DIVISION OF CORPORATION FINANCE

TRAINING PROGRAM LECTURES

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Subject: Analysis of Registration Statements of Insurance Companies

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MR. DUBOIS. The subject of today's session in the analysis of registration statements filed by insurance companies. The discussion will be presented in two parts. The first, dealing with analytical aspects, I will endeavor to present, and the second, relating to accounting problems, will be conducted by Walter Mickelsen of the Division's Accounting staff.

It should be emphasized at the outset, however, that complete coverage of neither of these areas can be accomplished in the allotted time. We will, therefore, confine our remarks to the more significant disclosure problems peculiar to the type of filing under consideration, omitting references to matters of lesser consequence or which are common to all registration statements.

Before getting into the details of today's discussion, it might be well to examine into the scope of the subject. The insurance business constitutes a very important segment of our total economy. According to the 1955 Economic Almanac, National Industrial Conference Board, its assets exceed those of the railroad, oil, chemical, steel and iron, automobile and motion picture industries combined.

Broadly speaking, the industry is divided into mutual companies, which have no capital stock outstanding and are owned in effect by the policy holders who receive all dividends, and stock companies which, as the term implies, have capital stock outstanding and are owned by the stockholders. These companies underwrite many types of insurance – life, health, accident, casualty, fire, marine, and title, to mention a few. Some companies underwrite only one type of insurance such as life insurance, while others may handle several types such as life, health and accident. All have the common purpose of assuming some sort of calculated risk for the payment of a fee, or premium, as it is called. These premiums, together with interest and dividends from investments, constitute the industry's principal sources of revenue.

Yet despite the magnitude and complexity of this industry, relatively few insurance companies file registration statements with the Commission and these are mostly the small promotional or semi-promotional type. There is a good reason for this. In the first place a very substantial portion of the industry, the mutual companies, such as the huge Metropolitan Life Insurance Company, have no capital securities to sell. The major portion of the balance of the industry, the established stock companies, such as Connecticut General Life Insurance Company, have no need for raising new capital. The big problem of both in recent years has been to find profitable investment outlets for the large amount of funds they already have and which keep pouring into their treasuries annually in the form of premiums, etc.

This leaves a relatively small segment of the industry with which we in the Commission for the most part deal. Registration statements filed by insurance companies are most frequently those of companies just starting out in business, or of companies that have been in business for a few years but have not yet reached the profit making stage and wish to raise additional capital to finance expansion into new territory. The proposed expansion may take the form of acquisition of another small company which, perhaps, is in difficulty due to under-capitalization. Almost all are still in the promotional stage and operate in limited local areas. Occasionally small insurance companies which have been insuccessful operation for a number of years have filed for the purpose of enabling persons in control to sell their holdings publicly but these are rare. Therefore we are primarily concerned with the small, local, promotional type of stock company.

The foregoing should not be misconstrued to imply that the subject of this session can be lightly dismissed as inconsequential. Millions of dollars of the securities of these companies are offered to the public each year, frequently without benefit of a responsible underwriter who might be inclined to explain the inherent risks involved to his customers, the public. Moreover, while anyone with common sense realizes that a new mining venture may eventually find its property devoid of ore, or that a company organized to produce a new gadget may or may not be successful, a prospective purchaser of the stock of a new insurance company may be easily deluded by the display of massive strength, conservatism, and success exhibited by the insurance industry as a whole. Also, the fact that insurance companies are subject to state regulation may induce a feeling of security. Less in evidence is the long inevitable period of operating losses, the struggle for a foothold in the face of fierce competition from the large established companies, that a new company, even though strongly sponsored, must survive, and that no amount of state regulation will supplant skillful, experienced management.

The Securities Act of 1933 requires registration of any securities offered in interstate commerce by insurance companies, except that Section 3(a)(8) of the Act specifically exempts from registration "Any insurance or endowment policy or annuity contract or optional contract, issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agent or officer performing like functions, of any State or Territory of the United States or the District of Columbia." Thus, any offering of capital securities must be registered. The form used for registration is Form S-1. The procedure followed in examining an insurance company registration statement is substantially the same as that of any other company. All of the applicable rules and regulations, Commission policies, the items of Form S-1, and Division memoranda apply. Considerations arising from the nature of the business and the individual registrant are, of course, different.

