and-without calculation unless circumstances indicate that future special deductions will not be directly affected by the timing differences when such timing differences reverse.

Companies adopting generally accepted accounting principles for the first time will be required to reflect such change retro-

[1] For purposes of computing deferred taxes, it will be necessary to identify the amount of dividends to policyholders deducted in the financial statements even when they are considered as benefits in the reserving method.

actively in the year of change. This retroactive change will apply to all of the adjustments necessary to present financial statements in conformity with generally accepted accounting principles, including the application of deferred income tax accounting. Since the adjustment will be applied retroactively, the restriction on the use of the "net change method" described in APB Opinion No. 11 will not be applicable. The intent of the restriction was to preclude a company that was not applying interperiod tax allocation prior to the Opinion from using the tax effect of the reversal of a difference to offset deferred taxes required to be recognized for current originating timing differences. Accordingly, a life insurance company adjusting retroactively will be able to use the individual transaction, gross change, or net change methods.

From a practical standpoint, the gross change method may be very difficult to apply to timing differences related to reserves. Companies that elect this method must maintain detailed records of originating and reversing differences or must be prepared to demonstrate, by use of modelling or other techniques, that reasonable approximations of originating and reversing timing differences have been made.

Because of the complexity of life insurance income tax computations, the net change and gross change methods can produce substantially different results. For the purpose of using the gross change or net change methods, adjustments to reserves and the deferral and amortization of acquisition costs constitute similar timing differences which could be grouped. While reserves and deferred acquisition costs will be segregated in the balance sheet, their grouping for the purpose of determining pretax accounting income is justified because of their interrelationship and similar reversing characteristics. In addition, grouping of other timing differences may be most appropriate because separate treatment of individual timing differences can produce results which vary significantly from those that would result from the grouping of all timing differences. These different results are produced when the with-and-without calculation causes a change in category of taxation.

When results are produced which vary significantly from the company's current tax status because of the method used or the grouping or separate treatment of timing differences, consideration must be given to the reversal of the tax effects calculated. In determining whether there will be any future tax

effect, the reversing characteristics of the timing differences must also be considered. Deferred taxes need not be provided unless such taxes will reverse in the future, and a change in category of taxation resulting from the with-and-without calculation should not be recognized unless circumstances indicate that such change in category will result when the timing difference reverses.

When the reversal of tax effects cannot be reasonably determined, deferred income taxes should be provided based on the differential computed using a with-and-without calculation as if the company's tax return was filed on the basis on which financial statements were prepared, including any resulting change in phase of taxation. In such cases, special deductions which are not timing differences or which are not affected by other timing differences and, therefore, do not reverse, should be limited to amounts calculated in the tax return.

Changes in Circumstances

If deferred income taxes have not been provided on timing differences on the presumption that such timing differences will have no tax effects when they reverse, and circumstances change so that it becomes apparent that tax effects will result, a company should accrue as an expense of the current period income taxes attributable to those timing differences; income tax expenses for such timing differences should not be accounted for as an extraordinary item.

If deferred income taxes have been provided on timing differences, and circumstances change so that it becomes apparent that the tax effects will differ from those originally expected, deferred income taxes previously accrued should be included in income only as the related timing differences reverse.[1]

The facts and circumstances known about the company's income tax position in prior years and the current year must be considered, together with any changes which have affected or are expected to affect income taxes. Long range forecasts may also be useful. Examples of changes in circumstances which

[1] Amortization procedures described in paragraph 10 of *Accounting for Income Taxes—An Interpretation of APB Opinion No. 11*, Donald J. Bevis and Raymond E. Perry, AICPA, 1969, should be followed.

might indicate the need for adjusting tax accounts would include the following:

1. Change in volume and/or profitability of business.
2. Change in mix of health insurance and life insurance.
3. Change in mix of participating and nonparticipating business.
4. Change in dividends to policyholders.
5. Acquisition or disposition of subsidiaries.
6. Change from rental to ownership of home office building.
7. Adopting of tax planning techniques such as the Section 818 (c) reserve strengthening election.

Policyholders' Surplus

APB Opinion No. 23 states that deferred taxes should not be provided on amounts designated as policyholders' surplus on the tax return of a stock life insurance company unless circumstances indicate that the insurance company is likely to pay income taxes, either currently or in subsequent years, because of known or expected reductions in policyholders' surplus.

Pre-1958 Timing Differences

Prior to the enactment of the Life Insurance Company Income Tax Act of 1959, which was effective for 1958, life insurance companies were taxed on investment income. Accordingly, most of the retroactive adjustments to conform to generally accepted accounting principles will create timing differences that would have had no tax effect prior to 1958 and, therefore, no deferred income taxes should be provided for cumulative timing differences at January 1, 1958.

Discounting

Representatives of industry have proposed that discounting should be applied to unamortized deferred income tax balances. It has been stated that such discounting is consistent with the discounting of other liabilities in a life insurance company. However, the application of discounting would be applicable only under the liability method of accounting for deferred income taxes, which method was rejected by the Accounting Principles Board in Opinion No. 11.

