RECORD OF SOCIETY OF ACTUARIES
1985 VOL. 11 NO. 2

MANAGEMENT FINANCIAL STATEMENTS FOR MUTUAL COMPANIES

Moderator:	HENRY B. RAMSEY, JR.
Panelists:	ROBERT W. STEIN
	OWEN A. REED
	GLEN M. GAMMILL
	GLENN H. GETTIER, JR.*
Recorder:	JOSEPH H. TAN

- o Overview of current activities
- o Evaluating accounting alternatives
  - Internal/external reporting needs
  - Consistency with pricing/dividend practices
  - Relationship to management performance standards
- o Accounting for participating business
  - Margins for adverse deviations
  - "Lock-in" for lifetime or until next dividend scale change?
  - Termination dividends
  - "Benefit Reserve" equal Statutory Reserve?
- o Differences in management reporting and generally accepted accounting principles (GAAP) reporting

MR. HENRY B. RAMSEY, JR.: The subject of management statements for mutual companies has been around for a long time but has developed momentum recently. In the early seventies, when the American Institute of Certified Public Accountants (AICPA) was developing the industry audit guide for stock life insurance companies, I participated in the process as chairman of the American Council of Life Insurance (ACLI) Financial Reporting Principles Committee. A number of us from mutual life insurance companies were interested in the subject because we felt that the principles established for stock life insurance companies would ultimately be applied to mutual life insurance companies. The subject of accounting for nonparticipating ordinary life insurance companies was so challenging that the further consideration of participating life insurance was impractical within the time frame allotted. The great pressure was with respect to the nonparticipating business of stock companies.

It was phenomenal that the audit guide which emerged for stock life insurance companies in 1972 contained such sound actuarial principles.

*Mr. Gettier, not a member of the Society, is Executive Vice President and Chief Financial Officer of the Equitable Life Assurance Society in New York City.

We are indebted to people who worked hard to explain the actuarial aspects of life insurance contracts. In particular, Gary Corbett was key in developing the principles which led to the stock company audit guide.

Subsequently, the American Academy of Actuaries Financial Reporting Principles Committee has had a designated subgroup for accounting for participating business. This subcommittee has met infrequently because there hasn't been a great deal of enthusiasm toward working out a proposal to the accounting fraternity. There had been little demand for a prescribed management financial statement in participating business.

In the early 1980s, however, mutual company managements became more concerned about good measurements of the financial results of their companies. It had always been possible to manage the mutual ship by observing the statutory rudder, even though considerable adjustments had to be made to interpret the results. With the substantial discontinuities caused by high interest rates and the introduction of interest-sensitive products, the shortcomings of the statutory blank have become a good deal less tolerable. Thus, many mutual company managements desire to have a financial statement which better measures the performance of the company. The industry diversification into financial services other than life insurance has also created a need for a financial statement which better demonstrates the results of several aspects of the financial services industry. Computer advances and greater understanding of the interplay between GAAP financial reserves and the financial statement contribute to the interest in a better financial statement. Another critical factor has been interest in demutualization. In 1984, The Society authorized a task force under the direction of Mr. Harry Garber to explore actuarial matters related to demutualization. Earlier this year, a subcommittee of that task force was formed to deal with related accounting issues (most of the larger mutual companies are represented on that subcommittee which is headed by Charles Greeley). That group is exploring the recommendation of appropriate guidelines for management reporting.

Mr. Robert Stein is both a Fellow of the Society and a certified public accountant. He is a partner and directs the actuarial practice of Ernst and Whinney, which has about a dozen mutual company clients who are producing management financial statements. Mr. Stein has been active with the Academy's Financial Reporting Principles Committee and headed the Task Force on Universal Life and Annuities. He is also a member of the subcommittee on accounting for mutual life insurance companies.

MR. ROBERT W. STEIN: When discussing management financial statements there is an unspoken premise that we are dealing with nonstatutory financial statements. For the major individual lines, statutory financial statements do not provide the kind of information that management finds essential for managing and operating the business.

I am aware of more than twenty major projects intended to convert financial statements to a management basis. I suspect that virtually all companies have at least evaluated the need for such financial statements and have studied alternatives. Many have projects in different stages of development, and some are intended to produce management basis results in the near term.

The nature of these projects varies, and the project objectives reflect the particular circumstances of each company. The primary management objectives heavily influence the specific characteristics of these projects. That is, what management is trying to accomplish in their management-basis statements determines the framework within which all of the key implementation decisions are made. Thus, the specific objectives of the project, e.g., how management intends to use the statements, will result in different implementation decisions and a different financial statement framework and reporting package.

The wide variety of statements which could be prepared still can be categorized into three broad types. The first is directed towards developing financial statements which would be relatively close to, if not completely consistent with, stock-life GAAP. This is the focus when the company has near-term demutualization objectives or other reasons to go public with financial statements. Most of these projects have relatively short time frames and are geared toward developing stock-life-GAAP financial statements.

A second type of project is characterized by the mutual company having no interest in external reporting, either on a stock-GAAP or a mutual-GAAP basis (when and if mutual GAAP is defined). These types of projects are internally oriented -- directed towards specifically meeting management's desire for improved information to use in the management process. Such projects are often primarily intended to present financial statements on a basis consistent with the manner in which products are priced, dividends are established, and the existing profit standards and performance criteria are used.

The third type of financial statement project attempts to accomplish both of the key objectives of the first two types. That is, the output should present financial statements that are reasonably consistent with stock-life GAAP, but they also must achieve management's key objectives with respect to the need for information. Thus, this type of effort tries to be as faithful as possible to pricing practices and standards by adopting accounting policies which are within the boundaries of stock-life GAAP.

