RECORD OF SOCIETY OF ACTUARIES
1976 VOL. 2 NO. 2

FILLING IN THE GAAP

Teaching Session

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This session will describe the basic features of GAAP accounting as applied to stock life insurance companies, both from an accountant's and an actuary's point of view. Current developments and problems will also be explained and discussed.

The presentation will be aimed at people who have some general knowledge of the subject but have not had direct responsibilities in the area or closely followed its development.

MR. DONALD W. DAILY:

I. Background and Principles.

A. Overview of How GAAP for Life Insurance Companies Came About.

1. Rules of Thumb Developed by Analysts and Life Insurance Companies - Era from 1950's through mid - 1960's resulting in over 30 separate methods.

2. "Committee on Life Insurance Earnings Adjustments" of the New York Association of Insurance and Financial Analysts project started in 1966 resulting in a generally accepted rule-of-thumb approach published in 1970. The AIFA method gained a good deal of acceptance.

3. The Life Audit Guide as prepared by the Committee on Insurance Accounting and Auditing of the American Institute of CPA's.

(a) Work began in 1966.

(b) First real meeting and exposure to life insurance industry and actuarial viewpoint was in 1970 on meeting with the Joint Committee on Financial Reporting Principles of the American Life Convention and the Life Insurance Association of America.

(c) The 1970 exposure draft of the Life Audit Guide embraced the so-called "natural reserve theory of accounting." As a result of many comments to the exposure draft, including most importantly the Joint Actuarial Committee on Financial Reporting, the final Audit Guide issued in early 1973 moved away from the "natural reserve" method.

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3. (CONT.)

   (d) The Life Audit Guide has resulted in a compromise between the first exposure draft and the percentage-of-completion method generally favored by the Joint Actuarial Committee.

4. The Audit Guide is GAAP, but does not begin to answer all the questions involved in GAAP for life companies. It is a guide which sets forth broad principles for guidance of the industry, actuaries and accountants to implement. The process of interpretation of the Guide has been going on since, and will undoubtedly continue for some years to come. The broad principles will be interpreted in many different ways in different fact situations. The practices under the Guide will evolve and change as time passes and the industry, actuaries and accountants will learn from experience and practice.

B. Outline of Major Differences between SAP and GAAP.

1. Recognition of premium revenues.

2. Recognition of costs.

3. Loss recognition.

4. Deferred income taxes.

5. Valuation of investments and recognition of realized and unrealized gains and (losses) thereon.

   (a) Audit Guide criteria.

   (b) Current state.

      (1) FASB regarding "lower of cost or market."

      (2) SEC position regarding realized gains and losses for public companies (not GAAP).

6. Accounting for investments in subsidiaries - cost versus equity method or consolidated.

7. Special reinsurance agreements.

   (a) Financing arrangements where minimal risk passes.

   (b) True sharing or passing of risk agreements.

8. Mandatory Securities Valuation Reserve.

9. Nonadmitted assets - provision for loss, if appropriate.

10. Other (a long list which includes some items peculiar to life insurance).

   (a) Charging reserve strengthening to surplus.

10. (CONT.)

(b) Charging surplus with prior year adjustments of, for instance, prior service costs.

(c) Netting encumbrances against related assets.

(d) Transferring par value of stock to capital for certain stock dividends.

(e) All other GAAP pronouncements which apply to a particular company.

C. Accounting Rationale Underlying GAAP.

1. Recognition of Premium Revenues.

(a) Three bases considered for timing of recognition of revenues.

(1) At the completion of the contract.

(2) At sale or issuance of the contract.

(3) During the life of the contract.

(b) Conclusion - premium revenues should be recognized over the life of the contract in proportion to performance under the contract: "Performance to 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.

(c) Conclusion follows GAAP for any industry "that revenues should be earned in relation to performance under the contract."

(d) Different premium revenue recognition for different type contracts.

(1) Whole Life - No predominant service or function. Recognize premiums as revenues when due. Result is the absence of adverse deviation.

aa. In mortality, some profits will emerge in relation to the net amount at risk.

bb. In investment yield, some profits will emerge in relation to investment income.

cc. In withdrawal rates, some profits will emerge in relation to difference between the benefit minus unamortized expenses and the cash value.

(1) (CONT.)

dd. Any additional profit in the premium will emerge in relation to premium revenues. Profits thus emerging give recognition to the importance of the sales effort.