Summary

As stated in APB Opinion No. 11, "the principal problems in accounting for income taxes arise from the fact that some transactions affect the determination of net income for financial accounting purposes in one reporting period and the computation of taxable income and income taxes payable in a different reporting period. . . . A major problem is . . . the measurement of the tax effects of such transactions and the extent to which the tax effects should be included in income tax expense in the same periods in which the transactions affect pretax accounting income." Tax effects are defined principally as "differentials in income taxes of a period attributable to . . . revenue or expense transactions which enter into the determination of pretax accounting income in one period and into the determination of taxable income of another period. . . ." The opinion further states that, "interperiod tax allocation procedures have been developed to account for the tax effects of transactions which involve timing differences," and that, "deferred tax amounts reflect the tax effects which will reverse in the future."

The foregoing language has been interpreted in this appendix to mean that interperiod tax allocation procedures should account for reversal of timing difference *and the reversal of their tax effects.* Accordingly, the calculation in the current period of the tax effect of a timing difference measured by the differential between income taxes computed with and without inclusion of the transaction creating the difference between taxable income and pretax accounting income must be reviewed to determine whether circumstances indicate that the tax effect so measured will reverse in the future when the timing difference reverses. This appendix describes some of the more obvious situations where there may be no reversal of effects measured by means of a with-and-without calculation and suggests that deferred taxes are not required to be provided if circumstances indicate that the tax effects so measured will not reverse in the future.

Because of the complexity of life insurance company taxation, it was not practical to discuss all the situations that might occur. Further experience will develop new situations and solutions thereto.

Appendix D

Supplementary Internal Control Questionnaire for Life Insurance Companies

This questionnaire is included herein to provide examples of the type of questions (in addition to those found in a general internal control questionnaire) that might be asked by the auditor in his review of internal controls of a life insurance company. It is not a complete questionnaire and must be augmented, modified, and adapted for a particular life insurance engagement. The questions are intended to create an awareness of the broad range of controls required by an insurance company because of its underwriting and investment activities. Additional questions will be required where a specific company issues contracts for other than ordinary life or accident and health business. It follows, therefore, that a more effective internal control questionnaire can be designed by the auditor to suit his needs in a specific client situation. Also, there are areas not covered by this questionnaire which must be reviewed by the auditor that are not peculiar to

the insurance industry; namely, the internal audit and electronic data processing functions.

The questions are basically designed so that a "yes" response would generally indicate satisfactory conditions, while a "no" response would indicate a weakness to be considered in determining the nature and extent of audit procedures and tests to be employed.

General

1. Is the general accounting department completely separated from:
   a. Agency department?
   b. Claim or benefit department?
   c. Underwriting department?
   d. Investment department?
   e. Premium accounting department?
2. Are schedules used by client in preparation of accrual basis statements for inclusion in Annual Statement filed with regulatory insurance departments reviewed by someone other than the person preparing these papers?

   Reviewer ....

   Title ....

Cash Receipts

1. Is access to daily mail cash receipts denied to persons with the following responsibilities:
   a. Authorize return premiums?
   b. Prepare or record the billings?
   c. Maintenance of securities records?
2. Are cash funds other than cash receipts handled by someone other than the cashier?
3. Are securities handled by someone other than the cashier?
4. Where the company utilizes the debit system of collecting premiums on certain policies, are collections by agents deposited daily to bank accounts under home office control?

5. If the company accepts postdated checks or drafts for later deposit as premiums become due:
   a. Are they under the control of someone other than the cashier who does not have access to cash receipts?
   b. Does the system of safekeeping provide for timely deposit of the check or proceeds of the draft?

Cash Disbursements

1. Are drafts used for payment of:
   a. Benefits and claims?
   b. Dividends to policyholders?
   c. Medical fees?
   d. Other items?
      Identify ....
2. Are drafts recorded when issued?

Securities

1. Are security transactions authorized by:
   a. The board of directors?
   b. The investment committee?
   c. An officer?
   d. Other? ....
2. Does release of securities require the signatures of more than one officer where securities are under:
   a. Control of a safekeeping bank or independent custodian?
   b. Dual control of two officers other than those authorized to sign the release?
3. Are the securities periodically inspected or confirmed with independent custodians and balanced with security records?
   a. By internal auditors?
   b. By executives?
   c. By others? ....
4. Is the investment portfolio reviewed by an executive with the responsibility for determining that investments are in compliance with the State insurance code?

Mortgage Loans

1. Are direct loans and purchases of existing mortgages authorized by:
   a. An investment committee or the board of directors?
   b. Someone else? . . . .
2. Are independent appraisals required to assure the loan is within legal limits and company policy?
3. For loans serviced by correspondent servicers:
   a. Are periodic trial balances of loans received and balanced to company's records?
   b. Are external audits made of the records of the servicer?
   c. Does the company's internal audit staff examine the records of the servicer?

Policy Loans

1. Is the amount of the policy loan checked against the cash surrender value at the date of the loan?
2. Is the in-force status of the policy checked before the policy loan is approved?
3. Does the company notify policyholders when the automatic loan provision is applied?
4. Are policy loan records checked for status of loans before any policy surrender or death benefits are paid?

