RECORD OF SOCIETY OF ACTUARIES
1982 VOL. 8 NO. 3

CURRENT DEVELOPMENTS IN GAAP

Moderator: CHARLES CARROLL. *Panelists:* DAVID N. BECKER, KRISS CLONINGER III, H. RAY EANES*, MICHAEL V. ECKMAN, BURTON D. JAY, THEODORE J. NEWTON, JR.**

1. FASB reformulation of audit guide.

2. Treatment of single premium deferred annuities.

3. Problems of applying GAAP principles to Universal Life.

4. Discussion of papers.

   a. "A Policy-Year Model for GAAP Valuation of Coinsurance and Modified Coinsurance," by David N. Becker and Michael V. Eckman.

   b. "GAAP for Nonguaranteed Premium Life Insurance", by Kriss Cloninger III.

MR. CHARLES CARROLL: Looking around the room I see a lot of people who have a vital interest in financial reporting for Stock Life Insurance companies, and for those of you who are so involved, it's really not necessary to emphasize how many and varied the new developments in GAAP are these days. After all, we are involved in an extraordinary period of change for the life insurance industry, and it's only logical that the reporting systems that we set up are undergoing similar types of changes. All we need do is compare 1982 with the period in the early seventies when the audit guide was being written. I think everyone would agree that the life insurance industry has undergone dramatic changes since that time. The major changes have to do, in my view, with the types of products that the industry is offering. The fixed premium, nonparticipating type plans, are still sold and represent a significant amount of industry sales, but the basic dominance has been taken over by new, more flexible, and more competitive products, such as indeterminate premium plans, Universal Life, deferred annuities with excess interest, super low cost term insurance, and variable life insurance. These are

*Mr. Eanes, not a member of the Society, is partner with Ernst & Whinney, Atlanta, Georgia.

**Mr. Newton, not a member of the Society, is president of T.J. Newton & Company, Inc., New York, New York.

all products that are assuming the dominant role in the industry today and the ones that are causing problems for GAAP. The pressures for adaptation of traditional GAAP principles and methodology are building up because of these products and because of their importance to the industry. From my point of view, I look at three major or primary implications of these types of products on GAAP principles and methodologies.

First of all, they all have elements of flexibility in them. They're flexible with regard to either: a) premium per unit of face amount, b) plan of insurance, c) cash value build up or all three, in the case of Universal Life, for example. This flexibility creates either real or apparent conflicts with the "lock-in" principle in the audit guide, and also some methodological problems.

Second, the investment intermediary function of the life insurance company is taking on more importance with regard to these products, than it had previously with regard to the more traditional products.

And finally, because of competition and rapidly changing environments, and products, the certainty of achieving the expected profits is greatly reduced as compared to the "good old days."

Our presentation this morning is going to focus on three major new developments in GAAP. The first area is the FASB recodification process and its current status. The second is the controversy over the proper treatment of single premium deferred annuity products. Finally, Universal Life will be addressed and the methods of handling it. Some of the same issues that get into the single premium deferred annuity controversy, raise their ugly heads again in the Universal Life arena.

Our panel is made up of individuals who are very much involved in the actuarial and accounting standards setting process, and have a great store of experience in the life insurance financial reporting area.

Our first speaker will be Ray Eanes, a partner with Ernst & Whinney in Atlanta. He is director of regional insurance practice for Ernst & Whinney in the Southeast region. Prior to joining to Ernst & Whinney in 1966, Ray was employed in various executive capacities in life insurance companies. He is a member of the AICPA and various other CPA organizations. He is part of the FASB task force for the insurance industry, the AICPA committee on relations with actuaries, the AICPA task force to study nonguaranteed premium products, and the Ernst & Whinney Insurance Industry Committee.

Our second speaker is Ted Newton. Ted is founder of T. J. Newton and Company, Inc. which acts as a consultant in the merger and acquisition of insurance companies. Prior to starting his own firm, Ted was Senior Vice President of Blythe, Eastman, Dillon and Company, where he was senior analyst in the Research Department for which he was responsible for following the insurance industry. Ted was a past president of the Association of Insurance and Financial Analysts, and has served as the Chairman of the Adjusted Earnings Committee since 1968. He is also a member of the New York Society of Security Analysts and of the Financial

Analysts Federation. In addition, he is a member of the FASB task force on specialized principles in the Insurance Industry, and has been responsible for presenting AIFA positions to the American Institute. In general I think he has a large stake and a large amount of commitment to the process of standard setting from the point of view of the users of statements.

