

Session 16: Accounting Topics

US GAAP for International Life Insurers
Amsterdam November 2007
Charles Carroll, Ernst & Young



SOCIETY OF ACTUARIES

Topics

- Income statement and balance sheet presentation
- Deferred taxes
- Sarbanes-Oxley



SOCIETY OF ACTUARIES

Income Statement and Balance Sheet Presentation



Condensed US GAAP Balance Sheet

December 31, 20XX

Assets

Securities, at fair value (cost 22.6)	22.1
Other investments	<u>5.7</u>
Total investments	27.8
Cash	4.9
Deferred acquisition costs	1.6
Amounts recoverable from reinsurers	2.4
Deferred tax asset	2.0
Separate account assets	<u>38.5</u>
Total	77.2



Condensed US GAAP Balance Sheet

<u>Liabilities</u>	
Policy and claim reserves	13.6
Contract holder funds	<u>20.1</u>
Total ins. & inv. contract liabilities	33.7
Separate account liabilities	<u>38.5</u>
Total	72.2
<u>Equity</u>	
Common stock	1.0
Retained earnings	3.5
Retained other comprehensive income	<u>0.5</u>
Total	5.0



Condensed GAAP Income Statement

<u>Revenue</u>	
Insurance premiums	1.1
Product charges	1.0
Net investment income	2.5
Realized gain	<u>0.3</u>
Total	4.9
<u>Benefits and Expenses</u>	
Benefits	2.2
Expenses (other than acquis.)	1.6
Amortization of DAC	<u>0.2</u>
Total	<u>4.0</u>
Income before taxes	0.9
Tax expense	<u>0.3</u>
Net Income	0.6



Deferred Taxes



SFAS 109 - Income Taxes



- Deferred tax liability computed by applying tax rate to temporary differences between GAAP and tax balance sheet
- Deferred tax asset must be recoverable to avoid a valuation allowance
- GAAP tax expense will equal the statutory tax rate times GAAP pre-tax income adjusted for permanent differences



Examples of Temporary Differences

- Investment valuation reserves
- Unrealized gains on trading securities
- GAAP deferred acquisition cost asset
- Excess of GAAP over tax reserves
- Deferred compensation liabilities
- Intangible assets (not goodwill)
- Depreciation



Examples of Permanent Differences

- Investment tax credits
- R&D credits
- Dividends received deduction
- Goodwill



Income Taxes - Example

	GAAP	Tax	GAAP - Tax
Securities	1,010	1,000	10
DAC	100		100
Reserves	(800)	(780)	(20)
Net	310	220	90

$$\text{DTL} = 90 * 35\% = 31.5$$



Income Taxes – New Developments

- FIN 48 – *Accounting for Uncertainty in Income Taxes*



FIN 48

- Two-step process for recognizing and measuring tax positions:
 - “More likely than not” threshold
 - Cumulative probability approach to measuring benefits
- Contrast to prior practice, which was based on “as filed” returns with a probability-based liability



FIN 48

- Potential areas of interest to actuaries
 - Documentation of tax-basis reserves
 - Areas where guidance is ambiguous
 - Areas where approximations are used
 - Foreign operations



Sarbanes-Oxley Section 404



Purpose of SOX 404

- Sarbanes-Oxley Act enacted in July 2002
 - Restore public confidence and renew investors' trust in corporate executives and financial reports
- Section 404 Requirements
 - Management must assert as to effectiveness of financial reporting internal controls
 - External auditor must separately attest and report on management's assessment, and on the effectiveness of internal control over financial reporting (i.e. 2 opinions)

