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FILLING IN THE GAAP

Teaching Session

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This teaching session was intended for those who have not been intimately involved in financial reporting of life insurance companies in the United States in accordance with generally accepted accounting principles (GAAP). The essential thrust of the session was, accordingly, directed toward a review of existing literature and knowledge, although certain practical aspects and unresolved issues were also discussed. The nature and scope of the session, therefore, support brevity in summarization of discussions. An outline of topics discussed is presented below. References to existing literature are presented following the discussion outline.

1. Principles

   a. Accounting rationale. Accounting concepts, such as "going concern," "installment sale," and "reasonable conservatism," were reviewed as supportive of principles underlying GAAP -- for example, "revenues" for matching purposes are premium revenues, and costs are to be matched against such revenues.

   b. Actuarial interpretation of GAAP. The release-from-risk reserving concept and the "intermediate" form of release-from-risk, were reviewed as being both supportive and interpretive of accounting rationale underlying GAAP.

   c. Demonstrations. The pattern and sources of earnings emergence under GAAP were illustrated by presentation of demonstration models which reflected application of relevant accounting and actuarial guidelines.

2. Basic Practical Considerations

   a. General. Several general considerations and problems encountered in converting to GAAP were discussed, including assessment of materiality (or immateriality).

   b. Benefit reserve. Advantages and disadvantages of alternative approaches and common problem areas were discussed. Topics covered included: seriatim vs. model; mean vs. mid-terminal vs. intermediate factors; grading into statutory reserves or cash values; and realistic costs of nonforfeiture and maturity benefits.

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c. Unamortized acquisition expense asset. Applicable guidelines were discussed relevant to the definition of acquisition expenses appropriately deferred, acceptable methods for amortization of such expenses, and recognition of non-level renewal expenses. In addition, several practical problems were discussed regarding amortization methods (e.g., with vs. without interest, worksheet vs. factors).

3. Advanced Practical Considerations

a. General. In addition to the review of rather elementary practical considerations outlined above, several more advanced topical areas were judged to be of sufficient importance to warrant presentation and were discussed in an introductory manner. Some of the areas discussed are outlined below.

b. Reinsurance. Applicable guidelines were reviewed as being applicable to all forms of reinsurance with the exception of special reinsurance transactions (mentioned on page 91 of the AICPA Audit Guide). Some of the problems encountered in dealing with coinsurance and modified-coinsurance treaties not on a "full original terms" basis were defined and illustrated.

c. Loss recognition. Applicable guidelines were discussed as relevant to: when a test for loss recognition is warranted; the type and bases of tests called for; the substantial degree of adverse deviation normally required in order to result in loss recognition; and the apparent variety of ways in which balance sheet items can be adjusted to reflect loss recognition.

d. Accounting for Federal Income Tax. Currently-popular methods of recognizing life insurance company deferred Federal Income Tax were reviewed. The deferral (or non-recognition) of tax on taxable investment income inherent in such methods was demonstrated by illustrating that pre-tax GAAP adjustments affect only gains from operations (notably, at the risk of oversimplification, that pre-tax GAAP adjustments level pre-tax operating gains relative to premium revenue). If tax was determined solely on the basis of operating gains, the pattern of pre-tax and after-tax earnings would be essentially the same. However, to the extent tax is imposed on the basis of investment income -- an item the incidence of which is not adjusted under GAAP -- then after-tax GAAP earnings can not only decline (relative to pre-tax GAAP earnings) but can actually develop into after-tax GAAP losses in later years. The reason for after-tax loss emergence is obviously that tax on investment income could exceed pre-tax GAAP earnings. The opinion was expressed that tax on investment income was not an "income tax" as covered under APB 11, but a "gross receipts tax," and should be accounted for by utilizing net-of-tax interest rates in all GAAP calculations.

The following references are presented for those who wish to make further inquiry:

(1) AICPA Industry Audit Guide - Audits of Stock Life Insurance Companies, prepared by the AICPA Committee on Insurance Accounting and Auditing.

(2) American Academy of Actuaries Opinion A-6 as to professional conduct, and Financial Reporting Recommendations and Interpretations published relevant thereto. (See American Academy of Actuaries Year Book.)

(3) Reading list on GAAP Accounting published in the Fall of 1974 by the Society of Actuaries Life and Health Corporate Affairs Committee. (Available through the office of the Society of Actuaries.)

(4) *Ernst & Ernst* GAAP - Stock Life Companies, prepared by Ernst & Ernst Insurance Industry Committee, 1974, Ernst & Ernst.