Burton Jay is a Fellow of the Society, and a member of the Academy of Actuaries. He's been the executive vice president and chief actuary of United of Omaha since 1967. He's chairman of the Academy's committee on Life Insurance Financial reporting principles which has worked very closely with the various AICPA and FASB task forces. He's a member of the Academy's Board of Governor's and recent past chairman of the Society's program committee.

In addition to the panel discussion, we have two papers from the Transactions which will be presented. I think it is significant that of the four papers being presented at this meeting, two of them are on GAAP accounting, which at least indicates that there's a lot of fuel for actuarial work there.

MR. H. RAY EANES: There has been an evolution in the rule making bodies for accounting standards over the last several years. Further, there has been a proliferation of standards that some believe may have reached the height of being ridiculous. In any event, we continue to see new rules, interpretations of rules and, more recently, an attempt to modify the rules for specific industries.

We formerly operated under principles that were established by the AICPA. When the FASB took over it became the standard setting body. FASB No. 32 addressed the authoritative status of the Guides and SOPS previously issued by the AICPA and, in a two-step approach, attempted to bring clarity to this matter. First, practices included in the Guides and SOPS were deemed preferable for purposes of changing accounting principles. Second, a project was undertaken to "extract" or "codify" all of the specialized accounting pronouncements and in so doing define GAAP.

Such a project was undertaken by the FASB for insurance enterprises. The goal was an extraction from current literature and not a reconsideration or an initial consideration of questions. In view of the change in the insurance arena over the last 5 to 10 years this resulted in some disappointment on the part of industry and practitioners.

A Task Force was appointed that included representatives from industry, investment bankers and public accounting. This group was to act in an advisory capacity to the Board. As you might expect, due to the make up of the Task Force there was not 100% agreement on the various issues the two times that it was assembled to discuss the project.

Nevertheless, an Exposure Draft was issued in November 1981 with the comment period ending February 1982. A surprisingly minimal response was received from the exposure period. Approximately 50 responses dealing mainly with editorial suggestions were all that the Draft generated. There were two responses that requested substantial reconsideration and another exposure period. However, due to the perceived acceptance of the first Exposure Draft, the Board had little choice but to ignore the bulk of the suggestions in the few critical letters that were received.

The result of the project is to integrate principles of the various insurance enterprises. It is expected to be issued so as to become effective for fiscal years beginning after December 15, 1982. The period of coverage will dictate the revenue and expense recognition. In this instance, the determination of a short-term versus a long-term contract becomes important whether it be a policy issued by a life or a casualty company. The period for which a policy is "expected to remain in force" determines its classification. The specific definitions will read as follows:

> "•SHORT-DURATION CONTRACT: The contract provides insurance protection for a fixed period of short duration and enables the insurer to cancel the contract or to adjust the provisions of the contract at the end of any contract period, such as adjusting the amount of premiums charged or coverage provided.
>
> •LONG-DURATION CONTRACT: The contract generally is not subject to unilateral changes in its provisions (including premiums), such as noncancelable or guaranteed renewable contracts, and requires the performance of various functions and services (including insurance protection) for an extended period."

The project also modifies disclosures. At least one disclosure had usually been presented but is not now required. That's the reconciliation of statutory to GAAP and I would expect Ted will want to speak to this point later.

The project does not address many issues which people had hoped the Board would resolve. However, an understanding of the previously defined objective leads one to realize that the project could not address the unresolved issues of:

- nonguaranteed premium products
- purchase accounting
- discounting

among many others.

As I have alluded to, it's my understanding we can expect the issuance of a Statement in substantially the same form as the Exposure Draft, except for some editorial revisions. Implementation guidance will again revert to the AICPA, if any is deemed necessary.

MR. THEODORE NEWTON, JR.: It's good to be with you this morning, in this lovely place. I was on the task force and I was outvoted. This was an attempt, as you know, to consolidate the various audit guides that had covered the different industries, and had been developed at vastly different times. The problem naturally arose as to what should be included in the new all inclusive audit guide that had been in the separate audit guides of the two different industries.