Most of the projects are of the management information variety. That is, most companies are not striving to develop management statements to go public in the near term. If the objective is management information, the selection of accounting methods is wide open. In such cases, mutual companies should fully understand that they do not need to be confined or restrained by stock-life-GAAP principles. This allows mutual companies to explore accounting and actuarial alternatives that may not fit within stock-life GAAP but which better accomplish their information needs.

Many of these management information projects are directed primarily towards developing statements that are consistent with pricing and dividend practices. Given management's pricing and dividend approaches, profit standards, and surplus contribution standards, the set of financial statements should be true to those principles and standards. This permits the reporting system to close the management loop relating the establishment of standards for profit and surplus contribution to the pricing of products on that basis, and the subsequent evaluation of performance. The management financial statements are an integral part of this process, and by being faithful to profit standards, the reporting system becomes a routine scorecard on how the company is doing with profit or pricing objectives. Such information then can provide a basis for taking action.

Financial statements are typically prepared for finer distinctions of business (e.g., strategic business units, profit centers, product lines) than are typical GAAP statements. The financial statements and operations are segmented into smaller, more homogeneous classes (in terms of pricing and other factors which impact profitability) so that the financial statements and reported results will be related more closely to the pricing objectives by line or by product within line. For stock-life GAAP, the statement orientation is consolidated. Management-basis statements are heavily oriented toward profit center, product line, or even product.

Such projects also feature an interest in developing different criteria for categorizing an organization's activities. Traditionally, the industry has used product characteristics (i.e., types of product) to define operating units. More recently there is a keen interest in developing information based on factors such as distribution system, market, or customer characteristics. The objective, of course, is to evaluate the efficiency, productivity, and profitability of different segments of an organization. In some cases, operating results are best analyzed, not by the nature of the product, but by the source of the business or the nature of the marketplace. Developing the capability to present financial statements with differing orientations is another key aspect of these management-statement projects.

Management-statement projects often are intended to develop the ability to use financial results in compensation programs. Incorporation of these results in an incentive compensation program is a relatively common part of the process of establishing and using these financial statements.

Finally, in order to get the best use of these management-basis statements, they need to be fully incorporated into the management process. The most important additional element is their integration into the operational and strategic planning process. Thus, management must be able to forecast management-basis results, develop plans based on these financial statements, and assess the reported results.

These, then, are some of the features on a nonstatutory set of management-basis statements. Perhaps it is clear that such characteristics (nonstatutory, more detailed reporting than consolidated statements, use in incentive compensation programs, routine reporting on a quarterly basis) cause such projects to go beyond a typical stock-life-GAAP conversion. Stock-life-GAAP consolidated statements can be prepared with less effort, time, and money than can these kind of statements. Since the reporting for management-basis statements is done for finer lines of business and different definitions of operations, the expense analysis and allocation questions become very important and materially impact the ultimate usefulness of the information. Thus, management-basis statements often require a more detailed analysis of fixed and variable expenses, overhead costs, and line allocations. Also, in almost every case, flexible budgeting concepts get examined as management-basis statements are defined.

Similarly, investment income allocations, asset segmentation, and asset/liability matching become more important. As management is trying to evaluate the profitability and performance of the traditional business, universal life, and various types of annuity business -- all with their own investment needs and strategies -- the identification of supporting assets and allocating or segmenting related investment income becomes key. Without appropriate procedures, the results will not be meaningful.

The critical issues of surplus management, surplus allocation, and monitoring the effective use of capital are closely related to these questions and frequently drive the decisions. Management financial statements often have, as a basic objective, the better allocation of the capital of the organization and the measurement of returns on capital across lines of business. Another allocation question, federal income tax, is an important element affecting the usefulness of the information. Generally, pricing and dividend processes are after-tax. Thus, performance measures and evaluation standards also need to be after-tax, on a consistent basis, including the equity tax.

There are certain practical considerations to make when preparing management-basis statements. A typical goal is to develop a system that will routinely prepare management-basis statements on a multiline basis. This means that as many as ten to twenty definitions of products within product groups or profit centers would be reported on routinely. In cases where the data support requirements, the information processing and the reporting processes themselves assume great importance. The need for timely information means that administrative, accounting, general ledger, and reporting systems and procedures all need to be reassessed.

A critical element in developing management financial statements is the definition of the accounting basis to use. These statements are nonstatutory, and some other accounting basis must be defined. GAAP is one alternative; in any event, the statements need to be prepared on a consistent basis of accounting. The criteria to evaluate the accounting possibilities must be defined. To do so, it is important that management fully understand the objectives of the project. Each management group will have a different set of objectives and priorities, and a good definition of what is expected from these nonstatutory financials will help in the selection of the basic accounting principles.

Some of these specific criteria include the degree of consistency of the accounting basis and the pricing and dividend practices and related profit standards or surplus contribution measures. Consistency with "economic reality" is also important, that is, when the organization is fundamentally and economically doing well, the accounting information should present similar data. Also, when the operations go badly, the results shown in the financial statements should show that.

Most companies have a defined set of corporate performance standards and objectives, in the financial sense, whether written or unwritten. Some accounting methods will report on a basis consistent with those objectives and some will not. It is important to consider the degree to which the defined accounting basis is consistent with management's long-term financial objectives.

Finally, a practical consideration that cannot be ignored is the consistency, or lack thereof, of the preferred accounting option and stock-life GAAP. GAAP will always be used as a reference point, and it is unwise to ignore its presence.