(2) Limited Pay - premiums recognized over premium paying period; recognition of predominant service during premium paying period.

(3) Term Life Contracts.

aa. Credit Life and Short-Term Contracts - Recognize premium in proportion to insurance in force.

bb. Relatively Long-Term Contracts - Recognize premiums over the premium paying period - greater risks regarding mortality and withdrawal assumptions should result in more provision for adverse deviation in mortality and withdrawal assumptions than for whole life contracts.

(4) Accident and Health Contracts - Wide variety of contracts; premiums to be recognized generally as follows.

aa. Contracts expected to be in force for a reasonable period of time and elements of expense or benefit costs are not level - follow same principles of accounting as for whole life contracts and recognize revenues as due over the premium paying period.

bb. Short-term contracts except credit-recognize premiums prc rata over the contract term.

cc. Credit A&H share coverage decreases by passage of time;recognize premiums over contract period in reasonable relationship to anticipated claims.

2. Recognition of Costs - The basic accounting principle to be followed in accounting for costs is that they should be associated with the premium revenue. That is, costs should be recognized in a manner to result in a matching of the costs with the related revenue stream. The recognition of revenues in the life insurance business under GAAP is not too difficult once the principles have been established. Two problems exist with respect to costs:

(a) Definition of costs.

(b) Method of matching costs with revenues or premiums. Mr. Jay to discuss this aspect.

(b) (CONT.)

(1) Definition of costs - Costs are defined as being inclusive of benefits and expenses.

aa. Benefits - Benefits include all benefits under the contracts. Actuaries are familiar with benefit definitions.

1. Death

2. Surrender

3. Policy dividends

4. Accident and health

5. Annuity

6. Conversion rights under term policies

7. Riders

bb. Expenses - Accounting definition of expenses is different from definition historically utilized in life industry, including views of management, accountants and actuaries. Cost accounting for expenses will thus or has presented challenge and changes in the typical life company. The actuary needs to understand the GAAP concepts of determining expenses.

1. Acquisition costs are deferred and amortized against premium revenue. Thus, they are matched with revenues.

a. Audit Guide stipulates that "only those acquisition expenses which both vary with, and are primarily related to, the production of new business should be deferred."

b. Definition of "vary with" is being determined in practice to be other than a strict linear relationship. A step-cost relationship is being applied.

(c) Types of expenses being included in acquisition costs will vary from company to company depending on their marketing methods. Definition of "primarily related to" is broad enough to include:

(1) Commissions to agents, including overrides and renewal year commissions in excess of ultimate service or maintenance commission.

(c) (CONT.)

(2) Allowances to agents in lieu of commissions.

(3) Branch office expenses paid by company.

(4) Salaries of field men who are not compensated by commission.

(5) Direct mail solicitation expenses.

(6) Underwriting and issue costs.

(d) Generally speaking, sales support costs of home office personnel are not regarded as acquisition expenses but rather as period expenses to be expensed as incurred.

(e) Regardless of type of expense involved, the test to be met is that the expenses both vary with and are primarily related to the production of new business. That is, the expenses should be directly related to production and vary with production in at least a step-cost relationship.

(f) Maintenance expenses - Those costs associated with maintaining the policy in force and servicing the policyholder. Generally regarded as essentially level in practice. The problem which exists is accounting for inflation in the future costs of maintaining the contract in force. Expenses beyond the premium paying period must be provided for during the premium paying period.

(g) Settlement expenses - Non-level expenses of settlement of benefits should be provided for. In practice, such costs are generally regarded as essentially level or immaterial, and thus not separately provided for.

(h) Development expenses - The Audit Guide provides that, if an expense has "substantial future utility" and is clearly associated with and recoverable from future revenue, it can be considered for separate deferral. An example might be unusually high agency development and recruiting expenses.

(i) General overhead - The residue should be expensed as incurred.

(j) All expenses other than general overhead should be allocated by line of business and by type of business in order to associate them with the related premium revenues. This process will generally be a rather broad allocation of the various types of expenses other than commissions. Important point is that it be done in a reasonable, systematic and consistent manner.

(k) Actual acquisition expenses, as distinguished from those assumed, should be deferred. Thus, assumptions used in setting rates and testing them should not be deferred.