Real Estate

1. Is investment committee approval required for:
   a. Purchases, sales and leases of real estate for investment purposes?
   b. Setting the sales price for previously foreclosed property?
   c. Renovations or improvements to real estate owned?
   d. Determination of the amount to be considered as rental income on real estate owned and used by the company?
2. If investment properties are being managed for the company by independent agencies, are such manager's records reviewed periodically by the internal audit staff or other company representatives to determine the propriety of expenses and to account for income?

Miscellaneous Assets

1. Are details of the cost and accumulated depreciation for furniture, equipment and automobile, and similar nonadmitted assets maintained and controlled by general ledger accounts or schedules evidencing control balances balanced to amounts included in financial statement balances?
2. Are established procedures in effect for authorizing advances to agents?
3. Do contracts with agents reflect company policy as to financing arrangements?
4. Are IRS form 1099s filed on agents' balances charged off and on the value of agency prizes and awards given to agents?

Policy Liabilities (policy valuation reserves)

1. Does the company maintain insurance in-force transaction registers and use such registers to reconcile insurance in force to corresponding totals of number and amounts of policies shown in valuation summaries?
2. Does the company have provisions for reviewing the reasonableness of life reserves and the yearly changes by reference to plan, year, and age-at-issue valuation analyses?
3. Does the company match data contained in the valuation file with corresponding data in the following records:
   a. Application file?
   b. Premium record file?
   c. Premium billing file?
   d. Dividend file?
   e. Other files? . . . .
4. Were the following items included in the comparison?
   a. Policy number?
   b. Policy plan?
   c. Year of issue?
   d. Age at issue?
   e. Amount?
   f. Mode of payment?
   g. Paid to date?
5. Does the company make other checks as to the completeness or accuracy of the in-force file?

6. Are the reserve factors and calculations checked?
7. Does the company utilize consulting actuaries to review or verify reserve valuations?
   Identify.
8. Do the consulting actuaries test the accuracy of the in-force listings and other summary items relied on in calculating policy reserves?
9. Does the company check the reasonableness of the "tabular cost" and "tabular net premiums" with respect to its ordinary life business?
10. Does the company establish active life reserves on non-cancellable or guaranteed renewable A&H contracts?

Policy Forms and Issue

1. Is the security of unused forms adequately safeguarded?
2. When policies are issued, are they properly recorded in a register or other control?
3. Are all numbers accounted for?
4. Are procedures in effect, such as use of a checkoff list, to determine that all underwriting and credit reviews have been satisfactorily completed prior to policy issue?
5. Are policy forms approved by State insurance departments?
6. Are insurance contracts issued only upon receipt of the initial premium?
7. Are contracts returned and properly voided if the initial premium is not received?
8. Are voided contracts retained for subsequent inspection?

Premium Income

1. Are the records from which premium billings are prepared reconciled periodically with in-force insurance listings?
2. Are premiums billed, but not collected, kept under ledger control?
3. Does a person not having access to cash control the records used for preparation and mailing of:

a. Premium notices?
b. Lapse notices?

4. Do copies of lapse notices go to another person not under the direction of the premium department for follow-up?
5. Does the system provide for prompt notification to policyholders of application of automatic premium loans or other benefits to the payment of premiums?
6. Are cash receipts and premium income balanced monthly to premium registers?

Policy Benefits

1. Prior to payment of benefits, are claims department personnel required to check:
   a. The in-force status of policies?
   b. Amounts of policy loans deductible from benefits?
   c. Existence of other deductible items?
   d. Policy coverage of claimed benefit?
   e. Policy amounts applicable to claim?
   f. Receipt of all claim documents with indication of review and approvals?
2. If drafts are used in payment of benefits:
   a. Is control exercised over unissued drafts?
   b. Are issued and outstanding drafts accounted for?
   c. Is documentation reviewed in support of payments by supervisory personnel other than the claims department?
3. Do internal procedures provide for periodic comparison, by someone independent of the claim department, of endorsements on cancelled checks issued for policy benefits with signatures on policy applications?
4. Are the statistical totals of claims paid by policy maintained and reconciled with cashier and accounting department totals?
5. When claims are paid or drafts accepted, are procedures in effect for:
   a. Recording the reinsurance recoverable?
   b. Cancelling the estimated claim and estimated recoverable reinsurance?

6. Are paid claim documents routed to the accounting department for billing and recording reinsurance recoverable under facultative and treaty contracts?
7. Does the system provide for the accumulation of claims paid that might result in recoveries under excess contracts?
8. Are procedures in effect to provide reviews for amounts recoverable from reinsurance?
9. Is paid up and extended insurance calculated and reviewed by someone not involved in the premium collection procedure?
10. Are the amounts accrued or paid for dividends to policyholders on all lines of business reviewed and tested for compliance with company policy?
11. Is there a procedure for review of interest earned and credited on policyholder dividends or other policy benefits left on deposit as to compliance with rates approved by the board of directors?

Reinsurance

1. Is there a departmental responsibility for the review of policy issues to determine compliance with the limits established by the company's retention or acceptance of liability on any one life? Identify.
2. Is the underwriting department required to mark policies clearly indicating whether or not reinsurance applies?
3. Are there procedures existing to determine that all risks includible under treaty reinsurance contracts are identified and declared to the reinsurance company?
4. Are procedures in effect to provide for prompt follow-up and reimbursement of reinsurance claims:
   a. For reinsurance ceded by the company?
   b. For reinsurance assumed by the company?
5. Does the accounting system in use generate the information necessary for management's clear understanding of:
   a. The status of reinsurance contracts?
   b. The transactions which occurred during the year?