The auditability, reliability, and credibility of the accounting bases results are other practical considerations. Some accounting bases may provide good information but may be extremely difficult to implement. Also, basic data may be so subjective that results lose credibility and reliability. This does not mean that statements have to be audited by a public accounting firm, but statements do need to follow a well-defined, well-accepted, and well-understood set of guidelines and practices. Also, development of the actuarial and other balances must be timely and consistent from period to period so that management is comfortable using the results.

Defining accounting principles is primarily related to defining actuarial balances in the financial statements. That is, how are the actuarial liabilities and assets calculated? This is the heart of the accounting principle question and requires a fundamental understanding of revenue and how costs and benefits should be matched with revenue. The biggest challenge is how traditional participating business should be handled. Stock-life GAAP does not deal with this product line. The audit guide and subsequently, Statement of Financial Accounting Standards No. 60 by the Financial Accounting Standards Board (FASB), address participating business written in a stock company, but whether stock company participating business is "truly" participating remains a question. It is not clear that the philosophies of a mutual company are properly reflected by the accounting for participating business as described in the audit guide. Thus, while the stock life guide presents one alternative, there is no need to be tied closely to it.

Many other alternatives overlap and many are easily rejected. Nonetheless, they all can be placed into one of three broad categories. One category is those methodologies which are strictly consistent with the pricing process. For example, if the pricing approach is return-on-investment/book-profit oriented, accounting policies can be adopted and statements can be prepared that relate directly to that pricing philosophy. The actuarial assets and liabilities can be defined so that they will produce the desired pattern of return on investment that is embodied in that pricing model. While only one example, it is the most important. Such methods also can accommodate allocated required surplus.

The second category can be described as prospective, net premium models. Many terms are now being used to describe stock-life GAAP and its variations for annuity and universal life business, and many of these fit into this class of methods. Prospective, net premium methods would include best-estimate natural reserves, i.e., stock-life GAAP without margin for adverse deviation. Also included is stock-life GAAP and composite GAAP as defined for universal life policies. The most promising alternative is one that can be described broadly as composite GAAP, which certain actuarial and accounting groups have proposed for universal life.

The third category is "retrospective methods". The source-of-earnings approach that the Equitable is using can be described as a retrospective methodology. The deposit accounting that has been considered as an alternative for universal life also is a retrospective methodology.

There can be possible differences between management reporting and GAAP, even if stock-life GAAP is adopted as the primary set of accounting principles. Many stock companies modify GAAP for internal purposes to better evaluate performance. Mutual companies are not constrained by GAAP, and some have adopted accounting principles which are different from stock-life GAAP. In addition, mutuals have a greater ability to make other adjustments, which are beyond GAAP as described for stock-life companies. For example, because the focus of such statements may be consistent with pricing, the definition of acquisition costs should be examined. GAAP would defer only certain acquisition expenses as only some of the costs assumed to be acquisition for pricing would meet the GAAP tests for deferral. Management-basis statements, however, could defer all pricing acquisition expenses in order to be faithful to pricing.

Similarly, GAAP discourages the deferral of certain expenses such as agency and systems development costs. Such project costs can distort the reported earnings and may be deferred and amortized for pricing and dividend purposes. Therefore, they might be considered for deferral in management statements.

Deferred taxes are another area that should be examined. To be consistent with pricing and to obtain an appropriate measure of after-tax performance, the standard, stock-life-GAAP, deferred tax calculation may be modified. For example, it may be desirable to discount deferred taxes, which can be done in the management financial statements.

In investments, some companies are considering the deferral of capital gains and losses to avoid the sudden impact which may be beyond control of the product manager. To avoid the possibility that capital gains and losses can be manipulated to achieve certain goals, some companies believe that such deferral is appropriate. This normally would be a non-GAAP adjustment.

There are several adjustments that might be considered in accounting for the portfolios that support pension products. For example, the normal flow of statutory or GAAP income from real estate investments does not match the flow of interest credits to the liabilities. Thus, adjustments to assets or liabilities to achieve a better matching of the long-term anticipated revenue stream and the crediting of those future gains are being explored. Thus, sophisticated adjustments, many of which would be outside of stock-life GAAP or GAAP for any industry, are being studied.

MR. RAMSEY: In Canada, statutory requirements and financial statements suitable for management are more closely related. Mr. Owen Reed is Vice President and Actuary of Sun Life and is engaged in the valuation of actuarial liabilities, projection of surplus earnings, analysis of earnings, and corporate modeling. That is the heart and soul of the financial reporting operation.

MR. OWEN A. REED: Most large, Canadian, mutual life insurance companies have been using some form of notional allocation of assets by territory and line of business for a number of years, primarily in relation to the dividend allocation process, but more recently with an eye to monitoring the performance of new-money interest products. The implication is that for some years, the statutory approach has not been judged to provide sufficient data for such purposes (more of a problem for the multinational companies). More recently, and for the same reasons applicable to U.S. Companies, it has been decided that in order to get a realistic financial picture of our operations, all Canadian mutuals need full asset/liability segmentation -- not just for a limited number of new-money interest products.

Even so, this segmentation has to be on a notional, or internal, basis because it's not permitted for external purposes under existing Canadian life insurance legislation.

In this day and age, mutuals feel that they need to manage their affairs in a manner similar to stock companies, paying more attention to earnings and how to plan for earnings. Monitoring earnings means monitoring the principal components of the income statement, two of which are investment income and increase in provision for actuarial liabilities; it's now well accepted that segmentation provides a superior allocation of investment income, so naturally more attention is being given to the actuarial liabilities -- one of the primary causes of surplus strain.