Immediately upon receipt of a registration statement, a copy of the prospectus should be forwarded to the insurance Commissioner of the state in which the registrant is organized for his comments. A copy of the type of covering letter used for this purpose can usually be found in the group file. This is done in the hope of obtaining from the Commissioner any significant information in his possession regarding either the securities to be offered or the company's status under state laws which is inaccurately set forth in the prospectus or omitted entirely. It has the further value of alerting the state authorities of the company's intentions of publicly offering securities, in case they do not already know. If the response is negative that, of course, ends the matter. If the state authorities raise questions bearing upon disclosure which we consider material, an appropriate comment will be included in our letter of comment to the company.

The methods by which the securities will be offered and the terms should, of course, be fully described in the prospectus. This is especially important with respect to the small promotional type of company whose media of distribution are usually limited. If an underwriter is to be employed, the prospectus should make clear whether the securities will be taken down on a firm commitment basis or are to be offered on a "best efforts" basis. Usually the latter is the case. Any relationship between officers, directors, principal stockholders, or promoters of the company and the underwriter should be disclosed, indicating whether any such persons will share in the underwriting commission.

In numerous cases of the type we are considering there are no underwriters, the prospectus as originally filed merely stating that the shares will be offered by the company directly. This is not adequate disclosure. The persons in the company, usually certain of the directors and officers, who will actually do the selling job should be named and it should be indicated whether or not they will receive any compensation.

One point worthy of particular note in connection with the matter of offering data, is the occasional practice among the small promotional type insurance companies of arbitrarily marking up the price from that of a previous offering. To illustrate, a company may have raised its initial capital a year or two ago on the basis of $5.00 per share. This may have been accomplished by means of strictly intrastate sales, avoiding the need for registering a Regulation A filing or a 1933 Act registration statement. During that time the shares may have been split two-for-one with the result that the $5.00 offering price, adjusted for the stock split, would become $2.50 per share. Now the company files a new registration statement for the purpose of raising additional capital for expansion purposes and prices the stock at $10.00 per share, even though it has operated at a loss since inception, which, incidentally is characteristic of a new insurance company for the first several years. The prices used here may be a little extreme but they serve to illustrate the point.

The rationalization for this mark-up in price, despite operating losses, seems to be that at the time of the initial offering the company has written little or no insurance but it now has on its books several millions of dollars of insurance in force – let us say, $10 million. How one evaluates insurance written, that has produced no profit for the company, for the purpose of determining the value of its stock I am unable to say. However, in such circumstances the company should certainly be required to disclose prominently in its prospectus: (a) that the offering price of $10.00 per share was arrived at arbitrarily since the company has continuously operated at a loss and nothing has occurred in its affairs since offering its stock at $2.50 per share two years ago that would justify the increase in price other than that it now has $10 million of insurance in force on its book; and (b), the amount of immediate dilution that will occur in the book value of the $10.00 stock by reason of shares having previously been sold at $2.50.

As Item 3 of Form S-1 is fairly explicit with regard to the disclosure requirements as to the proposed use of the proceeds from a public offering of securities, we will touch on only one aspect of this important matter which is peculiar to some insurance companies.

The laws of many states provide that before a newly organized insurance company may begin writing insurance it must have a prescribed amount of paid-in capital and surplus. For instance, the laws of the State of Colorado require that a life insurance company must have $100,000 of capital and $50,000 of surplus before it can receive a certificate of authority to transact a life insurance business. If the registrant is offering its stock on a best-efforts basis, the required capital and surplus will most likely be acquired only over a protracted period of time. Since the company cannot engage in the insurance business until the full required amount is paid in, the question arises as to how the funds being gradually accumulated from public sales of stock will be utilized in the interim and what will become of stockholders' money in the event that the required amount is never received.