Naturally, I wanted more disclosure, not less, and disclosures that had been required before I certainly wanted retained and hopefully expanded to the industries that they did not cover before. One very major change that was left out was the requirement for reconciliation of the GAAP earnings and book values with statutory. That of course had been required under the life audit guide, and had not been required under property/casualty. The result was that very few of the property/casualty companies had ever shown the reconciliation since they weren't required to. The life companies were required to and by and large did show a reconciliation. The reconciliation contained valuable information that was not found elsewhere in the financial statement. For example, that would often be the place where you would see the amount of amortization of acquisition costs that had been charged against earnings that year. You got breakdowns in the reconciliation that simply weren't available elsewhere. I've seen instances where it was the only place that you could tell the realized capital gains. The insurance analysts wanted to see that not only maintained in the new audit guide, but expanded to include the property/casualty companies. However, it is no longer a requirement, and the only requirement is that companies show statutory capital and surplus. Unfortunately, statutory results are only really important at critical times when a company is in trouble, and that's true of either a property/casualty company or a life company. When statutory surplus is in trouble, the company is in trouble. And I guarantee you once it's no longer a requirement to reconcile you won't see it. I think this opinion is voiced by every analyst in America, and probably every investor.

There are, however, some new disclosures required that I think are a step in the right direction, and I would like to touch on those quickly. To begin, both life and property/casualty companies (there's little distinction in the audit guide now) are required to show the amount of acquisition costs amortized during the period. It's very valuable information in the case of a life insurance company; however, in the case of a property/casualty company, the acquisition costs at the end of a particular period are largely amortized during the following period, so you're going to have acquisition cost deferred $100 million, amortized $97 million. It will be a rather amusing disclosure for a property/casualty company.

There are some good requirements. The first is that companies are encouraged to show their average rate of interest assumed on policy reserves under GAAP. This is something that I specifically requested and oddly enough got in there. In the final statement, however, it is a suggestion rather than a requirement. The purpose of showing the average GAAP interest requirement on policy reserves, the GAAP tabular interest requirement if you will, is to give the investing public some idea as to the conservatism of various companies. It also allows the analyst to calculate excess investment income on the GAAP basis, since the statutory figures are relatively meaningless in that regard now. At any rate, a few companies have been disclosing this in the past voluntarily and it should be quite helpful.

In addition, companies are now required to show and to discuss any statutory impairment of their operation. I would think that if a property/casualty company is suddenly writing at eight times its capital and surplus in terms of payments, and that relationship is considered precarious by the insurance department that some mention of that might be made. I think that the companies that are in trouble will, under this requirement, have to say something about it. Finally, companies are required to discuss statutory limitations on their ability to pay dividends to stockholders. This was not required in the past, but they will be required to disclose statutory requirements that restrict their ability to pay dividends. Companies must also disclose the amount of capital and surplus on which taxes have not been paid, so that they again cannot mislead the stockholders into thinking that the entire surplus account is available for the payment of dividends.

MR. BURTON D. JAY: Comments on the FASB Exposure Draft "Accounting by the Insurance Industry" were submitted on February 11, on behalf of the Academy's General Committee on Financial Reporting Principles. This Committee, chaired by Steve Bickel, is the Committee to which the Academy's Life and Casualty Committees on Financial Reporting Principles report. The Statement was, thus, the consolidated opinion of both life and casualty actuaries serving on these Committees. I will summarize the most important points contained in our Statement.

The comments focused on two basic areas: First we requested that the list of issues identified in the "Notice" section of the draft be included as an integral part of the final Statement, so that accountants and actuaries are formally made aware that there are still many unresolved issues. Some of the unsolved issues identified were: treatment of certain reinsurance transactions; purchase accounting; GAAP for mutuals; treatment of flexible and indeterminate premium contracts, such as Universal Life; and the issue of discounting claim reserves on short-duration contracts, such as most casualty contracts.

Second, numerous changes of a technical nature were suggested. Although the Exposure Draft primarily involved extracting existing practices and principles from the AICPA audit guides, we felt that many changes from this Draft were necessary. We further urged that once the FASB received comments from various interested parties that the Statement be redrafted and re-exposed before it is issued.

Some of the points made in our Statement follow:

1. We suggested that long-term versus short-term contracts not be defined in terms of functions or services but rather in the length of contractual provisions. Focus should be on the insurance protection period, renewability option, duration of premium payments and premium level guarantees.

2. We suggested that the FASB Statement not apply to Mortgage Guaranty Enterprises, since there is no existing audit guide for such enterprises. Development of appropriate principles should be undertaken as a separate project.

3. The FASB Statement states that for long-duration contracts premiums shall be recognized when due. We pointed out that Recommendation 5 of my Committee describes four methods of premium recognition. Three of the four: (a) due and paid, (b) due, and (c) continuous are considered acceptable for GAAP Financial Statements if the corresponding reserves are determined consistently.

4. We asked that a footnote to the paragraph describing actuarial assumptions be included stating that the selection of such assumptions are the primary responsibility of the actuary and that the Academy has developed standards for the actuarial profession in the form of Recommendations and Interpretations. The auditor should expect the actuary to demonstrate that his assumptions meet these standards.