The importance of managing surplus is recognized, and companies are in various stages of surplus management by reference to rate of return on capital. All companies would have at least one reason in common for doing this: it can afford a yardstick for comparison with the performance of other companies, not necessarily in the same industry.

There isn't really GAAP for life insurance company financial reporting in Canada -- stocks or mutuals. However, the existing system is a statutory format which comes close to what many Canadian actuaries and accountants visualize GAAP would be. For example, Mr. Stein refers to the problem of reporting with respect to stocks and real estate. In Canada, part of the unrealized and realized capital gain is amortized into income. And it is hopeful by the end of this year that the same will be true with respect to real estate.

For income statement purposes, the norm for statutory reserves is becoming "modestly conservative reserves" or "fairly realistic reserves," the type of reserve being the double decrement new premium reserve with provision for deferral of acquisition expenses.

The resulting reserve could be negative or less than the guaranteed cash value. There's a requirement that surplus be earmarked to cover negative reserves and to eliminate cash-value deficiencies.

For individual insurance, you could say that these statement reserves are similar to U.S. GAAP reserves, but with a major difference: the actuarial assumptions are updated each year.

Such reserves are therefore prime candidates for internal financial reporting purposes, since they're similar to gross premium reserves which are front-end to profits to the extent of the acquisition expenses being amortized.

The situation isn't as clear-cut for single-premium deferred-annuity business, which typically provides for interest guarantees of up to five years on a compound interest or simple interest basis, because Canada hasn't developed generally accepted practices. However, there is a specific trend. If the business appears to be profitable on the valuation assumption to the valuation actuary, the above-the-line statutory reserve would be policy accumulation value less unamortized acquisition expense; i.e., a GAAP-type of reserve. In practice, an interest rate, which is higher than the guaranteed rate, would be used to achieve approximately the same result. Thus there is the potential for using just the one reserve for both statutory and internal purposes. Hence, it is quite feasible to use Canadian statutory reserves for internal financial purposes.

If, in addition to internal reserves, we establish internal minimum surplus requirements, it's logical to consider the combination as the amount of assets the business unit manager has under his control, in particular for asset/liability matching purposes and for profitability purposes.

We'd expect this amount of assets to be less than the corresponding statutory requirements; the difference can be put into a pool with any free surplus and be separately managed. For a multinational company you can expect one pool for each territory, and further improvement would be to split out a separate pool of corporate surplus -- especially if your company follows the permanent contribution-to-surplus dividend philosophy.

Internal financial reporting should be timely and strong on analysis of results: why are the earnings the way they are, and, importantly, to what extent do they differ from "the plan" and why?

Original pricing assumptions just aren't relevant if the income statement is supposed to be realistic. Therefore, actual-to-expected experience should be studied in relation to current pricing or dividend standards. However, it's obviously valuable to study a product's overall performance on a historical pricing basis, if you have the data base. If you haven't, now's the time to start!

Corporate financial models provide a facility for projecting earnings for the current year plus a number of succeeding years. For a company with three-year plans, this number is three. Building good corporate financial models is challenging, especially for a multinational company. The goal is to use such a model to test alternative business scenarios to see how they might affect the income statement and balance sheet. As a result, some scenarios might be vetoed because they involve just too much surplus strain, others amended, and so on.

The question of internal rates of return on invested surplus hasn't been resolved satisfactorily. At Sun Life, our pricing reflects statutory reserving requirements, but we feel that pricing should reflect statutory requirements for both reserves <u>and</u> surplus appropriations; doing so would give us one estimate for the internal rate of return (IRR). Another calculation based only on the level of the operating assets of a segment would give us another (presumably higher) estimate for the IRR. It's not clear how useful this second estimate would be. Presumably it can indicate the impact of statutory requirements and probably could give us some insight into whether or not we're at a disadvantage compared with other types of competing financial institutions (such as trust companies).

In regard to financial results from sales efforts, the supplementary, traditional, gross-premium valuations should be done at the end of each year to estimate the present value of expected future profits. The increase in the present value of such profits will give an estimate of the increase in net worth of the company on a going-concern basis and can be broken down into new business written during the year and business in force at the beginning of the year. Any "bottom-lining" process needs to be keyed to net income; however, it also can and should be related to the increase in net worth of the portfolio of business.

With bottom-lining, I take it for granted that everyone has to satisfy income standards based on statutory reporting. And there is now a second set of standards based on internal reporting. I envisage that bottom-lining or "bonusing" for a business unit manager would depend on performance versus a number of key targets. In the context of the income statement and balance sheet, I see three things:

1. Earnings performance measured by the internal version of net income.

2. The financial performance of the "existing" business measured by the year-over-year increase in its net worth (as determined by a gross premium valuation).

3. The net worth of the new business written during the year measured by means of a gross premium valuation.

In accounting for participating business, I am strongly against using two sets of margins -- one for internal income statement purposes, the other for Canadian statutory purposes.

The norm in Canada is for explicit valuation assumptions to change as often as annually. Since some companies use dividend scale assumptions for valuation purposes (e.g., the valuation interest rate equals the dividend interest rate), you could say they change whenever the dividend scale changes.

When we select the actuarial assumptions at Sun Life, the aim is to use conservative mortality and lapse assumptions, starting from Sun Life experience. Experience expenses are used. The biggest challenge is to set the valuation interest assumption; we use a computer simulation of the flow of funds from the particular line of business and examine the results under different scenarios (i.e., scenarios of future and new business and future inflation). The computer develops the average net-of-tax portfolio rate. We're interested in this rate over a span of at least ten years, on a compound interest basis. I'm talking about an after-tax internal rate of return earned by the assets. Slicing something off this for modest conservatism gives the actual valuation interest rate.