I suppose there are numerous ways of handling a situation such as this. Academy Life Insurance Company explained in its prospectus that pending receipt of the full amount required, 80% of all funds received from the sale of stock would be placed in an escrow account with a bank and if within eighteen months and full required amount had not been received, the escrowed funds would be returned to subscribers to the stock. The unescrowed 20% was to provide funds for interim expenses. In any event, care should be exercised to assure that the prospectus adequately discloses the intent in this matter.

And now, although Item 16 of the Form S-1 clearly requires, among other things, disclosure of the experience of the executive officers for the past five years, I would like to emphasize the importance of management in a promotional type insurance company and the necessity for obtaining adequate disclosure as to its competency.

Competent management is, of course, an important factor in the success of any enterprise. It is of especial importance in the case of a small insurance business that is not yet thoroughly established because of the highly technical nature of the business and the terrific competition it is bound to encounter from the more advantageously situated large established companies which operate in every nook and crevice of the country. The advantages the large companies enjoy are too numerous to mention. Among them are their well-known names, highly skilled personnel in every department, almost unlimited resources, experience, and national and even international diversity of risk.

A stockholder contemplating investing his money in a new, or relatively new, insurance company is entitled to know fairly explicitly through the prospectus how well the management is equipped by actual experience to engage in the business. Prospectuses have been filed which attempt to cover up the inexperience of the management by stating that the president, or some other officer, has been identified with the insurance business for a number of years. This is totally inadequate. If such a claim is made, it should be amplified to explain the exact nature of the association with the business. Was the man merely an insurance salesman or was he a principal executive officer of a successful company? How long was he so employed? It should also be made clear whether any of the executive officers have had experience in the management of an institution's investments, which is an important aspect of managing an insurance company. The prospectus should state unequivocally that none of the officers or directors have had any experience in the management of an insurance company or in institutional investing, if such is the case.

One final point on the subject of management. If the available facts indicate that any of the principal executive officers of the registrant have other significant business interests that will most likely demand their attention, the prospectus should set forth the approximate portion of their time that will be devoted to the affairs of the registrant. This is of particular significance if the officer is a prominent person whose name might influence a prospective investor.

The prospectus should, of course, contain an adequate description of the business or contemplated business of the company. If it has been in operation and plans no change in the nature of its business, this will be largely evident from the operating statistics ordinarily furnished which, among other things, show the amount of insurance in force at the end of each year broken down by types, such as ordinary life, industrial life, health, accident, casualty, etc.

If the registrant is a new company, it should be clear whether the necessary authority to conduct an insurance business has been obtained from the appropriate state authorities. Or, if it is already an operating company but is raising additional capital for the purpose of extending its operations into other states, the prospectus should disclose whether the company has qualified to write insurance in the states it intends to enter.

The prospectus of a new company should always disclose very clearly the type, or types, of insurances it intends to write, specifying the type on which emphasis will be placed. In this connection, it is important to note that life companies should indicate whether they will write both ordinary and industrial (weekly payment) policies, again, indicating on which the emphasis will be placed. If industrial policies are to constitute a significant portion of the anticipated business, it should be explained that the rates on these policies are higher than those on ordinary life policies and that the ratio of lapses is also greater.

One feature of a new company that should be brought very forcibly to a potential investor's attention in the prospectus is the fact that the company inevitably will operate at a loss for the first few years of its existence. And, strangely enough, the more successful it is in writing insurance, the greater will be the operating loss. Conversely, the less new business it generates, the less will be the loss. The explanation for this anomaly is very clearly expressed on page 6 of the prospectus dated August 15, 1956, of the First Colony Life Insurance Company. It reads as follows:

> "Profits of life insurance companies are affected by several factors not usually found in other industries. In the year in which a policy is written it is necessary to provide for such items as reserves required by law, commissions, overhead, medical and investigation expenses, and other special costs. Accordingly, it is generally recognized that the aggregate amounts which a life insurance company expends or provides in putting a new policy in force are substantially greater than the amount of the first year's premium. The writing of new insurance, therefore, requires a substantial initial investment by the life insurance company, but once on the books such insurance becomes a valuable asset. A company, however, is not permitted to take credit for this asset in its financial reports made to the regulatory authorities or to the public except as the cumulative premium and investment income from the new policy exceeds the charges made and being made against it.
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> "The result of the above factors is that the reported profits of a company which is placing an increasing amount of new business on its books are adversely affected by the excess of the costs and reserves referred to above over the premiums received therefor; and, conversely, when new insurance is not increasing, the expenses and additions to reserves decline in relation to premiums received, with a favorable effect on reported profits.
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> "These factors serve to explain why an insurance company, even if it is being successfully operated, needs a large amount of capital in the early years when its rate of expansion may be greatest and why it is not able to pay dividends at least in the early years of the company. The statement of these factors should of course not be construed as any representation of certainty of profits in later years."

The length of time this situation will continue depends, of course, upon the individual company. In any event, the prospectus should make clear that because of it, dividends on the stock being offered cannot be effected for at least several years.

The prospectus should indicate the geographic areas in which the company conducts, or intends to conduct, its business. This is usually given by states, and in some cases the percentage of total premiums from insurance written during the previous year derived from each state is also shown, which provides an indication of where the company's business is concentrated.

A description of the sales organization is also important, and should include such information as the number of agents and general agents the company has and whether they are employees of the company or independent contractors. If a significant portion of the previous year's business, measured in terms of premiums on insurance written, was generated by any one or small group of agents, this also should be pointed out. The prospectus of Old Republic Insurance Company shows that in 1954 it had 1,180 agents of which 854 were under the jurisdiction of general agents and that 51% of the company's business for that year was produced by the ten largest agencies.

Selected operating statistics of an insurance company that has been in business for several years can be useful in judging the effectiveness of the management and will provide a clear indication of the importance of each class of insurance it writes. Of course, these must be supplied for a series of years to afford information regarding trends in the company and in a form comparable to those published by other companies to permit comparisons. The major operating statistics that usually appear in a life insurance company prospectus are discussed in the next few paragraphs. All, except those pertaining to investments and admitted assets, should be broken down by classes of insurance written, that is, ordinary life, industrial life, health, accident, etc.

Insurance in force and admitted assets at the end of the year, and net premiums for the year, portray the growth of the company over the period and show the areas in which the greatest risks have been assumed--for example, ordinary versus industrial life insurance. The statistics on insurance in force and net premiums will also divulge changes in trends in the classes of the company's business and the sources from which income is derived.

The termination ratios, that is termination of policies by surrender or lapse, by classes (actual terminated for the year to average insurance in force) is largely a test of management. A high ratio in relation to comparable companies may indicate, for one thing, a policy of high-pressure selling to persons who are incapable or uninterested in continuing their insurance. This is expensive business to the insurance company. An increasing trend over the years in the termination ratio, even though still low in **comparison to** comparable companies, might indicate a relaxing of management is vigilance over its agents. Significant changes in trends or any abnormality in **comparison with** other companies divulged by a company's statistics should be investigated in order to determine whether any development is taking place in the company that should be disclosed in the prospectus.

Actually, insurance is a dual business, the first part consisting of underwriting risks, and the second, of investing the large amount of funds the company receives from premiums and investment income from mortgages, stocks, bonds, and real estate. The latter function is very important and can have a significant effect upon the success of the company. A brief indication of the management's stewardship in this area is usually shown in the prospectus by presenting the ratio of investment income to average investments and cash for the year and to average investments excluding cash. Any conclusions as to the performance shown by this ratio must, of course, take into account numerous factors that bear on the matter, such as money rates prevailing during the period under review. In any event, these figures provide a basis for comparison with other companies and if either the ratios for the past year or two, or the trend of the ratios over a longer period of time, compare unfavorably, it would be well to inquire into the reasons.

Many other operating statistics are used in the insurance business but they would be largely meaningless to the average investor. Similar information should, of course, be furnished by companies engaged in fields of insurance other than life insurance. For a more extensive consideration of statistics commonly used in appraising the performance of an insurance company, reference is made to such standard statistical services as Best's Insurance Reports, Spectator Handbook, Standard and Poor's, and Moody's Manual.