5. The FASB Statement does not require that acquisition expenses be amortized with the same interest, mortality and withdrawal rates as used in calculating benefit reserves, or if a worksheet method is used that the results should not differ materially from those produced when these assumptions are used. We asked that this requirement, which is now contained in the audit guide, be preserved in the FASB Statement.

6. The Statement forbids increasing the value of an investment from a reduced cost basis prior to its disposition. We suggested that the inability to make such recoveries discourages companies from reducing values from original balance sheet bases and results in less conservative balance sheets.

7. The current audit guide requires a reconciliation from GAAP to Statutory, while the new Statement does not include this requirement. We asked that this reconciliation continue to be required since Statutory Accounting remains a necessary and very important means of reporting insurance company results to many users of financial statements.

8. The FASB Statement requires the disclosure of the assumed average investment yield. We felt that this requirement was ambiguous as stated and inappropriate on any basis since it does not reflect the margin for adverse deviation and highlights only one of several assumptions which affect the relative conservatism of a company's liabilities.

9. We also asked that the FASB Statement somewhere acknowledge that the technique for properly matching costs and revenues on single premium deferred annuities and other similar contracts where gain (or loss) of investment income is a substantial source of income has not been clearly specified.

On April 2, the FASB issued a redraft of their Statement which addressed some of the comments that we provided.

1. The list of unresolved issues which we asked to be retained are contained in footnotes in various places in the new draft.

2. The criteria for short-duration versus long-duration contracts are much improved.

3. Our comment on using the same assumptions for amortizing acquisition costs as for benefit reserves was accepted.

4. The redraft now encourages, rather than requires, disclosure of the average investment yield. This is some improvement.

All of our other suggestions that I have related to you were not accepted, although numerous minor wording changes that we asked for were made. The FASB Task Force that prepared the Draft asked for comments regarding changes contained in the April 2 Draft which may produce unintended results. The final recommendation was to have been presented to the Board on April 21.

Introduction to SPDA Controversy

The problem arises because the audit guide fails to properly address single premium contracts and by implication treats such contracts in the same manner as all other life insurance and annuities. GAAP involves a matching of costs and revenues, and revenue for insurance contracts is defined as premium income. This was not a problem when the audit guide was written since the volume of single premium contracts was not material and contracts providing high interest credits were not yet on the scene. Now, however, single premium annuities account for the majority of business of some companies and a literal application of the audit guide could result in all, or a substantial percentage of future profits being booked at issue. Some companies are doing just that and many auditors feel that this practice materially overstates earnings from what they "ought" to be. They contrast this to the banks which are required to recognize excess interest earnings on savings contracts when such earnings are actually received.

Relationship to Underlying Theory of the Audit Guide and Proper Choice of Deltas

The audit guide states that "the reasoning underlying the accounting method described for recognition of premium revenue for whole-life and limited payment life insurance contracts also applies to annuity contracts; therefore, annuity considerations should be recognized as revenue when due." This results in the recognition of premium revenue and related acquisition costs in the period written. No deferral of acquisition expenses would be permitted under a literal interpretation, as the guide also states that "the cost of acquiring new business should be deferred and other nonlevel costs should be provided for in order to charge operations in proportion to premium revenues."

The guide also provides direction with respect to the recognition of deferred annuity benefit costs. The description of deferred annuity contracts and related risks of writing such business which are contained in the audit guide provide an interesting commentary on the context within which the benefit cost recognition principles were developed. For deferred annuities, the guide recognizes the presence of two separate segments. "The first segment is the accumulated or deferred period, during which there is relatively little risk to the company except failure to earn the guaranteed net interest rate . . . the second segment is the pay-out or liquidation period, during which annuity income payments are made to the annuitant and the mortality risks described above are introduced."

The understated references to the interest risks during the deferred period strongly suggest that the circumstances which companies now face differ sufficiently from those present at the time the audit guide was developed that the benefit cost principles need to be reexamined for these contracts. Clearly, the investment and termination risks associated with single premium deferred annuities would have received more serious consideration had they been at the current magnitude when the existing accounting principles were adopted.

In establishing assumptions which address these risks, the audit guide states that, "in single premium deferred annuities, all of the net cash is invested immediately. However, some of the funds are usually reinvested and, therefore, some recognition of the possibility of adverse deviations in investment income is apppropriate." It further states that "Reserves should be based on the accumulation of the maturity value equal to the estimated initial reserve required at the time the annuity becomes income paying." It is thus suggested that the appropriate benefit reserve for single premium annuity contracts is the realistic present value of the projected maturity value. In conjunction with the total recognition of acquisition costs at the time of sale, this accounting would report the total income expected over the life of the contract at the time the contract is sold, except for the release of provisions for adverse deviation contained in the interest rate.