There are two types of terminal dividends -- those of Great Britain and those of North America. The Great Britain variety can somewhat inaccurately be regarded as emerging from capital appreciation of assets -- unrealized and realized. If the balance sheet asset values don't include any capital appreciation, you shouldn't be setting up a liability for them at all -- unless the dividend illustrations build up policyholder expectation. Otherwise, the liability simply would be that for the terminal dividends declared for the ensuing year.

For North American style terminal dividends, if you illustrate the terminal dividends, you should reserve for them. No doubt this would drastically change the amount of surplus attributable to individual insurance for companies on the temporary surplus philosophy.

MR. RAMSEY: The commitment by the Equitable Life Assurance Society to develop a management financial statement was a major development. While there are a great many of us who are doing that now, they started this activity with a flourish. Our next two speakers from Peat Marwick have been instrumental in that process.

Mr. Glen M. Gammill is another one of those unusual individuals who has gotten both his FSA and CPA. He is the national coordinator for Peat Marwick's insurance practice. He has been active with the Financial Reporting Principles Committee and was a member of the subcommittee on mutual life insurance company accounting. Mr. Glenn H. Gettier, Jr., has been active in insurance industry services, with Peat Marwick and recently became Executive Vice President and Chief Financial Officer of the Equitable.

MR. GLEN M. GAMMILL: A number of people have been involved in this financial statement conversion process for the last fifteen years or more and have gained a lot of experience. Hence, the information that we impart to you is really the result of a build up of many years of experience and not just an isolated year to year and a half experience.

We've observed an expanding interest by mutual life insurers in developing management-basis financial statements to supplement the traditional regulatory-basis statements. From Peat Marwick's perspective, the mutuals' interest in management statements is due almost solely to the desire of the company's board of directors and senior management to understand and manage their business in a better way. Many of the companies have indicated their interest is not in demutualization but in producing better management information to run their businesses. The actual use of these statements to measure performance is still somewhat obscure. The reason for this is that many of the quantitative objectives and goals of the organizations have not been satisfactorily articulated yet. We all know how to calculate return on equity (ROE) -- determine the numerator and denominator and then how those measures should vary amongst the various business units. Obviously, you can't hold each business unit accountable for the same ROE.

From Peat Marwick's perspective, the ability to use such management-basis statements as a communications tool is extremely important. Improving the communication link between the strategic business unit, senior management, and the chief executive officer (CEO) can be an important result of accounting conversion. The system should include the following attributes:

1. The preparation of such financials and their underlying accounting methodologies should be reasonably systematic and creditable to the user; if not, we are going to have a problem.

2. In order to achieve acceptance, the under lying concept of such statements should result in reasonably conservative financial statements.

3. Such financial statements should attempt to achieve comparability among interperiod financials, intracompany and business unit financials, and other peer companies that use similar accounting techniques.

4. The accounting models used for each business unit should be simple and practical relative to a realistic representation of the basic economic realities of that business unit.

5. The financial statement configuration should produce fair and equitable results between basic business units within the reporting

entity, and those results should not be unduly influenced by people whose performance or awards are, in a large part, based on such statements.

Additionally, the accounting models chosen should reflect the company's mission (its goals and objectives) and, further, should allow the company's senior management an opportunity to monitor predefined goals and objectives. These are the major characteristics of the reporting system that we would like to see in our management-basis financial statements.

A major issue for the management financial statement is not whether it can eventually be called GAAP, but whether it can be reconciled clearly with other sets of books required or defined by the company (regulatory, possibly general purpose financial statements, and, in the future, tax-basis statements). Although the accounting models developed within the mutual company framework are of major concern, such models are going to evolve naturally over time with or without codifications by either the FASB or the Security Exchange Commission (SEC). The framework for the mutual industry will evolve primarily due to commonly accepted practice as opposed to codification by authoritative accounting and regulatory bodies.

There are many varied and important issues relative to management financial statements. First is what I call garbage-in/garbage-out. These financial statements are only as good as the financial line items allocated to the business unit. The expenses, investment income, and taxes have to be allocated properly. Second, what are the objectives to be measured? Are they ROI, ROE, or actual merging experience versus pricing? It probably is a combination of all three or more.

One critical aspect of developing dialogue is the organizational view of the basic business unit's periodic financial reporting of financial performance, i.e., net income. The question is whether financial reporting views should be retrospective or historical, or whether they should be prospective. That issue could be most important in developing management-basis financial information.

Admittedly, as an actuary looking at the true earnings of any enterprise, a change in net worth approach can be useful in measuring the economic progress of the business units. However, such a prospective view may be appropriate only when used in conjunction with (or possibly in a secondary role) to historical or retrospective view of the reporting of the entity or business unit net income. Even though the historical, retrospective view does not necessarily support the concept of unlocking assumptions (in the absence of loss recognition), it still can reflect management reaction to actual emerging experience if such reaction is effectively monitored by measuring deviations from the locked-in (or pricing) assumptions implied by the retrospective approach. By allowing for the appropriate measurement of deviations of actual emerging experience from experience assumed under the retrospective point of view, historical financial statements will be more widely understood and accepted and will also be less subject to fine-tuning.