6. Are the companies reinsurance treaties written only with companies that qualify under the requirements of the regulatory insurance department? If not, identify those not so qualified.
7. Are the detailed accounting records maintained by other operating departments balanced to the accounting department records on a monthly basis?

Appendix E

Glossary of Terms

Accidental death benefit. A payment of a specified sum, in addition to the regular death benefit, in the event of the death of the insured by accident or by accidental means.

Actuary. An expert professionally trained in the evaluation of risk and the science of mathematical probabilities. Insofar as North America is concerned, membership in the American Academy of Actuaries or the Canadian Institute of Actuaries is evidence of professional qualification.

Ad interim policy reserve. A reserve calculated as of any date within a policy year.

Adjusted premium. An amount defined by the insurance laws of most states used in the computation of minimum legal cash surrender values.

Advance premiums. Premiums collected by the insurance company in advance of the premium due dates. A discount is allowed for certain advance payments.

Annual statement (convention statement, blank, or form). A statement on a prescribed form furnishing information regarding a company's financial condition as of December 31 and its operations for the year, filed by March 1 of the following year with Insurance Departments of the various states in which a company is authorized to transact business.

Annuity. A type of periodic payment of a fixed or variable amount arising out of a contract obligation.

Annuity, deferred. An annuity which will begin on a future date either at the expiration of a fixed number of years or at the attainment of a stated age.

Annuity, immediate. An annuity, purchased with a single payment, beginning currently.

Assessment companies. Companies selling to groups with similar interests such as church denominations or professional groups. Some assessment companies also sell directly to individual members of the general public. Such companies may or may not collect premiums. If funds are not sufficient to pay claims, assessments may be made against members.

Asset share. A realistic estimate of the amount accumulated by an insurance company for each dollar of insurance in force. An asset share study involves a projection of cash flow based on the best estimates of mortality, interest, withdrawals, dividends, and expenses, and their times of occurrence. Asset shares depict hypothetical financial results on a unit of business. Generally an asset share calculation is made for a unit policy on a particular plan and at a particular issue age representative of a particular class of policy. Asset shares calculation may be made prospectively or retrospectively. They are often made for projecting financial results into the future on the basis of assumed rates of mortality, interest, expense, and withdrawals, and for testing the effect of hypothetical changes in such rates. A company's entire business or a block of its business may be approximately represented by a grid of representative unit policies weighted according to the distribution of business. Asset shares for such a grid may be aggregated to show approximate financial results for the business so represented.

Assets, admitted. Assets stated at values at which they are permitted to be reported in the annual statement filed with the various Insurance Departments.

Assets, ledger. Assets which were traditionally recorded on a company's general ledger.

Assets, nonadmitted. Assets, or portions thereof, which are not permitted to be reported as admitted assets in the annual statement filed with the various Insurance Departments such as the excess of book value over statement value of investments, agents' balances, furniture, fixtures, supplies, and equipment other than certain data-processing equipment.

Assets, non-ledger. Assets which traditionally were not recorded on a company's general ledger such as the excess of statement value of

stocks and bonds over book value, accrued interest, other accrued income on investments, and due and deferred premiums.

Association value. The value for Annual Statement purposes of certain invested assets. These values are set by the National Association of Insurance Commissioners and may differ from market value or amortized value.

Assumption. In life insurance, a set of rates (e.g., mortality or interest rates) on which calculations to determine premiums, reserves, etc., are based.

Automatic premium loan. A loan made under a provision in a life insurance policy that a premium not paid by the end of the grace period will be automatically paid from the proceeds of a policy loan made by the company if there is sufficient loan value.

Benefit. Any payment made under the terms of an insurance policy.

Block of business. In the broad sense, a group of policies as distinguished from a line of business. The term can be used in a narrow sense to refer to a particular group of policies issued under the same plan in a particular year.

Cash surrender value. The amount of cash which may be realized by the owner of a life insurance policy or annuity contract upon discontinuance and surrender of the policy or contract prior to its maturity.

Ceding company. The original or primary insurer who reinsures with another company called the reinsurer or assuming company.

Cession. Insurance passed on to the reinsurer by the primary or ceding company. Frequently, under certain types of reinsurance treaties, each transaction is given a number called a cession number.

Claim. A demand for payment of a policy benefit because of the occurrence of an insured event such as the death or disability of the insured or the maturity of an endowment or the incurrence of hospital or medical bills.

Coinsurance. The sharing of an insurance risk. In life insurance this arises most frequently in connection with reinsurance where the company which is the direct issuer of insurance passes some of it onto another company, the reinsurer, in order to avoid a disproportionately large risk on one insured. The reinsurer receives a proportionate part of the premiums less commissions and is liable for a corresponding part of all payments (dividends, cash values, death claims) made by the direct issuing company. Less frequently, "coinsurance" refers to an arrangement whereby the insured, himself, stands part of a loss.

