leasing is accomplished through establishing balance sheet liabilities generally *not related* to revenue, e.g., the provision for unpaid losses. Does the principle imply that safety margins should be built into liabilities and if so should these margins be optional or should they be mandatory and in accordance with prescribed rules.

The term "cumulative" should relate to the balance sheet rather than the earnings statement; the balance sheet reflects complete financial results on a cumulative, all-time basis. The significance of earnings statements lies in what they relate concerning a definite, specified period of time such as a calendar year.

The term "substantially certain" is interesting and may prove to be a useful addition to financial statement vocabulary. The term would be more meaningful if it were considered in relation to the present words of virtue, "full and true," under which the system now operates.

Some further elaboration on points in which statutory accounting *is* or *is not* consistent with the "substantial certainty" principle would make the reviewer's general evaluation more meaningful. Also, can several important concepts of virtue such as "substantial certainty," "full and true," and "objectiveness" all be accomplished at the same time?

DISCUSSION BY ROBERT G. ESPIE

Mr. Otteson's paper is very timely in that the financial statements of fire and casualty insurance companies have within recent years been questioned, at least implicitly, by investment analysts and professional accountants who have shown no reluctance about adjusting official results to produce figures more suitable for investors or more in accord with accounting principles generally acceptable for other types of enterprises. Our financial statements need to be re-examined as to their ability to do what they ought to do and their avoidance of what ought not be done.

Unfortunately, in addressing himself to the "full and true" phrase in the jurat the author has with one stroke claimed an objective that is intrinsically above reproach and posed an ethical problem for which he offers no solution. If the statement signer truly believes, for example, that "statutory over case-basis" reserves are not liabilities, he can hardly sign a statement which so includes them; if he omits them from liabilities and signs the statement he will be charged with perjury on the ground that "full and true" means "full and true in accordance with the requirements for filling in the blank." It seems to this reviewer that only in the area of loss evaluation does the author really concern himself with fullness and truth and that in his other comments he really concerns himself with the usefulness and meaningfulness of the prescribed statement form and preparation rules. To the extent that he does so he concerns himself with whether the statement, as prescribed, does a good job of fulfilling its objective, and yet he does not define that objective. In this respect, he leaves undone a task which badly needs doing and he exposes himself to the consequences in logic of building an argument without properly examining his basic premises.

CONSOLIDATION

The author does not seem to have clarified the objectives of consolidated statements and might perhaps have reached different conclusions if he had done so. For the purposes of the shareholder of a parent company, it is appropriate to consolidate all significant subsidiaries so that the shareholder can determine a proper figure of the earnings attributable to his holdings and a proper figure of the capital funds represented by each share. The policyholder, on the other hand, may be completely misled by a consolidated statement if, for example, his claim is in fact a claim only against a subsidiary which is itself a limited liability company whose liabilities are not guaranteed by the parent. To policyholders and other creditors, information as to surplus protection is only relevant if it is available to them, and a consolidated statement could be quite misleading. Between the two extremes of ownership status only and creditor status only comes the policyholder of a mutual company who has something of the interests of the shareholder, particularly if he is a policyholder of the parent company, and something of the interests of the creditor, particularly if his own policy is backed only by the assets of a particular subsidiary.

If the author had set forth objectives of consolidation in the above terms, his dicta on the subject of consolidation might have been somewhat different.

VALUATION

The author also appears only to touch the surface of the valuation problem and has relied upon concepts applicable to other types of business in forming his judgments.

Two alternative philosophies of asset valuation, and for that matter liability valuation, may be considered. One is the liquidation concept—what happens if all assets and liabilities are immediately exchanged for the common denominator of cash? The other is the going-concern concept—what happens if all assets and liabilities are held in their present form until liquidated in an orderly fashion as a part of the business process?

The liquidation approach has been the classic approach in insurance company statements because of the preoccupation of regulatory authorities with their role of guardian of solvency for the protection of the policyholders and claimants. It has the advantage that it is simple and within the administrative capacity of the regulatory authorities. It may also approach the valuation which would be made on reinsurance of an entire company which is going out of business. It has the drawback of being unrealistic for the company which is in infinitesimal danger of going out of business and unrealistic for large blocks of assets whose rapid sale would of itself depress the market. It is also unrealistic for those assets which are intended to be "used up" during their lifetimes as part of the costs of operation, for which the depreciation approach is more reasonable.

The going-concern approach has the advantage of being more realistic for the vast majority of companies and of producing more accurate earnings statements. Accuracy of earnings statements has come to be generally considered by accountants to be the paramount objective for other types of businesses, particularly where the creditor interests are sophisticated enough to make their own determinations, and where the thrust of the regulatory authorities must be in the direction of protecting comparatively unsophisticated investors.

For the purposes of the insurance regulatory authorities it therefore appears that the real purpose of valuation—the determination of whether a company is in such circumstances as warrants its being continued to sell insurance—is not satisfied by either the liquidation concept or the going-concern concept. It must be a combination of the two.

This approach to valuation supports the author's dictum that market values should be used for common stocks but not his claim that these values should be discounted for potential capital gains tax unless the basic policy of the company is to speculate in common stocks and sell for profit rather than to invest in common stocks for virtually permanent ownership. On the going-concern concept the stocks are not expected to be sold and capital gains tax is not expected to be paid. If the company has to liquidate its holdings to finance an underwriting disaster the underwriting loss may be expected to offset the capital gains, no tax will be paid, and valuation at market without tax discount will in fact have been shown to be the best measure of the value of these stocks to pay off claims. If a company has an expectation of an underwriting loss every year (a sort of "continuous disaster" such as is produced in some current rate-setting situations) it may deliberately plan to invest in growth stocks whose value can be realized without capital gains tax, just as it may deliberately choose taxable bonds over tax-exempts when faced with annual underwriting losses.