If the projected maturity value is assumed to be the accumulation of the premium at the assumed credited interest rate and the present value is based on a corresponding earned interest rate, the profit recognized at issue is the present value of the "interest spread," adjusted by acquisition costs and any initial loadings. While in stabler investment environments this procedure may have been more reasonable, the current unpredictability of policyholder actions, the unproven ability of maintaining anticipated investment spreads, and the severe disintermediation risks associated with these products suggest that these risks be appropriately recognized when GAAP reserves are established. It is felt by many actuaries and accountants that substantial provisions for adverse deviations for all of these risks should be properly included in the reserves for these contracts. Conceptually, this means conservative lapse assumptions coupled with surrender values and market value loss assumptions on underlying assets, and assumptions for interest rates earned and credited which are closer together than the "most likely" spread. Practically, there may be simpler calculation techniques which can approximate the results produced by these conceptual reserves reflecting all of the above variables. In any event, the result would be the recognition of most earnings over the life of the contract, at least for many of the single premium annuities written today.

MR. EANES: In connection with SPDA's, some of the current controversy relates to a perceived inconsistency within the industry as to revenue recognition. There are apparently companies recognizing profits per the guide's suggestion for single premium business. There are others that take in profits on the spread only as realized and finally there are those that fall somewhere between these two approaches.

The controversy has now been expanded to raise the question as to whether there should be any difference between profit recognition of an insurance company selling SPDA's and a bank which accepts savings deposits. Those who question this conceptual inconsistency state there is very little, if any, difference in the two products sold by the respective industries.

At a minimum, based upon discussions with certain authors of the guide, the volume of SPDA's and the interest atmosphere we see were not anticipated at the time the current authoritative literature was written.

The monumental questions that must be addressed and resolved include:

1. Should insurance and bank accounting be consistent?

2. Are there differences between the two industries' products? Do the insurance companies' contracts contain certain restrictions that make the relationship sufficiently different so that different profit recognition is appropriate?

3. Are you able to set deltas that appropriately respond to the nature of the product and the associated risk the insurance company is undertaking?

4. Should an insurance company be allowed some reasonable profit at issue and, if so, how do you define that profit in order to gain more consistency within the industry?

The Nonguaranteed Premium Products Task Force has wrestled with this problem for at least three meetings. The resolution will not be easy even with the outstanding contribution and cooperation we are receiving from the Academy.

Let's turn to another product that was not contemplated by the guide; however, is now receiving a great deal of publicity and some companies have indicated they intend to invest substantial resources in marketing in 1982 and 1983. Of course, I am referring to the infamous Universal Life policy.

A reading of the guide seems to indicate that it expected definable premiums and definable benefits at the date of policy issuance. Accordingly, can this product be "fit" to the guide? Should earnings be recognized as a theoretical level percentage of premium or do we need to go to earnings as realized? Has the nature of the profit sources, the product, the market, etc., sufficiently changed that it is impossible to refer to the direction received from the guide to account for the product?

There are those that hold to the premise that the guide's provisions will never respond. Of course, the FASB project specifically excludes the product from the release that is expected to soon define GAAP. Accordingly, we find ourselves possibly on the threshold of the most prominent product in the industry not having defined accounting guidelines.

Our firm has conducted a research project to compare the answers between various accounting alternatives. The project indicates the results are such that a company should evaluate the nature of its product, its marketing efforts, the risk being undertaken and adopt a responsive accounting policy. If you sell basically an investment vehicle then maybe the EAR approach is most appropriate. Conversely, if your product is designed to be substantially a mortality risk the LOP approach may continue to be the most responsive. While there is much pressure being brought to respond to this issue, the due process is such that I am fearful the release of definitive guidelines by the end of 1982 may be overly optimistic.

One of the nagging issues on this new product is the replacement issue. Universal Life is discussed as a viable product to refine existing inforce and make it more responsive to current economic conditions. However, for some companies an internal replacement program is viewed as detrimental in view of the perceived need to write off DPAC.

While the concept may run into resistance in the due process, it appears that business should be allowed to make what it perceives to be a valid judgment in response to economic changes. In this regard, it appears reasonable and realistic that a company should be allowed to "roll over" or "redefer" costs associated with internal replacements assuming appropriate recoverability tests are defined and calculated.