Contract premium. The premium specified by the insurance contract; also referred to as the gross premium.

Contribution method. A method of computing dividends under which contributions made by any class of policies to the company's earnings is determined by comparing actual experience with assumptions made for mortality, interest, withdrawals, and expense in setting premium rates. Mutual life insurance companies are required to distribute divisible surplus to policyholders equitably. This is understood to mean distribution of divisible surplus to the various classes of policies in accordance with the contributions of such policies to such divisible surplus. In its classic form the contribution method determines dividends according to the three main sources of surplus earnings reflecting the experience with respect to mortality, interest, and expenses.

Convention statement, blank, or form. See Annual Statement.

Credit life insurance. Insurance issued on the lives of borrowers to cover payment of loan balances in case of death.

Decreasing term insurance. A type of term insurance the face value of which decreases over a period of years.

Deferred first year commission. A commission payable on monthly, quarterly, or semiannual premiums for the first policy year except the initial premium.

Deferred premiums. The semiannual, quarterly, or monthly net valuation premium needed to complete premium payments for the current policy year but not yet due. In computing statutory policy reserves for individual life insurance, deferred premiums are assumed to be paid in full.

Disability. Incapacity because of accident or sickness. In connection with life insurance, special benefits are sometimes provided in the event the insured is totally and permanently disabled.

Disability benefit feature. A feature included in some life insurance policies or annuity contracts providing for waiver of premiums or payment of a monthly income in the event the insured has become totally and/or permanently disabled.

Dividend class or classification. A group of policies which the company decides to consider as comprising a homogeneous unit for dividend purposes because of similarities in essential characteristics (premium rate, reserve, nonforfeiture bases, etc.). Sometimes more narrowly taken to mean a group of policies for which dividends per $1,000 of insurance are identical because all essential characteristics (policy series, plan, age, year of issue, etc.) are identical.

Dividend deposit. The accumulated amount, including interest, of

all dividends which have been left by a policyholder as interest-bearing deposits.

Dividend fund method. A method used by some mutual life insurance companies in the development of the company's premium-dividend-policy value structure.

Dividend option. The privilege allowed a policyholder of choosing among certain methods of using his dividends. The dividends may be, for example: (1) paid in cash, (2) applied toward the payment of premiums, (3) left on deposit at interest, (4) used to purchase paid-up additional insurance, or (5) used to purchase one-year term insurance.

Dividends (to policyholders). Amounts distributed or credited to policyowners of participating policies. Under the various insurance laws, dividends must be apportioned to policyholders on an equitable basis. The dividend allotted to any policy should be based on the amount which the policy, as one of a class of similar policies, has contributed to the earnings available for distribution as dividends.

Endorsements or riders. Agreements not contained in the standard printed policy form, but printed, stamped, or written on or attached to it. When they are made a part of the contract, they alter, amend, extend, or restrict the provisions of the standard form.

Excess interest. The excess of interest credited by an insurance company over the amount guaranteed.

Experience premium method. A method for determining dividends to policyholders. Under this method the dividend is determined as the excess of the premium charged over a premium reflecting current levels of claim experience, interest, and expenses with appropriate provision for contingencies. This method is most commonly used for dividends earned under supplementary benefits such as Accidental Death or Waiver of Premium Disability Benefits. A variation of the method has sometimes been used for dividends on life insurance policies. In this modified form a conservative interest assumption is used in determining the experience premium, and an excess interest factor is added to the dividend as otherwise determined from the excess of the premium charged on the modified experience premium.

Expiry. Termination of insurance when the end of the period of term insurance is reached.

Extended term insurance. Insurance acquired under a nonforfeiture option in a policy providing for the use of cash surrender value to acquire term insurance for the face amount of the policy, the length of the term depending on the age at lapse and the cash surrender value.

First-year commission. Any commission payable on first-year premiums.

First-year premiums. Any premiums due during the first year the policy is in effect.

Fraternal companies. Companies having no stockholders, but which restrict their policyholders to a group with a common interest, such as a church group. They operate on a nonprofit basis for the benefit of policyholders and their beneficiaries.

Full preliminary term reserve method. A modified reserve method under which no reserve is established at the end of the first policy year.

Fund method. A method of computing dividends based upon asset share calculations.

Gains or losses from interest. The difference between net investment income and interest required to maintain reserves. A change in the interest basis on which reserves are determined automatically results in a change in the indicated gain or loss from interest.

Gains or losses from lapse or surrender. Differences between reserves held on surrendered or lapsed policies and cash values paid or reserves required on other forms of insurance taken by the insured in lieu of payment of cash value.

Gains or losses from loadings. Differences between expense loading contained in the premiums of the period and expenses for the period.

Gains or losses from mortality:

Annuities and supplementary contracts involving life contingencies. Differences between expected reserves released by death and actual reserves released by death during the period.

Ordinary life. Differences between expected death benefits on the company's reserve basis and death benefits incurred for the period, net of reserves released by death.

Grace period. The period, usually one month (31 days), following the due date of a premium during which the premium may be paid without penalty or other additional requirements. The policy remains in full force during this time. The grace period is required by law.

Gross premium. The premium specified by the insurance contract. The term is used in contrast to "net premium."