The CEO and the Board should be alarmed if (a) there is substantial difficulty in understanding the underlying methodologies and characteristics of the management-basis financial statement, or (b) they have to rely heavily on technical people to explain why there have been deviations for the plan. Creditability and the idea of trying to achieve the very common denominator in terms of communication to both senior management and the Board are essential.

The Equitable's senior management recognized some of the pitfalls of the prospectively denominated reporting system and its collective attitude was to achieve a compromise between economic realities on the one hand, and internally coordinated reporting philosophies and internal financial controls on the other hand. So there is a compromise between true earnings reporting and earnings that could be monitored.

In its conversion to management-basis financial statements, the Equitable used the accounting principles materially consistent with general purpose financial statements as currently codified or generally practiced for each basic business unit.

There has been a lot of dialogue about how margin-driven products should conform to GAAP and there are issue papers and consideration being given to various methodologies (e.g., deposit approach). I believe that the Equitable approach is consistent with general purpose financial statements as currently codified and generally practiced. The accounting models employed by the Equitable for each business unit tend to reflect the accounting principles which emphasize the retrospective or historical view, with sufficient controls and procedures to monitor actual emerging experience deviations versus deviations assumed in the pricing decisions. For participating individual life, the Equitable uses an accounting model referred to as the source of earnings approach (or SOE approach). The SOE is related to a family of accounting models which should reflect the economic and business considerations for margin-driven product types with the periodic financial reporting prepared on a systematic, rational, and reasonably conservative basis. The SOE should reflect the company's underlying pricing philosophy and corporate mission for traditional participating life insurance products as embodied in the contribution principle. Under the SOE, the company projects experience using assumptions appropriately consistent with the dividend scale at issue. Such projected experience subsequently is reduced by the original dividend scales providing net margins, which after absorbing policy maintenance expenses, are utilized to recover deferred policy cost -- not deferred acquisition cost. As the company employing a DOE approach reports new income, over time, each layer of business activity (or years of issue) will produce a greater or lesser amount of net available revenue with which to amortize these deferred policy costs. Management ability to return to policyholders, retrospectively, some measure of actual experience through the vehicle of policyholder dividends while, at the same time, maintaining net available revenue sufficient to recover deferred policy costs, may be at least one of the key financial objectives to be measured and managed. The variation of actual emerging experience from pricing assumptions and the company's action in returning such deviations, in part, to the policyholder are the major elements of the SOE. To the extent that the participating philosophy embodied by the contribution principle is based on returning an equitable share of favorable experience deviations to the policyholder, one would expect that net available revenue will be returned to the policyholder only to the extent required to sufficiently ensure that all the deferred policy costs associated with the participating individual life contract are recovered. To the extent that management falters in (a) either managing the company toward favorable experience deviations, or (b) correlating the retrospective policyholder dividend to appropriately reflect emerging experience, currently codified loss recognition principles may need to be triggered and financial losses may need to be recognized immediately. The company can choose to declare any policyholder dividend it wants. If the company has an unfavorable dip in its experience and its net available revenue has been squeezed, the company can still choose to pay a higher scale that is somewhat inconsistent with its experience. But they are going to pay a price at the bottom line. Over time, if enough of those actions are taken, it is possible that the net available revenue would not be sufficient to recover policy cost. Hence, there is no discontinuity between frozen assumptions and the emerging dividend pattern of actual experience versus assumed experience.

One final footnote, when viewed through the SOE accounting model, the economic resemblance between the traditional participating life insurance contract issued by the mutual insurer and the emerging nontraditional/universal life contract is striking. The accounting model which should be used eventually by the insurance industry for both products will almost surely reflect such similarities. I applaud the mutual insurers' motivation and focus on the use of general purpose financial statements, modified where appropriate, to provide appropriate management-basis financial information. I hope that such motivation will lead to accounting models for margin-driven products, which will be codified in a large part over time for general purpose financial statement prepared in accordance with GAAP.

MR. GLENN H. GETTIER, JR: I would like to tell you about the approach and model that the Equitable elected to use and why. It is closer to stock-life GAAP than some of the other alternatives that have been mentioned this morning. Our reason for moving into the GAAP project was that the Board was getting tired of hearing that profits were down because sales were up, and various other excuses that attempted to explain the financial results. Interestingly, at the same time as the GAAP project was commissioned, Equitable also commissioned a management-information, systems-development project that ran parallel with the GAAP project. So the focus of this whole exercise was one of improving management information for both the senior management and the board.

Some of the principles or criteria in deciding how we were going to approach this were:

1. Let's not make it too complicated. We can develop some grand theories about what is the most precise way of doing something. But being practical and using the body of experience that

presently exists in the world of insurance accounting today seems to be a very important criterion.

2. We wanted to be able to compare our results to others.

3. We wanted something that could be applied consistently to our various lines of business and would treat them fairly.

4. It must have creditability.

5. It was very important to us that the results be auditable. Not because we expected to use them in any sort of demutualization but because we felt that it was important that the results could be audited and that satisfactory opinion could be provided.

We attempted to apply stock-life GAAP principles, and they required modification. We adopted the SOE method for participating life insurance. That method is reasonably faithful to the methods that are in use today for nonparticipating products as well. The systems and methods that we use are reasonably close to pricing, and at least in terms of directional signals and broad orders of magnitude, we have achieved what we wanted in that respect.

The comparability question has been one that is most important. We wanted to be able to compare ourselves better to the other mutual companies than we could by using statutory information. We also wanted to be able to compare ourselves to stock life insurance companies and other financial services industry companies, because that is where the broad development of our business is going. Of course, GAAP is no cure-all. But there is a discipline that is a part of it; it's constantly being updated, refined, and improved. For us, the disclosure requirements that go along with GAAP are particularly desirable.