The valuation of bonds on an amortized basis without regard to current vagaries of the market must be the preferred basis unless it is conceded that the company is going out of business or that for some other reason there may be an expectation of bond investments not being held to maturity. Note that on the going-concern basis a company could normally finance an underwriting disaster by temporarily "warehousing" bonds rather than dumping them in a poor market.

INCURRED LOSSES

The author is on surer ground in the area of measurement of unsettled losses. It is apparent, as he has shown, that marked differences exist in the abilities of individual companies to measure at the end of the calendar year in which the accident occurs the ultimate amount for which that accident will be settled. One suspects that if his Exhibits A and B had been constructed for a series of years he would have found that this ability may also vary markedly from year to year within an individual company. He might also have found that valuation ability varies from line to line within a company and that one line may offset another.

He might have commented on the fact that a well-managed company does not take drastic managerial action on the basis of a single year's results and that by the time enough years' results are known to establish a credible trend the redundancy variations of a line for a year will most likely have been smoothed out to a point where the management, or the regulatory authority, will not actually have been seriously misled by the accuracy shortcoming of the statement for a particular year.

His exposition should also be helpful in discouraging analysts from placing excessive reliance on individual year's results as being indicative of a trend.

Incidentally, the author's difficulty in distinguishing between consolidated and unconsolidated statements is borne out by the (e) and (f) columns of the first lines of each of Exhibits A and B. The column (e) figure is for one company of the group only; the column (f) figure is for both.

SCHEDULE P

The author's comments with respect to this schedule seem to overlook the general consensus that its shortcomings are too many and too important to warrant its retention in the statement. Without considering the fundamental flaws in it he points out some of the disadvantages which arise from its use and suggests means of patching it. His patches do not correct the fundamental flaws and their suggestions will be a disservice to the cause of "full and true" statements if uncritical readers assume that such patching will correct the schedule into a good thing.

This reviewer questions his statements that voluntary reserves are not liabilities, that statutory excess reserves are not liabilities, and that separation of the two on the balance sheet, in the surplus block, would give the regulatory authorities information which is meaningful and which is not now readily available.

The distinction between a "liability" for the apparently precise costs of an event which has happened and a "reserve" for the apparently imprecise costs of an event which may happen is a distinction which is practically impossible to draw for an insurance company. If a "going-concern" insurance company sets aside a reserve for a rainy day (or a very windy day) or for possible future upward development of case-basis reserves, is it any different except in technique of measurement from the reserve for payment of an annuity-type benefit? Does some imaginary line exist which divides "liabilities" based on statistical tables from "reserves" based on managerial judgment?

UNEARNED PREMIUMS AND PREPAID EXPENSES

The author in this section makes some pertinent comments on the subject of "prepaid expenses" and "equity in the unearned premium reserve" but after setting forth some of the problems he rather weakly concludes that "a note of caution" should be sounded before introducing this concept into official balance sheets.

In this reviewer's opinion he has fallen into the common trap of assuming that prepaid expenses do exist because the statement speaks of "unearned" premiums and because it seems to imply that premiums are "taken into income" over a period of time.

A more consistent approach is to regard premiums as being taken into income when written and the corresponding acquisition costs charged off at that point. Thereafter, it may be necessary for an insurance company to have a reserve to provide for the fulfillment of the obligations which arose from that transaction. Generally, the reserve which would be adequate for this purpose would be 65% or 75% or 80% or some other percentage of the gross premium. If the policyholder has the right of cancellation at any time with return of part of his premium, it would be imprudent for management to hold as a reserve less than the amount returnable. (It would also be imprudent for the management to discount this policy obligation by its expectation of being able to secure a return of commission.) Under these circumstances the regulatory authorities cut through the various arguments as to what percentage of the gross premium should be held by stipulating the outside figure of a pro-rata of 100% of the gross premium. To the extent, if any, that this reserve is more than adequate to liquidate the anticipated outgo, there is an element of overvaluation which reduces surplus and may distort the emergence of earnings. If the situation is so looked at, the concept of prepaid expense disappears and the argument boils down to (1) should there be two different annual statements which would not agree, one for regulatory purposes and one for other purposes, or (2) should the objectives of policyholder protection be submerged in favor of other objectives, or (3) should the over-valuation of policy reserves be regarded as simply an example of that conservatism which underlies many accounting principles? To this reviewer the third alternative seems to be the only one acceptable to a management with stewardship responsibilities such as we have in the insurance business.

Mr. Otteson has touched upon a number of aspects of the annual statement which badly need exploring. It is to be hoped, however, that further explorations of this nature will be preceded by a deeper probe into the underlying philosophies of statements.

AUTHOR'S REVIEW OF DISCUSSION BY MR. ESPIE

Mr. Espie begins his review by pronouncing complete judgments as to the overall merits of the paper. The relationship of these judgments to either the intent or the substance of the paper at times appears quite distant. The review then continues on a point by point basis.

CONSOLIDATION

The first sentence of this section of the review reads as follows:

> "The author does not seem to have clarified the objectives of consolidated statements and might perhaps have reached different conclusions if he had done so."

In reply, the following statement contained in the paper appears to express the author's objective quite clearly:

> "The consolidated balance sheet is the only method available to reflect properly the financial situation of a group of insurance companies when