Gross premium reserve. A reserve determined by subtracting the present value of future gross premiums from the present value of future expenses and benefits.

Group insurance. Insurance issued, usually without medical examination, to a group of persons with related interests. It is usually

issued to an employer covering his employees. A master policy is issued to the employer, or other representative of the group, and individual members of the group receive certificates as evidence of their insurance.

Guaranteed renewable policy. A health insurance policy which the insured has the right to continue in force by the timely payment of premiums which coincides approximately with the average working lifetime (for federal income tax purposes at least until age 60), with the right reserved to the insurer to make changes in premium rates by classes. Also see Noncancellable policy.

Income disability benefit. The income disability benefit of a life insurance policy commonly requires that the insured be totally and permanently disabled, but the requirement of permanence is not ordinarily made for an income disability benefit contained in a health insurance policy, and some health insurance policies provide reduced benefit during partial disability.

Incontestable clause. A provision in a life or noncancellable accident and health insurance policy that the insurance company cannot contest the policy, except for nonpayment of premiums, after the policy has been in force for a stated period (usually one or two years) from date of issue.

Industrial insurance. Insurance written in relatively small amounts covering life, total and permanent disability, and accidental death benefits, the premiums on which are usually collected on a weekly or monthly basis by an agent of the company.

Initial policy reserve. The reserve on a policy at the beginning of the policy year. It is equal to the amount of the reserve at the close of the preceding policy year (the terminal reserve) plus the net premium for the current policy year.

Installment premium. A premium paid in installments throughout a policy year, rather than annually. Semiannual, quarterly, monthly, and sometimes weekly premiums are considered as installment premiums. (The basic premium in life insurance is an annual premium.)

Insured. The person on whose life an insurance policy is issued.

Investment expenses. Expenses which are properly chargeable against investment income.

Issue age. The age of the policyholder on the effective date of the policy. This is frequently the "age nearest birthday" on the effective date.

Lapse. The termination of a policy in its original status by failure to pay a premium due. If the policy has no cash value, the policy becomes forfeited, is terminated, and is out of force. If the policy has a cash value, the protection may be continued in modified form.

Lapsed policy. A policy terminated from the premium paying in force because of nonpayment of premiums. Sometimes, for accounting purposes, the term is limited to a termination occurring before the policy has a cash or other value.

Lapse rate. The rate at which insurance policies terminate through failure of the insureds to continue making premium payments. The lapse rate may also be considered a rate of "non-persistence." It is usually expressed as a ratio of the number of policies on which the insureds failed to make premium payments during a given period to the total number of policies at the beginning of the period from which those lapses occurred.

Legal reserve life insurance. Life insurance provided by an insurance company operating under insurance laws specifying the minimum basis for the reserves the company must maintain for its policies.

Level premium insurance. Insurance for which the premium is distributed evenly over the period during which premiums are payable.

Liabilities, ledger. Liabilities traditionally recorded on the company general ledger.

Liabilities, non-ledger. Liabilities traditionally recorded not on the company general ledger, but on other basic records.

Life expectancy. The average number of years of life remaining for persons of a particular age according to a particular mortality table.

Loading. An amount obtained by subtracting the net premium from the gross premium.

Mandatory securities valuation reserve. A reserve computed according to a formula specified by law or regulations to provide for possible losses on securities.

Maturity. The time when payment under a life insurance or endowment policy becomes due. A life insurance policy matures upon the death of the insured. An endowment policy matures upon the death of the insured or at the end of a specified period of time, whichever occurs first.

Mean reserve. A policy reserve computed as of the middle of a policy year on the assumption that the full net annual premium for that year has been paid. The mean reserve for any policy year is equal to the mean (or average) of the initial reserve at the beginning of that year and the terminal reserve at the end of that year.

Mode. The frequency of premium payment. The mode may be weekly, monthly, quarterly, semiannual, or annual.

Modified preliminary term reserve method. A method of computing a policy reserve under which a lesser portion of the first year's

premium paid by the insured is added to the reserve than of premiums of subsequent years. There are various methods for arriving at the difference. The Illinois Standard Method and the Commissioners' Reserve Valuation Method are both modified preliminary term valuation methods.

Modified reserve method. Any of various reserve methods whereby a company establishes smaller reserves in the first policy year than under the net level reserve method.

Morbidity. The state of being diseased, mentally or physically, or being physically impaired.

Morbidity table. A statistical table showing the incidence, by age, of eligibility for a given sickness or accident benefit, based on the assumed morbidity which is being defined by the table. It is an instrument for measuring the probabilities associated with the given benefit and is one factor in computing premiums and reserves for policies providing such benefit.

Mortality cost. The assumed mortality cost (cost of insurance) for any year is the contribution necessary from each policy to meet the net death benefits anticipated during that year. It may be calculated by multiplying the net amount at risk at the beginning of the policy year by the death rate (shown in the mortality table employed in the computations) at the age attained by the insured at the beginning of the policy year.

Mortality ratio. The ratio of actual death benefits of the period to expected death benefits.

Mortality table. A statistical table showing the proportion of persons expected to die at each age, based on the assumed mortality which is being defined by the table, usually stated as so many deaths per thousand. It is the instrument for measuring probabilities of life and death. It is used as one factor in determining the amount of premium required at each age at issue of a policy.