There is a convergence of the financial service industries through "reregulation." It seems we cannot continue to do business with state insurance regulators, state and federal bank regulators, and a number of other bodies that look at regulation of the financial services industry. In order for us to be able to finance or find the capital (short of demutualization) for this, we will be directed into the debt markets. This will result in certain types of capital-generating instruments that may not exist in the markets today. All of that will bring an increasing focus on mutual life insurance companies (and their accounting processes) by rating agencies, lenders, and the general public. That focus is going to be a driving force soon for causing an accounting method for mutual companies to become generally accepted -- one which will allow public reporting and comparability.

Equitable Life has adjusted to a GAAP basis in our 1983 and 1984 results and in our 1985 plans by business units. We manage the company on the basis of business unit profitability and return on capital. With respect to return on capital, we have targets that are simply stated in the range of 30 percent pre-tax. We will not be tolerant of those product lines not reaching satisfactory return on equity. For 1985, we are also reporting on this basis both internally and to the Board. We are watching statutory results as well and using the results of both systems of accounting in making management decisions. As we progress in our understanding of the GAAP results, we will be using those more and more.

For Equitable Life, this has been a tremendous learning experience. The adjustments to a new basis of accounting are very complex. The company throughout is learning how to interpret these results, and there are obvious signals we find helpful in bringing new focus. For instance, on a statutory basis, surrender activity may, in fact, cause earnings to increase; whereas on a GAAP basis, increased surrender activity will cause earnings to be depressed. That is the right signal for that business activity to send. Hence, it brings a new focus and a new understanding of the meaning of some of that activity.

We are also developing mechanisms for comparing the GAAP results to what we expected to happen (i.e., pricing assumptions and expectations). In order to make this new system of accounting work for purposes of general purpose financial statements, we have to supplement the general purpose financial statements with a number of ad hoc analyses that relate specific financial-statement account movements with an underlying common denominator, like relating new acquisition costs deferred to first year or new premium activity, and relating amortization of acquisition cost to proper benchmarks. Without that, we would have difficulty in understanding the message of the financial statements themselves. The combination of a new basis of accounting and the supplemental information is really designed to bring about "goal congruence." A management information system should cause the management to behave in a way that is healthy to the enterprise as a whole. A set of financial statements with all of the deficiences that are a part of any system just won't do that by itself. So there have to be a number of ad hoc measures that go into achieving that end.

In our case, the results of these adjustments were rather substantial in their effect on the financial statements. The policyholder surplus account has increased by 60 percent. Pre-tax earnings during this three-year period are 70 percent higher on a GAAP basis than they were on a statutory basis. However, after-tax improvements are not nearly as impressive because of the effects of deferred taxes. There are a number of tax shelter items in our statutory accounts that result in the recognition of deferred taxes as we move to a GAAP basis. So the improvement on an after-tax basis has only been 25 percent.

With all of the movement in mandatory securities valuation reserves (MSVR) charges, capital gains and losses, different depreciation methods in statutory versus GAAP financials, it becomes confusing to sort out what the real contribution to profit from the group pension line was in a particular period.

The recommended composite method for accounting for universal life products is being studied by the FASB. We have used the source of earnings method. But we have demonstrated internally that if we use reasonable and permitted assumptions, SOE would fit under the composite method and get the same answer. In my view, the composite method has too much latitude.

We have chosen not to defer agency and computer software development costs, which can be deferred and amortized under GAAP. Having to pay for those things out of current earnings places an important discipline on operating management. These expenditures are often large and the payback is often uncertain. We need to consider that if we had an accounting policy that allowed those types of cost to be capitalized, it would be easier to spend money on those things before the case is made that it is beneficial.

It is important that an accounting system for management produces a good matching of incomes and expenses within an accounting period. More importantly, the system should be applied consistently from quarter to quarter because the directional signals that an accounting system provides are the most useful kind of information.

The accounting system must be conservative. Stock-life GAAP methodology has a built-in level of conservatism in the way the GAAP method is applied. We have got a good fit with our business, and the analysis that it is providing is very meaningful.

MR. ROBIN B. LECKIE: Mr. Gettier, what is your capital base? How do you get a 30 percent target of pre-tax return on equity on all products?

MR. GETTIER: The target is a return on equity target for a particular business. We assign capital to each business based on the characteristics of that business, and on an analysis of the fundamental risks that are a part of it. It is not an assignment of capital that is dictated by corporate management, but rather it is a determination of capital that a particular business thinks it needs in order to support its business. That is then reviewed, and we either agree or disagree with it and negotiate from there. That is one-half of the equation; the other half of the equation is that the target is based on the earnings that emerge from that business. We developed profit/loss statements for each business (which is not necessarily a single product line, but a group of products that are somewhat homogenous). We exited the small group business about a year or so ago, because we did not believe it could produce a satisfactory return for us. I do not mean to imply that if we cannot get individual life insurance products up to a 30 percent return on capital that we are likely to get out of that business. But as an internal standard to shoot for, we are using 30 percent.

MR. RAMSEY: Let me try to clarify the question. If you have assigned a particular dollar amount of assets to a segment of business, is the difference between that amount and the segment's net liabilities the equity which Mr. Leckie was asking about?

MR. GETTIER: I cannot answer with a simple yes or no. Unfortunately, our asset segmentation process was done a few years ago (by allocating assets to a small number of lines). Our management basis has extended beyond that, and we are now doing management accounting on a basis that is not consistent with the segmentation. So assets are allocated to broad groups of business, and investment income is allocated on that basis. We then make an adjustment that brings the investment income that is allocated on an assets basis into line with investment income that would have been allocated (given the assigned capital basis we've determined for that business). So it is not fully in sync.