Turning now from statistics to the subject of competition it cannot be exphasized too strongly that the latter can be a very important and real problem to an embryonic insurance company. There is little we in the Commission can do about it, however, except to make certain that the facts are presented to a prospective stockholder via the prospectus. Consequently, a statement is required in the prospectus to the effect that the insurance business is highly competitive and that the company will be indirect competition with many long-established, well-known, companies having resources far in excess of those of the registrant, indicating the approximate number of such companies serving the same area as the registrant. A statement is also required as to whether the company is, or will be, in a position to issue policies that compare favorably with those issued by competitors in respect to premiums, diversity of coverage, and other significant terms.

These are some of the more important matters to be considered in examining a registration statement of an insurance company. As indicated at the beginning of these remarks, they are not all-inclusive. All of the detailed information called for by the applicable items of Form S-1 should be disclosed and nothing will take the place of the employment of imagination tempered by common sence. Mr. Mickelsen will now take over.

MR. MICKELSEN. My discussion will relate primarily to financial statements and to the summary of earnings.

Most casualty insurance companies keep their books on the basis of cash receipts and disbursements with modifications to the written basis for premiums received. The preparation of the annual financial statements of an insurance company at the end of the year is a major project. This involves the making of numerous adjustments based upon an analysis of detailed subsidiary records and the preparation of many lengthy, detailed supporting schedules. The same situation is present when an insurance company files a statement with the S. E. C. Principally, assets must be converted from book values to the so-called "admitted asset values" which are permitted by the State regulatory authorities; and there must be computed the amounts of (1) the deffered credit for unearned premiums, (2) the reserves for unpaid losses and expenses, and (3) the reserves for commissions. A casualty company keeps a record of losses, setting forth data as to the filing of the claim, the estimated amount payable and the amounts actually paid. From this is derived what is known as the per case basis of determining the amount of the reserve. Case basis estimates may be in error for two principal reasons: One, that claims when they are first filed are not fully developed and often involve a larger payment in the end than is originally estimated and, two, there is always a lag in the reporting of claims. In Lasser's <u>Handbook on Accounting Methods</u>, in the chapter on insurance accounting, it is indicated that there is a tendency for these losses to be underestimated initially.

The recent filing of Continental Casualty Company illustrates the possibility of errors and miscalculations in preparing financial statements of an insurance company. This filing on Form S-1 late in 1956 disclosed that the reserve for unearned premiums on December 31, 1955, was overstated by $370,000. That meant, of course, that the reciprocal income statement item was understated by the same amount. The filing also disclosed an error of $593,000 in computing the market value (which was also the admitted asset value) of stock held as an investment. This filing included financial statements of National Fire Insurance Company. A note to its financial statements indicates that it had increased its reserve for unpaid losses by $1,000,000 as of June 30, 1956, and by an additional $450,000 in July 1956. The apparent reason for these two credits was the losses to be provided for as of December 31, 1954 and subsequently had been underestimated when earlier statements were prepared. These are large, reputable and well-managed companies, so it can be seen that in the case of a small or new company an error in the financial statements could readily occur also.

Because of the various differences between insurance accounting and what are considered generally accepted principles of accounting for industrial and commercial companies, this Division has, after consultation with various independent public accounting firms, agreed upon a modified form of accountants' certificate which certifying accountants now generally use in insurance company filings. This revised **form** of **certificate** differs principally by the insertion of a modifying clause "or as otherwise prescribed for insurance companies by the State regulatory authority as explained in Note _____ to the financial statements" in the opinion sentence of the certificate. The note referred to then includes **references to** these various differences in accounting. Certificates covering insurance company financial statements filed with us often describe briefly the various audit verifications made by the accountants.

For life insurance companies, generally we require that policy reserves be verified by an actuary and that reference thereto be made in the accountants' certificate. The actuary's consent to the use of his certificate or report is required to be filed in Part II.

