dent 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

ownership or financial control by one company over another is involved. It is the only means by which total capital can be compared with and related to the magnitude of the total insurance operation."

The review fails to consider the significance, truth, and propriety of the above statement. The question of whether the surplus of the parent company only must be related to the premium volume of the entire group in establishing "surplus to policyholders – premium volume" relationships is not considered or evaluated.

The example quoted by the reviewer is relevant concerning a subsidiary company policyholder but would not be properly applicable to a parent company policyholder. Also, the example is somewhat irrelevant in that the paper does not specify or contemplate that individual company statements would be eliminated.

VALUATION

The differences in viewpoint and position between the author and reviewer concerning this section of the review are complete.

The reviewer compares liquidation and going concern concepts of valuation. He defines the going concern concept to mean:

"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 Accountant's Handbook (1960), R. Nixon and W. G. Hell, quotes Paton and Paton *(Asset Accounting)* in explaining the meaning of going concern valuation as follows:

"The value of the business as a going concern is primarily a question of earning power. The cost approach, dominant in the treatment of individual tangible assets, loses significance when the center of attention shifts to the business entity. The enterprise, a conglomeration of facilities, has value in proportion to its ability to produce income."

It is difficult to see how this principle which relates to the overall worth of a business, without reference to any specific category of assets or liabilities, can be applied appropriately to the valuation of investment securities.

The reviewer believes in the liquidation concept (market value) as applicable to the valuation of stock. On the other hand, he opposes the capital gains tax reserve.

> "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."

He then uses his own going concern definition to justify not establishing the reserve through the assumption that the stocks will not be sold:

> "On the going concern concept the stocks are not expected to be sold and capital gains tax is not expected to be paid."

There is no explanation as to how companies would be classified as to whether they were "speculators" or whether they bought stocks for "permanent commitment". If capital gains tax is to be avoided the permanence must be absolute and complete even though it meant restrictions as to changes in overall investment strategy and tactics, or restrictions as to shifting among individual stock issues in light of changing situations and conditions.

The reviewer implies that if capital gains tax is used as an offset to a future underwriting loss it means that no capital gains tax cost is involved. The author believes this reasoning to be completely in error; the cost of a capital gains tax applied to reduce a loss carry forward is just as real as though the tax were paid in cash.

Concerning bonds, the reviewer relates his argument to the question of whether or not the company is going out of business. The author believes this question to be irrelevant. The current market evaluates bonds on the basis of present value of future interest earnings and principal payment in terms of current interest rates. The amortized value relates to cost values and these are in reality the market values of former times when interest rates were at different levels.

The reviewer suggests that

> "a company could normally finance an underwriting disaster by temporarily 'warehousing' bonds rather than dumping them in a poor market."

This suggestion poses a basic question. How is a "poor market" to be recognized? It is easy to look backwards at the ups and downs but how is it possible to look ahead to determine what the market will be at a future date? The company in trouble may be assuming additional market risks beyond its capacity if it "warehouses" rather than liquidates.

Failure to recognize the verdict of the market place in the valuation of investment securities can be a dangerous game, and failure to recognize potential Federal tax liability is unwise and improper.

SCHEDULE P

The reviewer expresses disagreement with the author's Schedule P suggestions in a general sort of way. Specific recommendations for revising Schedule P contained in the paper are referred to as "patches." The author's proposal to transfer Schedule P reserves from the liability section to the "below the line" section of the balance sheet is not evaluated; this transfer would eliminate completely the effect of these reserves upon surplus to policyholders and thereby reduce their financial significance to a meaningless status. This seems like more than a "patch."

The reviewer then reveals much concerning his attitude toward financial statements. He advances the position that it is practically impossible for an insurance company to draw a distinction.

> "between a 'liability' for the precise costs of an event which has happened and the apparently imprecise costs of an event which may happen."

The author disagrees completely and wholeheartedly with this position and believes that it could lead fire and casualty financial statement principles down dangerous paths. From the standpoint of a financial statement declaring assets and liabilities as of a given date, past events and future events are as different as night and day; the former *must* receive financial recognition, and the latter *must not* unless a contractual liability relating to future events exists as in life insurance.

The "windy day" reserve and the reserve for an annuity benefit reflect situations which are entirely different. The liability for the annuity *exists* at the statement date and if future premiums are involved, these would be considered as an offset to the present value of the benefit. The liability for a future windstorm does not exist as of the statement date and therefore it cannot receive financial statement recognition.

The reviewer's question as to the imaginary line dividing "liabilities" based on statistical tables from "reserves" based on managerial judgment is difficult to understand. Tables are useful in evaluating outstanding losses when the elements of mortality and interest are involved. This valuation process has certain characteristics pertinent to this question: (1) the tables can be applied objectively, uniformly, and consistently; (2) the basis of valuation is understandable to the user of the information; and (3) a reasonable degree of valuation accuracy is presumed to be present. A reserve based on managerial judgment would have none of these characteristics and it may not even be related to existing liabilities. A review of actual

cases of Schedule P voluntary reserves for companies establishing such reserves reveals this lack of uniformity, consistency, and objectiveness most emphatically.

UNEARNED PREMIUMS AND PREPAID EXPENSES

The following reviewer's statement is unusual and somewhat puzzling:

> "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."

This seems like a great departure from the customary earned premium definition of income which provides the basis of the annual statement accounting method. Further, it is difficult to relate this statement and the ensuing argument developed by the reviewer to the argument he actually selected in supporting the 100% unearned premium reserve concept.

DISCUSSION BY JOSEPH LINDER

I must confess to a feeling of disappointment upon reading Paul Otteson's paper and studying the exhibits, the preparation of which must have taken considerable time and effort. My appetite was whetted in the opening paragraph of his paper when he underlined the words "full and true" in the quotation from the sworn statement contained on page 1 of the annual statement. I am sure that all of us would like the annual statement to be "fuller and truer." Personally I believe that substantial improvement is not only highly desirable but entirely feasible with a substantial bonus in the form of economy in record-keeping. I must seriously question, however, whether Mr. Otteson's "observations" do much to help a most praiseworthy cause.

In considering the section on Consolidated Statements, I must first assume that, regardless of purchase price or other investment, a wholly owned or controlled subsidiary would have a per share *carrying value* based on an amount which is not in excess of combined capital and surplus. (This is the law in New York and some other states, and I am sure that Mr. Otteson will readily agree with me that it should be so by regulation, at least, in all states.)

Had Mr. Otteson limited his advocacy to multiple line companies, I would probably be in agreement with him if the group were all stock companies or even if the parent company were a mutual company with one or more stock subsidiaries. I might even be willing to agree, somewhat