As is true with the SPDA controversy between the banking and insurance industry, there may be other perceived similar circumstances that will surface as precluding such accounting for referral. However, at the present time, it appears that many people who are intricately involved with the industry and the recommendation of standards are in substantial agreement that this approach is the most practical and appropriate under the circumstances.

MR. NEWTON: I've been in this business for twenty-eight years and I've acquired in that period of time a great deal of respect for the knowledge and perception of the investing public. The market knows, I don't know how it knows, but it knows. I have seen case after case of this over the years, and one case that I would like to call your attention to is the level of life insurance stocks on the marketplace today. These stocks, as you know, have been toying around the five, or six times earnings level for a period of years now. Smart alecks like myself would have told you a couple of years ago that stocks were historically cheap (which they were) and that they should have been bought (which they shouldn't have been). The market directly foresaw the problems that were facing the life insurance industry long before they really hit in the past year or so. Before their earnings started to drop, the prices of the stocks started to drop. We have had in the past two years a sloppy earnings pattern that has really not existed for over twenty years in the life insurance business. It's the first time that you've seen actual earnings decline. I used to say that show me a company who's earnings are down and I'll sell it's stock. I don't need to know why, it's just something that shouldn't happen. Sell the stock and go onto something else. Maybe it still holds true.

I would suggest that you in the accounting profession and actuarial profession could all go back and look at what the makeup of financial statements is all about, and what does the future hold. How does a company come back from a 30% decline in earnings? It's going to take lower lapses and higher sales, but how much lower lapses and higher sales?

I think that we have entered very interesting new ground in terms of earnings predictions. It used to be very easy. I used to predict earnings within less than 5%. When you ask a company where their earnings are bound, they don't know. They say, "Oh, well, sales were bad, our lapses were up," but they really can't define how much was due to this and how much was due to that.

In purchase accounting where GAAP reserve levels are so much below statutory levels, much more so than in the case of historic GAAP, you see the losses. This suggests that the lapse on the GAAP reserves, which are only 70% of statutory is a pretty rough treatment. In purchase accounting you do get GAAP reserves that are 70% and less of statutory. Unfortunately, at the same time purchase accounting doesn't mark the policyholders cash surrender values down by a similar amount (good old statutory). That's an issue that needs to be addressed, rather than the purchase accounting itself. Purchase accounting was never intended to reflect the conditions that we have today. It simply does not do a very good job of it.

When I get involved in a transaction or a potential transaction I correctly recognize the need for help. We were advisors to Ethel Corporation in the acquisition of First Colony Life which was completed in the last couple of weeks. I immediately suggested that they retain an actuarial firm to assist in evaluating actuarial work that was provided. I also got their accountants involved in correctly assessing the impact of purchase accounting on the income statement and financial statement that Ethel would have to show in its own report. I would say that was probably my smartest move because, we immediately needed all the expertise that we could get. Section 334(b)(2), and the accounting ramifications of that acquisition dominated everyone's time; accountants, actuaries, investment bankers, company officials, and so forth. I have found that in these situations both accountants and actuaries tend to talk about the complexities of purchase accounting and I try desperately not to get involved.

In regard to reporting to investors on such matters as single premium deferred annuities and Universal Life, I would suggest utmost conservatism becuase these are new products that may come and go very quickly. We have seen the problems in single premium deferred annuities, where there would be a tremendous inflow of money, then interest rates would go up and there would be a tremendous outflow of money. Accounting for the profits from these products should certainly take into account the huge volatility that's involved.

I don't think that you're going to see investors warmly grasp earnings that are based upon present values of future potential profits on single premium deferred annuities and I don't think that they'll pay for those earnings. In fact, they are paying very low multiples in the market today. I don't know of a single example of a high multiple company where they're getting away with something.

With regards to Universal Life, I would again caution conservatism. For one thing the product is in a lot of potential trouble and if not the industry is in a lot of potential trouble. Normally, I would be 100% on the side of the consumer in an issue such as this, and I still feel that I should be, but I think that Universal Life might be the vehicle that will wreck the life insurance business as we know it today. This, I'm sure, is not in the best interest of the public. I think that the chances are very good that this product will be drummed out of existence by Uncle Sam. I for one will be pleased to see it because I don't think that the modest benefits to the public are enough to outweigh the enormous damages this product can do to the industry.