Mortgage servicing agent. An agent servicing mortgage loans for the mortgagee at a prescribed rate under a contractual agreement.

Mutual life insurance companies. Companies which operate for the benefit of their policyholders and their beneficiaries and have no stockholders. Earnings are distributed to holders of participating policies. Some mutual life insurance companies issue non-participating policies.

Net amount at risk. The face amount of the policy less the terminal reserve for the policy year.

Net level reserve. A policy reserve computed by a method under which the increase in reserve on account of the first policy year is

not reduced to accommodate acquisition expenses. For comparison, see Preliminary term reserve.

Net premium (valuation premium). As used in regulatory practices, that portion of the premium used in determining the valuation reserve and computed on the basis of prescribed mortality and interest rates. As used under generally accepted accounting principles, the portion of the gross premium required to provide for all benefits and expenses.

Noncancellable policy. A health insurance policy which the insured has the right to continue in force by the timely payment of premiums for a period which coincides approximately with the average working lifetime (for federal income tax purposes at least until age 60) during which period the insurer has no right to make unilaterally any change in any provision of the policy while the policy is in force. Also see Guaranteed renewable policy.

Nonforfeiture value. The value, if any, either in cash or in another form of insurance, available upon failure to continue the required premium payments. The other forms of insurance available are extended term insurance and reduced paid-up insurance.

Non-ledger assets. See Assets, non-ledger.

Non-ledger liabilities. See Liabilities, non-ledger.

Nonparticipating insurance. Insurance on which no dividends are payable. Usually issued by a stock life insurance company (as distinguished from a mutual company) at premium rates which are lower than those charged where dividends are payable.

Nonparticipating policy. A policy which is not entitled to dividends.

Ordinary life insurance. Life insurance, usually issued in amounts of $1,000 or more with premiums payable on an annual, semiannual, quarterly, or monthly basis, as distinguished from industrial insurance. The term is also used to mean a plan of insurance for the whole of life with premiums payable for life.

Paid-up insurance. Insurance, including nonforfeiture paid-up insurance and paid-up additions purchased by dividends, on which all premiums have been paid and which is payable at the death of the insured or at the maturity date. It may be participating (sharing in dividend distribution).

Participating insurance. Insurance in which the policyholder is entitled to share in the company's earnings through dividends which reflect the difference between the premium charged and the actual experience.

Participating policy. A policy which is entitled to share in the dividend distribution.

Policy. The printed document issued to the insured by the company stating the terms of the insurance contract.

Policy anniversary date. The yearly recurrence of the "policy date." The policy date is a date specified in the policy as the date from which premium-payment dates are calculated and the date from which "policy years" for nonforfeiture option purposes are measured. The "date of issue" is the date of execution and is the date from which incontestable and suicide clause time limits are measured. The policy date frequently differs from the date of issue as for example, where the policy is dated back to the same age.

Policy loan. A loan made by a life insurance company to a policyholder on the security of the cash surrender value of his policy.

Policy or membership fee. Under the monthly premium plans for some accident and health insurance, the initial consideration is larger than the subsequent monthly premiums. The extra initial consideration is ordinarily termed a "policy fee" but is sometimes designated a "membership fee." It is common practice to permit the agent to retain the entire amount of this fee as compensation for securing the business. This term is also used sometimes in connection with life insurance to designate a portion of the gross premium which is the same, whether the policy is for a large amount or a small amount, so that the total premium per thousand is less in large policies than in small policies.

Policy reserve. The policy reserve may be regarded as the excess of the present value of the future benefits provided in the contract over the present value of the future net premiums payable under the policy. The policy reserve may also be regarded as the excess of the accumulated value of the net premiums already collected over the accumulated value of the benefits already paid.

Policy reserve strengthening. The voluntary transfer of amounts from surplus to policy reserves in order to provide for future policy benefits on more conservative assumptions. Such a transfer may be due to the employment of a lower interest assumption or of a different experience table with the assumption of the same or a lower rate of interest in the valuation of the respective benefit contracts than was employed in the respective valuation at the previous year end.

Preferred risk. An insured on whom the company expects to experience a better-than-average mortality.

Preliminary term reserve. A policy reserve in which a lesser portion of the first year's premium paid by the insured is added to the re-

serve than of premiums of subsequent years. There are various methods for arriving at the difference.

Reduced paid-up insurance. A form of insurance available as a non-forfeiture option. It provides for continuation of the original insurance plan, but for a reduced face amount with no further payment of premiums.

Reinstatement. A restoration of a lapsed policy to an active status. All policies contain a provision stating the conditions under which reinstatement will be allowed.

Reinsurance. A process by which the reinsurer (the first party) in consideration of a premium agrees to indemnify the reinsured (the second party) against a risk insured by the reinsured under a policy in favor of the insured (a third party). The reinsured may be referred to as the original or primary insurer or the ceding company.

Reinsurance assumed premiums. All premiums (less return premiums) arising from assuming the liability, in whole or in part, of another insurance company which is already covering the risk with a policy.