(k) (CONT.)

Rather the actual expenses should be ascertained on the basis of a cost study. However, the Guide further provides that assumed expenses can be deferred so long as they do not vary significantly from actual acquisition expenses. In practice, assumed acquisition expenses are in fact deferred through the reserve calculations. The company should compare their actual annual acquisition costs to their assumed costs to be certain that significant variance does not exist or is not developing. If so, the assumptions should be modified or a separate adjustment of results should be made. The problem is more acute when acquisition costs do not vary with production in a strict linear relationship, which is usually the case.

(l) Estimates of costs, particularly for prior years, are an essential part of the process. As companies become more sophisticated in cost accounting and refine their internal expense data derivation techniques, the estimates should become more refined. Consistency is important.

MR. BURTON D. JAY:

II. The Actuarial Interpretation of GAAP - Release from Risk.

A. The operation of the policy reserve system is the mechanism which determines the incidence of earnings.

1. I will discuss the policy reserve system based on the concept of release from risk and analyze the earnings which emerge from this system.

2. While the reserving system determines the incidence of earnings, it does not affect the final amount of accumulated earnings.

B. Risk is the essence of business of a life insurance company.

1. A company's hazard lies in deviations from the expected value of risks rather than the expected values themselves.

(a) These underlying risks associated with life insurance products are - mortality, investment, expense, and withdrawal.

(b) A company must provide for both the expected values of the risks inherent in their products and the deviations from the expected values.

2. The quantification of the risks of adverse variability can be accomplished practically by allocating all, or part, of the profit margin contained in the gross premium to the various risk elements.

(a) Judgement is required to determine how much profit margin to allocate to each of the risk elements.

2. (CONT.)

(b) A valuation premium would be calculated on the basis of actuarial assumptions, each of which contain a reasonable margin for adverse deviation.

(c) The assumptions used need to result in a valuation premium that does not exceed the actual gross premium.

(d) The formula for the valuation premium is similar to a Cammack-type gross premium formula.

(1) The actuarial assumptions, such as for mortality, can be expressed as $q_x + \Delta q_x$, where q_x is most likely value and Δq_x represents the provision for adverse deviation. The notation used by Dick Horn in his paper on the subject include q_x', i' etc. to represent the total of the expected values and the deltas.

(2) The retrospective formula for the valuation reserve looks like an asset share formula based on the valuation premium and the valuation assumptions which include deltas. A prospective reserve can also be calculated which equals the retrospective reserve, as in the case of statutory reserves.

C. Analysis of emerging earnings.

1. Dick Horn in his paper provides the formulas for the calculation of the release from risk valuation premiums and reserves.

(a) Gain from mortality is provision for adverse mortality (the Δq_x) for the year.

(b) Similarly, the gains from interest, expenses and withdrawals are equal to the provisions for adverse deviations in those assumptions.

(c) Finally, the gain from loading is defined to be the excess of the gross premium over the valuation premium for the given policy year.

2. The difference between actual mortality, interest, expenses and withdrawals over the amounts corresponding to most likely assumptions in the valuation premium provides an additional source of profit each year which can be either positive or negative.

(a) The sum of profits from each of these sources will equal the total GAAP profit emerging in any given policy year.

D. According to GAAP, generally, as it was developed over the years by the accounting profession, earnings of any accounting period should be the result of matching the revenues with the costs of the period.

D. (CONT.)

1. Bringing period costs and period revenues together for life insurance companies means deferring the recognition of some current income to a later period or anticipating in the current period some of the costs that will emerge in later periods.

   (a) The mechanics of the policy reserve system accomplishes this matching whether current income is regarded as being deferred or later costs are regarded as being anticipated.

   (b) The result of the release from risk reserve is that the portion of the gross premium needed for all current costs and for adverse deviations in all of the assumptions for that year is recognized as revenue in that year. Amounts in the current gross premium needed for future costs plus future adverse deviations is deferred by the reserving system.

E. Special Cases

1. Case 1. If all Δs are set equal to zero (assumptions are expected values with no provision for adverse deviations), earnings consist solely of gains from loading and emerge as a constant percent of premium income over the premium paying period.

   (a) An early exposure draft of the Audit Guide adopted this approach referring to the resultant valuation reserves as "natural reserves."