MR. JAY: The first of the, so called, new products addressed by the Academy's Life Insurance Financial Reporting Principles Committee dealt with what we called Nonguaranteed Premium Policies. These are nonparticipating policies which permit the company issuing the policies to modify the gross premiums from time to time based on current and prospective actuarial assumptions. This class of policies includes adjustable premium whole life policies, which have fixed cash values and death benefits, and guaranteed renewable health insurance policies. An Exposure Draft of Interpretation 1-I was issued in January of this year asking for comments from the Academy membership. We received about 13 comments which were very helpful to us and many of which will be reflected in the final Interpretation which we hope to get out in June. The basic principles described in the January Draft will not be changed. Probably the concept of greatest significance contained in this Interpretation is an expansion of the "lock-in" principle. Paraphrasing the wording in the Interpretation, we said that when current or anticipated experience changes enough to cause a change in gross premiums, the GAAP assumptions for benefit reserves and deferred acquisition costs should be changed for future periods to reflect the new experience assumptions which resulted in the premium charge. The previous GAAP assumptions can be maintained only if the resulting pattern of GAAP earnings is not materially different than the earnings which would flow from appropriately revised assumptions.

Another principle stated in the Interpretation is that the margins for adverse deviation may be smaller than for guaranteed cost products if the level of risk retained by the company is smaller due to the right to revise premiums if actual or anticipated experience deteriorates.

This Interpretation has the general support of not only Academy members but also of the AICPA's Nonguaranteed Premium Task Force which reports to the AICPA's Committee on Life Insurance Accounting. Our Committee has worked closely with this Accountant's Task Force in establishing the principles to follow on these products as well as on other "new products" such as Universal Life and flexible and single premium annuities.

Progress has also been made on these other new products. Several joint meetings have been held with members of our Committee, the Accountants' Task Force and representatives of the ACLI's Committee on Financial Reporting Principles. The first approach was to try to address

Universal Life, and the various annuity types all at the same time. Discussions were wide ranging and progress was elusive, though we were developing a better understanding of the issues we were dealing with. The strategy was for the Academy to develop an Interpretation quickly, with the support of the accountants and the ACLI, and for the AICPA and the FASB to establish consistent rules later on in accordance with their normal rule making procedures, which take longer because of having to go through more levels of approval.

We found that we were dealing with a continuous spectrum of products with single premium annuities at one end and the whole life form of Universal Life at the other end. Earnings from this form of Universal Life should emerge in a pattern that is substantially the same as the guaranteed cost form of whole life. Thus, the life insurance audit guide should apply to this form of Universal Life. Some of the accountants felt initially that the banking accounting model should apply to single premium deferred annuities to avoid the front ending of profits that could result from applying a literal interpretation of the life insurance audit guide. This produced a dilemma of having different accounting models at each end of a continuous spectrum of products with no logical cutoff point where accounting models should change.

The actuaries and at least some of the accountants now feel that the way out of this dilemma is to apply life audit guide principles to the single premium deferred annuity, but to expand the interpretation of the guide for these products to accomplish a deferred pattern of most of the earnings, at least in those cases where investment, persistency and other risks are retained by the company. We believe that this can be accomplished by applying appropriate provisions for adverse deviations, or conservative deltas, to assumptions that represent all of the risks for these products. We are hopeful that the resultant GAAP reserves and earnings patterns may often be approximated by setting GAAP reserves equal to the accumulated value in the annuitant's account. Much testing is yet to be done in this area.

In any event, since single premium deferred annuities are at the far end of the product spectrum and seem to be the most troublesome product to address, we are now focusing all of our attention on this product. The next Interpretation of the Academy's Committee will treat only this product. We believe that once this is tied down the accounting procedures for the other new products will flow in a consistent manner.

The next meeting of our Committee is June 2. We have invited members of the Accountants' Task Force to discuss the second draft of an issues paper on accounting for single premium deferred annuities, prepared by Bob Stein, of our Committee. Bob is an Actuary with Ernst & Whinney. Before we go much further we want to ask for input from actuaries and accountants working with those companies that are substantial annuity writers. While it is possible that some existing practices will be changed, we do not want to cause problems for people inadvertently and without giving full consideration to other points of view.

MR. CARROLL: At this point we'd like to have some discussion from the floor. I have a few questions for the panelists. Could any of you comment on what is happening and what companies are actually doing with Universal Life as far as reporting GAAP earnings?

MR. EANES: I think to date, there has been, in our experience, a real move to try to fit Universal Life into the audit guide and to try to come up with mechanisms that, in fact, are substantially recognizing profits under the audit guide concept of the level percentage of premium.