Reinsurance ceded premiums. All premiums arising from policies or coverage purchased from another insurance company for the purpose of transferring the liability, in whole or in part, assumed from direct or reinsurance assumed policies.

Renewable term insurance. Term insurance providing the right to renew at the end of the term for another term or terms without providing evidence of insurability. The premium rates increase at each renewal.

Renewal premium. Any premium payable for an insurance policy after the first year.

Reserve basis. The particular set of assumptions as to interest and mortality or morbidity on which reserves are calculated.

Retention. The amount of insurance risk which a company carries for its own account. Any insurance issued in excess of the retention is reinsured. In group insurance this term is also used to define the percentage of premium collected which the company will retain for expense and contingencies.

Retention limit. The maximum amount of insurance which a company will assume on one life at its own risk.

Separate accounts. Separate accounts constitute a separate operation under which the assets fund the liabilities to variable annuity contractholders, pension funds, and others.

Service fee. A fee paid to servicing agents (usually about one-half of one percent per annum) for collecting mortgage loan payments, remitting them, inspecting the security, and checking on tax and insurance matters affecting the property. Service fee is also often used to indicate non-vested renewal commissions paid to the servicing life insurance agent after the expiration of normal renewal commissions on a policy.

Settlement option. A choice of an alternative method of payment of the proceeds of an insurance or annuity policy, by the insured or his beneficiary, in lieu of the basic method of payment provided in the policy. Usually a settlement option envisages annuity or installment payments even if the basic method of payment provides for a lump-sum settlement.

Single premium. A lump-sum consideration received by an insurance company in accordance with an insurance or annuity contract.

Statutory. Relating to the laws of the federal or state government. Also loosely used to include governmental regulations.

Statutory reserve. A policy reserve equal to, or greater than, the minimum computed under the method prescribed by state regulation, which method specifies the mortality or morbidity table to be used, the rate of interest to be assumed, and the formula to be applied.

Stock life insurance companies. Companies which operate for the purpose of obtaining profit for their stockholders. In general, stock life insurance companies issue nonparticipating policies, but some also issue participating policies.

Substandard insurance. Insurance issued on lives involving extra hazards due to physical condition, occupation, habits, or family history. An extra premium is charged for the extra risk, thus making the total premium higher than that on standard insurance.

Suicide clause. A provision in a life insurance policy that the risk of death by suicide (sane or insane) is excluded during the first one or two years after the date of issue. In event of suicide within this period, there is a refund of premiums paid.

Supplementary contract. A contract issued by the company to a beneficiary in exchange for the matured policy when a life insurance policy is settled under one of the settlement options.

Supplementary contract without life contingencies. A supplementary contract providing for leaving a specified sum with the company at interest at a specified rate, subject to withdrawal under stated conditions of all or any part of the interest or of the original sum

with interest or for payment by the company of a specified number of installments of a specified amount. Interest is taken into consideration in computing the amount of each installment. No life contingencies are involved.

Supplementary contract with life contingencies. A supplementary contract issued in the form of a life annuity contract on one or more lives or a combination of an annuity certain for a specified period and a deferred life annuity of any type.

Surrender. To accept some form of nonforfeiture option. Usually the policy is physically surrendered to the insurance company either for cash or in exchange for an extended or paid-up policy.

Tabular cost. As used in the Annual Statement, the aggregate expected mortality and disability cost for life insurance policies.

Tabular interest. Generally known as the interest required to maintain the reserve. The amount of interest which it had been assumed would be earned during the year on the policy and claim reserves and the valuation premiums on all benefit contracts which were in force at any time during the year.

Tabular net premium. As used in the Annual Statement this term refers to the premium which is used in determining the policy reserve. It is frequently referred to as the net premium or the valuation (or actuarial) premium.

Terminal policy reserve. The policy reserve at the end of the policy year. It is equal to the amount of the reserve at the beginning of the policy year (the initial reserve) plus interest on the reserve for one year and less the cost of insurance for the respective policy year.

Term insurance. Insurance providing for a death benefit only if the insured dies within the period of time specified in the contract. Coverage is for level or reducing amounts for stated periods such as 1, 5, 10 years or to a stated age. It provides life insurance protection for a temporary period of time and, therefore, is the least expensive. There are generally no loan or cash values. A term policy may be convertible, that is, it may grant the privilege of exchange without medical examination, for permanent insurance on the whole life or endowment plan. It may also be renewable at the option of the insured without furnishing evidence of insurability (automatically renewable).

Total and permanent disability. Total disability which is presumed to be permanent in character. Frequently total disability is presumed to be permanent (for the purpose of beginning benefits) if it has persisted, and been total, for some specified period of time, such as three or six months.

Uncollected premiums. Premiums payable, but not yet paid, on policies still carried on the company's books as being in force.

Underwriter. (1) An individual or company who insures risks, (2) an agent who solicits insurance, or (3) an employee who determines whether applicants are suitable risks for insurance.

Valuation premium. See Net premium.

Variable annuity. An annuity which includes a provision for benefit payments to vary according to the investment experience of the separate account in which the amounts paid to provide for this annuity are allocated.

Waiver of premium. A waiver of premium benefit is also typically included in noncancellable or guaranteed renewable disability income policies. In such policies it is not required that disability be permanent.