MR. THOMAS F. EASON: I hypothesize a large mutual company whose current statutory surplus is group health, minus 10 million dollars, and individual life, plus 110 million dollars. Everything else has broken even since the company began operations. Could Mr. Stein, and perhaps one or two of the other panelists, talk about the allocation questions in establishing management financial statements with respect to the initial surplus and the equity tax?

MR. STEIN: This question is related to the question concerning the equity base one would use to measure returns. Under many of the pricing models and analysis techniques, earnings are distributed from the lines of business as they are earned. You can define several alternatives. Historically, generated profits are retained by lines of businesses. Periodically (whether it is monthly or quarterly or annually), earnings are distributed from a line back to the corporate line, which controls the flow of funds to lines of business. Within those two broad models, in the case where you have a line that historically is in a deficit position, you still have a couple of options. If you take an earnings distributed model approach, you still can keep track of your total cumulative investment in that line of business. With these measurement questions, the equity definition is not all that clear. We could forgive all the past losses on a period by period basis, in which the allocated surplus would be the required surplus plus the net effect of the GAAP adjustments. That could be one definition of equity in that line of business. The assets allocated to the line on a statutory basis would equal reserve liabilities plus the required surplus. Therefore, on a GAAP basis, equity becomes required surplus plus the net affect of the GAAP adjustments including deferred tax numbers. So, superficially, the allocation of surplus is on a current period required basis at all times. You have to keep the line statutorily solvent so that you forgive past losses. You need to have the required surplus notion which causes you to have additional capital invested there. Then you would go through the GAAP process and create adjusted liabilities which would define the equity base. That sounds like you would continually forgive prior losses and measure returns on a reconstituted surplus position each period. Even under those kinds of models, if the line continues to lose money, some approaches would permit you to measure those "renewal investments" (i.e., those continuing investments). If losses continue to take place, those additional subsequent investments can be included in the equity base. That may or may not change the current allocated surplus, but it would change the measurement base for the return of equity calculation.

Another model is the earnings retained model. One approach is to simply make the initial investment required statutorily. Let earnings accumulate and let that line fund its own growth. To the extent that new business strain exceeds general earnings, the corporation would have to contribute more funds. So you would end up with a mix where your opening surplus under that model approach could be historically generated retained income, plus any infusions from the corporation that were necessary because of the imbalanced growth of new business and the generated earnings from old business. This methodology is harder to implement; it requires you to go back to time zero to reconstruct cumulative gains and losses and track capital infusions from the corporation which becomes exceedingly complex.

Generally, to answer surplus questions, I would tend to categorize them by answering questions such as: Am I going to forgive past losses or not? Will the corporation demand the same return on subsequent reinvestments as it does on its initial investment? Do I retain income in the line or not? All of which could be partly addressed by evaluating how management sets its operating objectives and how you price the product. There should be some consistency there.

MR. GETTIER: Make each line of business operate like a subsidiary. Each business management has to make its case to senior management on how much capital it needs in order to be in that business, and that is their capital allocation determined at a point in time. Then the business operates for a year and either incurs a profit or a loss. If it incurs a profit, then reevaluate how much capital they need. If they have excess capital, they in effect dividend the excess back up to the parent organization. If they have a loss and their capital is insufficient, the parent has to decide whether it wants to continue to fund that business. If it does, it makes an additional capital contribution to bring the capital up to the level that those management groups believe is appropriate.

MR. GARY CORBETT: I sense that the definition of exactly what you include in the denominator of the return on equity is a much more difficult problem than defining the numerator and getting that dollar amount in GAAP definition. But there are a number of different definitions for the denominator. Mr. Gammill prefers a historical basis because it is more meaningful and better understood by line managers. I find it exactly the opposite. From an actuarial point of view, if we want to get true sources of earnings on a product, we should be looking historically, but we find this impossible to explain to line managers. They only want to look at one set of indices. If their mortality experience is greater than what they are building into the products, there should be a loss. Conversely, there would be a profit. For expenses, it is the same, as they want comparisons versus their basic current pricing assumptions. So we basically have gone to a current measure to develop a source of earnings or analysis of earnings.

MR. GAMMILL: I'd have to have a two-step process. If the assumptions had one expense level, and current experience had another expense level, I would know that up front. I would know that the deviations should occur from current levels, but the underlying basis would still be on an expected level, measuring the deviations and making sure that no loss recognition would be present. My main concern is not that the line managers will understand the financials. Whatever the accounting model is, smart people that are doing the work can understand the financial statements and define objectives. My main concern is with the top senior management of the organization -- the CEO and the Board. How do we talk to them about earnings? A group of managers might walk into the Board and say, "We have just reviewed the future, and we have changed our assumptions, and the earnings for this year are such and such." There are a lot of Boards and CEOs that will reject that. If those same managers say, "For the last period, based upon original pricing assumptions, our net income was such and such, and this period such and such plus 10 percent, and our deviations from plan are these," top senior management will 'like' it better. Even though the financial reporting may not be in congruence with current expected experience, you still can measure deviations.

We have an opportunity to do something great. Most stock companies went to GAAP for compliance. Most stock companies are not using it for management reporting. But the mutual companies' focus is on management reporting. They have the opportunity to construct some financial statements that reflect economic realities and at the same time help them run their business. They have an opportunity to also get statements codified and accepted by the Board and senior management.