MR. CARROLL: We have two papers, on GAAP accounting, that should be discussed here. Particularly apropos of the discussions we've had so far is Kriss Cloninger's paper on GAAP for nonguaranteed premium life insurance which I recommend for those of you trying to struggle with the mechanics of the problem. Kriss is a principal in Atlanta with Peat Marwick and Mitchell.

MR. KRISS CLONINGER, III: We've heard something today about the length of time it takes for professional bodies to come out with pronouncements on how to go about doing things. I wrote this paper as a defensive measure for my own protection, and a way to provide that at least one conceptual framework can be used to account for nonguaranteed premium products throughout their life cycles. The key issues I saw were 1) how to go about setting the initial assumptions, 2) whether or not the "lock-in" principle applies, 3) what happens to the balance sheet at the date you change premiums, 4) how to test the recoverability and 5) what are you going to do mechanically to implement any prospective changes in assumptions that you might ultimately make?

I felt on the initial assumption basis in order to achieve a reasonable matching of revenues and expenses, you had to relate your initial valuation assumptions to your current pricing assumptions. In addition, the provision for adverse deviation was implicitly contained in the premium structure. I felt the "lock-in" principle should apply until the date premiums are changed, and that it shouldn't apply if premiums were changed significantly and future earnings patterns might be distorted. I argued that prospectively, we should be allowed to change valuation assumptions on the same basis that we changed our pricing assumptions, and that a change in prospective valuation assumptions would not generate any change in the deferred acquisition cost balances or benefit reserve balances that existed at the date of the change subject to loss recognition tests. I felt the recoverability should be tested against the current premium level, and that we should not rely on future premium increases. Mechanically, I described one way to achieve prospective changes without altering the balance sheet.

MR. CARROLL: The second paper has to do with accounting for reinsurance. The authors are Dave Becker, who's in the reinsurance division of Lincoln National, and Mike Eckman, who is with Northwestern National in the corporate actuarial area.

MR. MICHAEL V. ECKMAN: Since the time the methods outlined in this paper were conceived, the reinsurance business itself and some of the requirements of financial reporting have changed. Nevertheless, the principles and methods outlined in the paper still apply.

The original problem which was to be solved was obtaining accurate quarterly valuations. Currently, monthly valuations for monthly earning reports are desired. As the paper points out, these more frequent valuations can be accommodated with the theories and methods given.

Originally, we wanted to solve a valuation problem which was leading to fluctuations in reported earnings. Currently, there is a desire to analyze earnings by source. Using the same data sets as for the valuation, assumed premium, commission, mortality, lapse, and interest figures can be calculated. The deviation of actual results from these figures can be reviewed. Also, a GAAP commission figure can be calculated which has some value in analysis.

As originally conceived, the system would use individual policy valuation records. Currently, anywhere from 25% or 50% of a reinsurer's new business is being reported on a bulk or Bordereau basis, neither of which involve individual records. To accommodate the system to this new administration, the age and plan distributions could be added as assumptions and composite factors calculated. Given new business, in-force, and statutory reserve figures by calendar year, composite factors could be applied to produce total GAAP reserves. The ratio of actual commissions to assumed commissions or actual statutory reserves to assumed statutory reserves could be used to produce a model adjustment factor.

The paper was designed to be applied to reinsurance retroceded, as well as accepted. For direct ceded business, however, some different theory may be considered. For example, a discussion of the paper suggested considering the commission and expense allowance stream as revenue to the ceding company while actual expenses would be the outgo item. For retrocession of reinsurance accepted, original contract terms are usually used so that the two methods should give the same result.

MR. DAVID N. BECKER: I would like to complete some of the items that Mike has begun. He mentioned that the original purpose of the GAAP model was to smooth the fluctuations earnings which we had with the prior GAAP accounting procedures. The first work we did was limited to merely validating the model and getting up the main frame system to produce the valuation. We validated the model by relying on essentially low-level computer usage in our reinsurance department. This limited some of the other applications which we would have like to have done at that time. Since then, due to increases in hardware and software availability for the user department, we have been able to expand the capabilities of what the models will do beyond their late evaluation and some of other items suggested by Mike. Currently, we have operative (or soon to be operative) with the model: 1) tests for the recoverability of deferred acquisition costs, 2) tests for loss recognition, 3) what-if testing with regard to any of the experience assumptions, and 4) tests on the emergence of profit for experience assumptions different from original pricing assumptions. We have also had certain computations done that give us additional insight on pricing for amateurs, for example: 1) statutory profit margins, 2) statutory return on investment, 3) GAAP profit as a return on premium, 4) GAAP return on equity, and 5) the ability to run the model with or without Federal income taxes with an 818(c) optional.