2. Case 2. Could use a Δi and set all other Δs equal to zero. Then earnings consist of gain from loading plus gain from investment risk release.

   (a) The gain from loading element would emerge as in Case 1, and investment gain would emerge each year over the entire benefit period as a function of the initial GAAP unified reserve.

3. Case 3. All of the Δs could be chosen so that the valuation premium equals the gross premium. Earnings would then emerge from four sources of risk release - investment, mortality, expense and withdrawal. The loading element would drop out.

4. The system actually adopted by the current Audit Guide is referred to as "the intermediate release from risk" method.

   (a) All assumptions contain deltas, but the valuation premium is generally less than the actual gross premium.

   (b) In this case, earnings emerge from all five sources.

F. The GAAP reserve just described has often been referred to in actuarial literature as a "unitary" reserve as it combines in one number both the expense and benefit portion.

F. (CONT.)

1. The expense portion of this reserve can be determined.

   (a) The expense portion of the "unitary" reserve for a given policy is the present value of all future policy expenses (discounted with chosen actuarial assumptions for GAAP) less the present value of expense portion of the total GAAP premium (similarly discounted).

   (b) The expense portion of the GAAP premium is the present value of all policy expenses (including initial expenses) over the life of the policy valued at time of issue, divided by an annuity factor of 1 per year discounted to time of issue (all discounting using GAAP actuarial assumptions).

2. The amount remaining after subtracting out the expense portion of the "unitary reserve" is called the "benefit reserve."

3. The Audit Guide requires that only the benefit reserve be shown on the liability side of the GAAP balance sheet.

   (a) The expense reserve is shown as an asset on the balance sheet and is the "unamortized acquisition expense" item.

   (b) The unamortized acquisition expense item can also be calculated by alternative methods described in Appendix B of the Audit Guide, to be discussed later by Mr. Daily.

III. How large should the Δs be? The concept of conservatism.

A. What is the process that an actuary goes through to determine GAAP assumptions with adequate Δs?

1. Could determine most likely assumptions and add deltas.

2. Perhaps more actuaries tend to start out with assumptions which they feel are adequately conservative, but never really know, or care, what the underlying most likely assumptions were or specifically what the Δs are.

3. The answer is, there are few quantitative guidelines; most experienced actuaries feel they have a pretty good seat-of-the-pants feel for establishing GAAP assumptions for their company or client.

4. The Audit Guide states that conservatism in GAAP assumptions must be reasonable and realistic.

   (a) Implies too much conservatism is improper.

B. Recommendation 1-B promulgated by the Academy of Actuaries' Committee on Life Insurance Financial Reporting Principles gives some guidance to the actuary.

B. (CONT.)

1. States that no portion of actual gross premiums should be available as specific loading for profit unless risks for adverse deviation have been duly provided for in the valuation premium.

2. With respect to each assumption, provisions for adverse deviations should be made in a way that does not decrease the valuation premium.

   (a) In certain circumstances an increase in a lapse rate assumption will decrease the valuation premium.

3. Must distribute Δs among policy years by considering degree of uncertainty and financial effect on company of deviation from valuation assumptions.

4. For all durations, aggregate reserve should exceed an aggregate reserve based on most likely assumptions.

5. Interest assumption for distant policy years should take historical levels into account - not be set at current high yields.

C. This Committee is working with the Joint (SOA-CAS) Committee on Theory of Risk in studying ways to quantify deltas by studying probability distributions of resultant valuation premiums and reserves from variations in specific deltas.

1. Use of SOFASIM (Society of Actuaries Simulation Model).

2. Is difficult problem and much has yet to be learned.

MR. DAILY:

IV. The accountant/actuary relationship roles and responsibilities.

A. No precise, clear breaking point between roles and responsibilities. Cooperative effort between them. Accountant will furnish data needed by the actuary and vice versa. Generally speaking, the actuary will have more time involvement and many of the more difficult judgmental problems to deal with in GAAP implementation.

B. Basic roles and responsibilities will vary from company to company depending on organizational structure and personnel involved. There will also be a lot of overlap within various aspects of GAAP implementation.