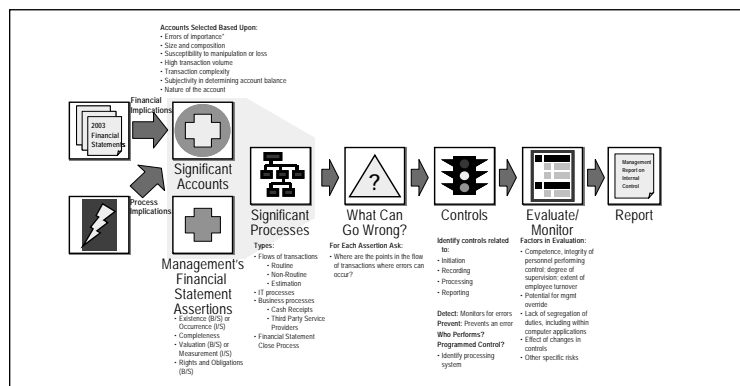


Auditing Standard No. 2

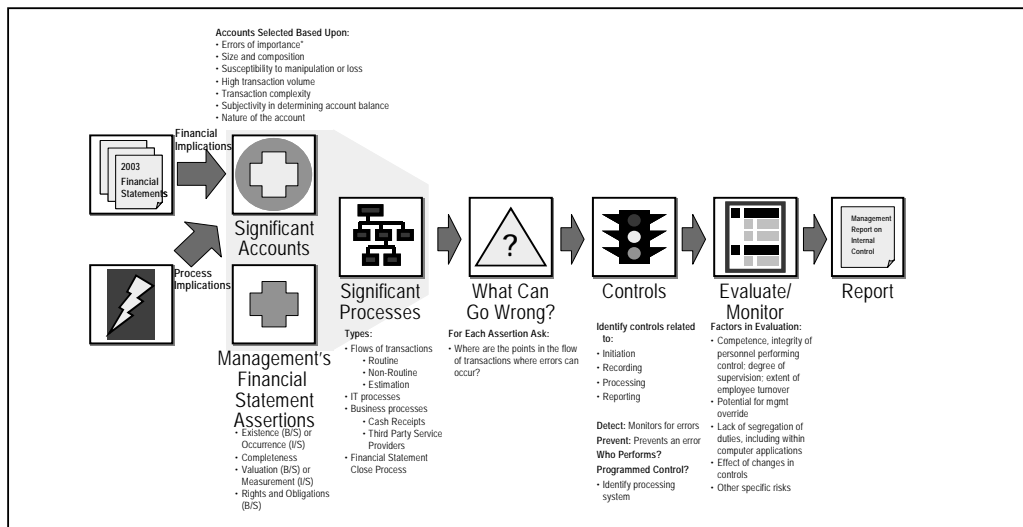
- PCAOB adopted on March 9, 2004 Auditing Standard No. 2, “An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements”
- Key Areas
 - Management’s responsibilities
 - Performing an audit of internal control over financial reporting
 - Using the work of management and others
 - Internal control deficiencies
 - Evaluating the results of testing
 - Reporting and communication



Overall Schematic of Framework



Overall Schematic of Framework



Overall Framework (cont'd)

- Identify and document significant processes and accounts
- Identify risks – the “what could go wrong”
- Identify mitigating controls
- Select and test key controls
- Evaluate and communicate findings



Actuarial Processes Affected

- Most actuarial processes will be considered significant and subject to documentation under SOX 404 due to the magnitude and complexity of their associated balances
- Some sub processes (e.g the reserving process for a specific product) may be considered immaterial, and thus deemed outside the scope of documentation and testing requirements



Significant Processes and Related Elements

- Processes may be subdivided by product
- Reserve process
 - Assumption setting
 - Methodological approach
 - Information Technology / systems and data flows
- DAC / VOBA determination process
 - Recoverability and Unlocking
 - Assumption setting and methodological approach
 - Information Technology / systems and data flows



Identification of Risks and Controls – Examples

Risk

- Inconsistencies between valuation data and inforce data as recorded in admin system

Controls

- Reconciliation of valuation data with financial ledger accounts
- Data extracts are reviewed by Systems Manager



Identification of Risks and Controls – Examples

Risk

- Projected EGPs and historical actual GPs (AGPs) are not consistently aligned by DAC cohort

Control

- EGP trends reviewed for reasonableness and signed off by chief actuary



Identification of Risks and Controls – Examples

Risk

- “Unlocking” decisions are not appropriate in light of trends in experience

Controls

- Regular experience studies performed on all key experience elements
- Key assumptions reviewed for reasonableness



Identification of Risks and Controls – Examples

Risk

- Deferrable expenses are incorrectly calculated

Controls

- Reconciliation of amounts of deferred expenses from actuarial valuation system to ledger
- Annual expense studies performed to support definition of deferrable expenses



Identification of Risks and Controls – Examples

Risk

- Reserves (for example, FAS 60) are incorrectly calculated

Controls

- Preparation and review of reserve “roll-forward”
- Regular analyses of the “fit” of the valuation models are performed



Common Control Weaknesses

- Use of Excel spreadsheets
- Too much reliance on “black box” processes
- Lack of timely/complete data from ceding companies
- Too much reliance on “outdated” assumptions with insufficient periodic review
- Lack of management review/sign-off on key controls



AS-5 - An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements



AS-5

- Revised interpretation of Section 404
- Top-down approach and focus on biggest risk areas
 - Alternative approaches for low risk areas
 - Use of work performed by the company
- Eliminate unnecessary procedures
 - Auditors no longer evaluate management's evaluation process
 - Simplifies process for multi-location companies
- Scalability
- Simplified text