With respect to insurance companies, our accounting rules prescribe that except as to form, which is outlined in Regulation S-X, such companies shall follow the rules and instruction governing the definition and computation of items in annual statements to their State regulatory authority. Regulation S-X does not specify the accounting requirements for life insurance companies or for title **insurance** companies. We generally apply to these the pertinent provisions of Article 7, which sets forth the requirements applicable to all insurance companies other than life and title. Rule 4-09 of Regulation S-X also sets forth the circumstances under which consolidations of insurance companies are permitted.

In **accordance with** MAP No. 4, the examination of summaries of earnings is **the joint responsibility of the** examiner and the accountant. As indicated above, **an insurance company prospectus** usually points out in the financial statement notes certain accounting practices of insurance companies which differ from those used in industrial and commercial accounting. These are often explained in more detail in the text of the prospectus. These differences arise principally because the various State regulatory commissions in their requirements place primary emphasis upon the protection of policyholders. The first principal difference is that insurance companies are required to value their assets for financial statement purposes at "admitted asset" values. These, in general, are supposed to be akin to current market values, although under certain conditions may be in excess of liquidation values, and sometimes substantially. Admitted asset value for the purpose of most corporate bonds which are deemed to be amply secured and not in default of interest and principal obligations is amortized value; i.e., cost plus amortization of a portion of **the discount or less amortization of** premium. During the 1929-1933 depression, **market values of these bonds were much** lower than their amortized or admitted asset values. The admitted asset values of bonds in default of interest and corporate preferred and common stocks are their market values. Insurance companies are authorized by some State commissions to carry home office real estate at estimated market value.

The second principal difference from commercial accounting is that casualty insurance premiums when **written** are credited to an unearned premium reserve account and are transferred to underwriting income on an accrual basis over the lives of the policies. On the other hand, underwriting expenses incurred in issuing the **policies,** such as commissions, state taxes on premiums and miscellaneous office **expenses,** etc., are charged against underwriting income as incurred. These items, in effect representing prepaid acquisition expenses, are not permitted to be treated as admitted assets. For example, the prospectus of Continental Casualty Company (File 2-12822) states as follows:

<u>Unearned Premium Reserves</u>

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"This required accounting treatment has the effect of charging against current income all the expenses in connection with the issuance of a policy at the time it is issued, but the premium income from the policy is spread over the period for which the policy is in effect. As a result, in a period of increasing volume of premiums written, statutory underwriting income is penalized to the extent of the prepaid acquisition expenses on the excess of premiums written over premiums earned. Conversely, in a period of declining premium volume statutory underwriting income is benefited.

"To the extent that prepaid acquisition expenses charged to current operations are applicable to premium income which has been deferred in the unearned premium reserve, insurance companies may be considered to have an equity in the unearned premium reserve. Specialists in the evaluation of insurance company stocks frequently consider this equity to be equivalent to 40% of the unearned premium reserve in connection with the 'fire' lines of business and 35% in connection with 'casualty' lines of business, both percentages being contingent on satisfactory loss ratios."

The third principal difference from commercial accounting is that insurance company financial statements exclude so-called "non-admitted" assets such as furniture and fixtures and equipment, agents' balances and premiums in course of collection over three months due, etc. The last item may in effect be deemed to be a statutory reserve for bad debts. Over a period of subsequent operations certain of these non-admitted assets may turn out to be of value.

The financial statements of a casualty insurance company prepared on a statutory basis, that is, the basis required by State regulatory commissions, do not present the full story desired by investors in regard to a company's earnings and book value. Accordingly, insurance company prospectuses usually include not only a summary of earnings consistent with State regulatory requirements, but also additional supplementary data regarding net income and book equity. Two of these computations are "adjusted net income per share" and "adjusted capital stock equity per share".

As you have noted from looking at insurance **company summaries, they present,** in two separate sections, the income derived from the two principal sources (1) underwriting operations and (2) investment **operations, i.e., interest and dividends** earned and net realized gain (or loss) on investments. In the case of most insurance companies, earnings summaries are followed immediately by an analysis of surplus. Most established insurance companies have combined earned, capital and paid-in surplus. In such cases we generally require analysis in a note of the source of surplus since inception. For newly established companies, we generally require segregations by types of surplus. The principal reason for inclusion of a surplus recapitulation at this point is the numerous recurring adjustments made direct to surplus in accordance with **regulatory commission** authority.