C. In general, the accountant will be responsible for:

1. Cost accounting with respect to expenses, but not benefits, of course.

2. Adjustments to premium revenues.

3. SAP to GAAP adjustments other than the GAAP valuations.

C. (CONT.)

4. Deferred federal income taxes.

5. Preparation of GAAP internal and external financial statements.

D. The actuary will have primary responsibility for most everything else, including:

1. Devising the mechanism to associate costs with premium revenues.

2. Derivation of data to establish assumptions as to mortality, morbidity and withdrawals. Normally the accountant will derive data for making decisions on interest assumptions, but the actuary will have a strong input into actual assumptions utilized.

3. Reviews and tests for recoverability of acquisition costs and for loss recognition.

4. Actual mechanics of valuations, i.e., producing the valuation runs, assisted of course by EDP department.

5. Adjustments, if required, for financing type reinsurance transactions.

E. As a general premise - the actuary has the larger role and responsibility in the overall conversion process. He does more of the actual work than the accountant. However, communication between the accountant and the actuary is essential and the key to production of good GAAP-basis financial statements, whether for internal or external usage.

F. Role of independent accountants and independent consulting actuaries-Roles and responsibilities are similar, but the independent accountant assumes the responsibility. Thus, the independent accountant will be more involved in what the company's actuary is doing than the company's accountant in most instances. The CPA will utilize the consulting actuary as he deems necessary and such usage will vary from accounting firm to accounting firm.

V. Amortization of Acquisition Expenses

A. To be consistent with the matching concept of revenues and costs, acquisition expenses should be amortized in proportion to premium revenues. In theory, this procedure requires estimation of all premiums to be received with respect to a block of business, and the incidence of such premiums; acquisition costs would then be amortized annually in an amount which, expressed as a percentage of total acquisition costs originally deferred, is equal to premiums received or recognized as revenues in that year, expressed as a percentage of premiums expected to be received in all years. Such procedure is inclusive of two concepts.

1. Acquisition expenses are to be amortized over the premium paying period.

A. (CONT.)

2. The method of amortization is the "sum-of-the-years" premiums method. The actual approach, that is, the mechanics of accomplishing the matching objective, can and does vary from company to company and by line of business within a company. Practical considerations are and should be implemented.

B. Before discussing the two basic methods further, a couple of points where latitude is permitted and employed.

1. Should acquisition costs be amortized with interest or without interest? The Audit Guide does not require that acquisition expenses be amortized with interest. Rather, the Audit Guide's language first describes an amortization approach without interest and then states "To be fully consistent with actuarial concepts, the rate of amortization should give effect ... to the interest assumed in benefit reserve calculations. Thus, the question of whether to amortize acquisition expenses with or without interest is a matter of choice." In practice, actuaries and, I believe, most accountants hold to the pure theory of amortizing acquisition expenses with interest.

C. Variances from assumed persistency - The Audit Guide establishes the "lock-in" concept whereby assumptions for a particular years' business are not changed once adopted. Mr. Jay has already discussed such concept. However, the Audit Guide further provides that, where acquisition costs are concerned, factors should be recalculated if actual termination experience differs significantly from assumed. Thus, if assumed lapse rates are later found to be significantly at variance from actual experience, the future amortization pattern for acquisition expenses should be modified. Future expectations as to persistency should be considered. The question of how bad the variance has to be before you modify the lapse assumptions is one of judgment and of the method utilized to amortize acquisition expenses.

D. The factor method - Mr. Jay has already discussed the factor method from an actuarial viewpoint and further discussion isn't necessary. From both a practical and theoretical viewpoint, I believe most accountants are of the opinion that the factor method is the best approach to amortizing acquisition expenses. The factor method has a number of advantages over the worksheet method which I'll discuss later.

1. The factor method tends to provide some degree of self-correction when actual persistency varies from assumed persistency in that it causes the rate of amortization to increase or decrease as actual persistency is lower or higher than initially estimated. Thus, the need for revising assumed future lapse rates is not as critical if experience starts to vary from assumed.

2. The probability of mechanical error is smaller.

3. Interest is automatically taken into account in developing the factors.

D. (CONT.)

4. Renewal year acquisition costs are easier to take into account.

5. The degree of refinement in allocating costs to various blocks of business and plans is of necessity greater when factors are developed. Accountants would regard this as a plus.

E. The worksheet method involves determining actual acquisition expenses by block of business and amortizing them in accordance with a predetermined plan against future anticipated premiums over the premium paying period. It involves:

1. Developing a projection of gross premiums for each year of issue for each block of business for which costs are going to be incurred;

2. Computing the percentage which the premiums to be received in each year bear to the total of projected premiums; and

3. Applying the percentages thus derived to first year acquisition costs.

Very easy and can be done by accountants without the help of the actuary if acquisition expenses are to be amortized without interest. If amortized with interest, then the present value of future premiums must be calculated to compare to incurred acquisition costs to develop the percentages to amortize each year.

F. The worksheet method has advantages, one of which is that it is more readily understood by non-actuaries. In addition -

1. Simple to set up initially, and for smaller lines of business, to maintain thereafter.

2. Splits up the work better between the accountants and actuaries.

G. Disadvantages

1. Variances from assumed persistency become more acute.

2. Difficult to take renewal year costs into account.

3. Greater probability of error - that is, not as refined.

VI. Deferred Income Taxes - Brief overview of principles of APBO No. 11 with specific comments about application to life companies. Deferred taxes is the one area where CPA's and industry had difficulty getting together, and one of the most difficult areas from a theoretically correct approach to apply.

A. Basic principles of APBO No. 11

1. Interperiod tax allocation is an integral part of the determination of net income.

A. (CONT.)

2. Tax allocation should be based only on the tax effect of timing differences - it is not appropriate to account for the tax effect of permanent differences.

3. Tax allocation should be made under the deferred method rather than under the liability method or the net-of-tax method. Comment re not a liability.

4. The tax effect of a timing difference should be measured by computing income taxes with and without the inclusion of the transactions creating the differences between financial statement pre-tax income and taxable income.

5. The measurement can be accomplished by either considering individual timing differences or by grouping similar timing differences. Comment re practical application to life re one calculation.

6. May be done by either the gross change method or the net change method. Comment re practical application to a life company re net change and consistency.

7. Tax effects of operations loss carrybacks should be allocated to loss periods. The tax effects of operations loss carryforwards should not be recognized until the period of realization. Comment re differentiation between a loss carryback or carryover for tax purposes and for financial statement purposes.

8. Not proper to discount deferred taxes.

B. Appendix C of Audit Guide application to life companies -

1. Timing differences - for a life company timing differences arise primarily with respect to Phase II income. That is,gain from operations includes:

   (a) Adjustments to defer acquisition costs.

   (b) Adjustments to tax return benefit reserves - Comment re 818E reserves compared to SAP reserves.

2. Permanent differences - Guide indicates that the only timing differences in Phase I are occasioned by reporting items of investment income on one basis for financial reporting purposes and another for tax return purposes. An example would be straight line depreciation for financial statements and accelerated for tax. Thus, it is not appropriate to recalculate taxable investment income for the effects of deferring and amortizing acquisition costs and using GAAP basis benefit reserves. Further, deferred taxes generally need not be provided with respect to the policyholders share of taxable investment income.

3. Mechanics:

3. (CONT.)

   (a) Identify the differences between financial statement income and taxable income.

   (b) Classify the differences as timing differences or permanent differences.

   (c) Determine an appropriate method of grouping timing differences.

   (d) Measure the tax effects of timing differences by making "with" and "without" calculations.

   (e) Examine the tax effect thus calculated to ascertain whether such tax effect will reverse in the future so that a determination can be made as to the amount of deferred taxes to be provided. This is the difficult part.

4. Reversal of tax effects - The guide provides that timing differences affecting only gain from operations may result in a current tax effect in "with-and-without" calculation which may not reverse in the future for companies who continue to be taxed on taxable investment income. Thus, in theory, a life company need not provide for deferred taxes if it can demonstrate that it will continue to be taxed on taxable investment income indefinitely or at least for an extended period. Likewise, if a company is moving toward such tax category and expects to achieve it in several years, it is not necessary to provide for deferred taxes for those future years when they anticipate they will be taxed on taxable investment income. However, in practice, many companies are providing for indicated deferred taxes because of the inherent difficulties in projecting their future taxable position. In addition, the Guide provides that, if deferred taxes are not provided because of a TII tax base and the company's taxable position changes - no longer TII, then deferred taxes applicable to all then existing timing differences which will reverse in the future must be provided in the year the facts and circumstances change.

5. Special deductions.

   (a) Unused special deductions or recalculated unused special deductions should be utilized in making the calculations unless it is reasonably clear from known or anticipated circumstances that special deductions of equal amount will not offset timing differences when they reverse. In practice, most companies are utilizing either unused special deductions per tax return or recalculated special deductions.