"Adjusted net income per share" is computed by deducting from statutory net income the net realized gains (losses) on investments after Federal income tax applicable thereto, and adding the increase in equity in unearned premium reserve, also after Federal income tax applicable thereto. This adjusted net income per share in periods of increasing volume normally is greater than the statutory net income and is considered by analysts a more representative index of true earning power.

Casualty insurance company investors are also concerned with book value. The book value or "capital stock equity" per share is computed in two general ways, i.e., with and without unearned premium reserve equity, although the details as to the items to be used varies with companies. Basically, in an all-common stock company, the equity comprises capital stock and surplus. In order to made a more accurate determination, however, companies may add in other items as the following: (1) reserve for contingencies (if of true surplus nature); (2) excess of statutory reserves over case estimates and loss expense **reserves; (3)** reinsurance in unauthorized companies; and (4) in some cases, **depreciated value** of equipment, furniture and fixtures, a non-admitted asset. **They may also deduct** the excess of statement value over market value of securities owned.

If the company should happen to be one which has substantial appreciation in stock investments, a 25% capital gain income tax provision would be applicable and common stock equity may be shown in two amounts, one before and one after, allowance for capital gains taxes. An example of how significant this factor can be is shown in the prospectus of the American Insurance Company (2-12756) where the equities before and after tax allowance at June 30, 1956 were $32.17 and $28.97, respectively, a difference of $3.20, or 10%.

The capital stock equity including unearned premium reserve equity, which is called "Adjusted capital stock equity", is considered more representative of the intrinsic value of insurance company assets than is book value per share. In effect, there is added to book value as ordinarily computed certain percentages of unearned premium reserve accounts at the balance sheet date, less provisions for the related applicable Federal income taxes. The percentages of unearned premiums used depend partly upon the line of insurance and upon the underwriting experience. A rate of 40% is customarily used for "fire" business and 35% for "casualty" lines. If underwriting losses are being incurred, I think there is some question as to whether these percentages are not too high. In the American Insurance example cited previously, the $32.17 and $28.97 per share figures are by inclusion of unearned premium reserve equity increased to

$42.89 and $34.66, respectively. These are increases of 33% and 19.3%. In most filings, these computations are shown in detail. Some present the date for the most recent balance sheet only; others show the computation over a series of year ends. Where one insurance company owns the stocks of other insurance companies as affiliated or associated companies, the investments therein are carried in the parent company's statements at the pro rata portion of the subsidiary companies' net worths as required by the State Insurance Departments. In the recent filing of Continental Casualty (2-12822) a note to the recapitulation of capital stock equities states how much of the equities per share would have been increased by inclusion of its holdings of two associated stocks at market value. These two associated companies were Continental Assurance and U.S. Life Insurance, both life companies. By using market values for these two, capital stock equity of Continental Casualty at June 30, 1956 would have increased from $46.93 to $66.64, or by $19.71, or nearly 42%. This computation, too, should theoretically give effect to the 25% capital gains tax.

Over long periods of time casualty insurance stocks sell for less than book value, due principally to underwriting operations being conducted at unsatisfactory margins of profit.

Life Insurance Companies

Life insurance company financial statements do not differ materially from casualty statements. A life insurance company does not have a reserve for unearned premiums in the same manner as a casualty company, hence no so-called equity in unearned premium reserve is present for asset valuation or for income statement purposes.

In the underwriting section of a life company income statement a portion of the premium income is deducted for credit to actuarial reserves for the life policies.

In the investment expense section of a life company income statement, there is deducted from net investment income an amount designated as "Interest required to maintain **reserves**." This tabular interest item plus the premium credit to reserves will build up the policy reserves to meet death payments as they occur. A reciprocal credit is shown in the premiums earned section.

Dividends to policy holders on participating policies should normally be shown as an underwriting expense.

Life insurance companies under present Federal income tax laws pay, relatively, very low Federal income taxes.