   (b) Dividends - Practical problem of determining dividends for GAAP purposes when dividends are considered as benefits in the reserving method.

MR. JAY:

VII. Models and Modeling.

A. Many companies take a modeling approach to calculating benefit reserves for GAAP, as opposed to making a total seriatim valuation for every plan, age and duration in a company's portfolio.

B. Our company uses a modeling approach for ordinary life insurance which may be illustrative of one of many possible approaches.

1. Model has 6 age groups, which are not necessarily all the same length.

2. Has 14 general plan groups.

3. Uses all durations for inforce from most recent ratebook groups. For older ratebooks we assume that each issue age-plan cell can be represented by a single duration.

C. Each year we adjust the groupings such that total statutory reserves are reproduced with an error of less than 1/4% and total valuation net premiums in force are reproduced with an error of less than 1% for each major block of inforce business.

D. Then calculate GAAP benefit reserves for each block of business in model by applying reserve factors and adjust for any percentage error inherent in model for statutory reserves.

E. Advantages and disadvantages of modeling.

1. Advantage - simplicity and ease of calculation. Do not need to calculate nearly as many GAAP reserve factors.

2. Disadvantage - requires much checking and testing of model for accuracy. Somewhat less confidence in results. Cumbersome to apply for interim year valuations.

3. We plan to go to a complete detail GAAP valuation system as soon as we can get such a system designed and implemented.

VIII. Loss Recognition - the "locked-in principle."

A. Is anticipated that original assumptions will continue to be used during the life of a block of policies as long as reserves remain adequate to provide for future benefits and expenses.

1. Deviation from original GAAP assumptions are recognized in period in which they occur.

B. When GAAP benefit reserves less unamortized acquisition expenses for any block of business is less than a gross premium valuation based on most likely assumptions, a loss is indicated which should be recognized immediately.

B. (CONT.)

1. The larger reserves based on most likely assumptions should be used from that point on, unless those assumptions result in inadequate reserves at a later date.

2. Recommendation 1 of the Committee on Life Insurance Financial Reporting Principles provides further insight and methodology in performing loss recognition tests.

MR. DAILY:

IX. Materiality - What lines of business should be adjusted?

A. The theoretically correct approach and preciseness is quite obviously not practical with respect to implementing GAAP for a life company. The same is true for accounting for most entities, some of which are far less complex than a life company. Assumptions and estimates are an everyday part of the accounting process. The answer in converting to GAAP is to be sure that the decisions as to what to adjust and the assumptions and estimates do not inadvertently result in a material error or misstatement of the financial statements.

B. What is material? The accountants do not at present have written authoritative guidelines to define immateriality in percentage terms. However, by most standards, if an error exists and it had an effect of overstating or understating net earnings by 5%, then a problem exists. This is a general statement and should not be interpreted as a hard-and-fast rule to apply in all situations.

C. In deciding what adjustments to make and how close the assumptions or estimates should be, life companies need to consider whether or not the statutory accounting for a line of business is sufficiently close to GAAP such that the effect of not adjusting to GAAP would not have a material effect on stockholders' equity or, more importantly, on net earnings from year to year. The important thing to watch is consistency from year to year.

D. Examples of business or benefits which might not be adjusted.

1. Hold SAP reserves for:

(a) Miscellaneous benefits such as waiver of premium and ADB.

(b) A&H reserves.

(c) Annuities - immediate and deferred.

(d) Group business.

2. Do not adjust older blocks of business on basis that any adjustment would be immaterial.

E. Important point is to review all lines and benefits for possible adjustment and make rough calculations as to approximate effect.

E. (CONT.)

Be sure to document decision.

F. Later refinements.

1. Certain to occur.

2. Restatements will be permitted in only very unusual circumstances which are very material.

X. Other Topics.

A. Analysis and interpretation of GAAP financials.

1. Published financials - Not possible to analyze financials - Some feel can be developed for conservatism or liberalism of GAAP adjustments - Same is true for most industries.

2. Internal financials - Good management tool - Analyze by line of business - Good tool to catch errors or inconsistencies.

B. Interim financial reporting - New topic of immediate concern for certain SEC companies - Long-range problem for all SEC companies.