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### NEW PRODUCTS ACCOUNTING ALTERNATIVES

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MR. WILLIAM J. SCHREINER: Mr. Michael Sonderby is a partner with Touche Ross in their Newark office. He is a member of the American Institute of Certified Public Accounts (AICPA) Task Force on Nonguaranteed Premium Products that gave rise to the AICPA issues paper on accounting for universal life and annuities.

Mr. Edward S. Silins is the regional director of Life Insurance Actuarial Consulting in Chicago for Coopers and Lybrand. He is a member of the American Academy of Actuaries Life Insurance Financial Reporting Principles Committee, which works extensively with the AICPA on these issues.

I am an actuary with the American Council of Life Insurance (ACLI) and can bring you up to date on where that particular issue stands with the Financial Accounting Standards Board (FASB) as well as some of the statutory areas being considered by the National Association of Insurance Commissioners (NAIC).

MR. MICHAEL M. SONDERBY: The real issue in new product accounting is whether or not the stock company audit guide, which was issued in the early 1970s, applies and also whether it applies to single premium deferred annuities (SPDAs). SPDAs aren't new but recently have become very popular and a lot of attention has been focused on SPDA accounting. In the early 1970's when the life guide was issued, the universal life product was not contemplated when the accounting model for traditional policies was established.

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The AICPA does not establish generally accepted accounting principles, but it takes positions on accounting principles presenting them to the FASB in the form of issues papers. The AICPA is no different than any other interest group in terms of providing input to the FASB for their deliberations on accounting issues. The Nonguaranteed Premium Products Task Force, of which I am a member, got started in 1982 and was established for a very narrow issue -- dealing with nonguaranteed premium contracts. A company had asked a specific question on how to account for a nonguaranteed premium product that it was about to issue under the stock life guide. In 1983, the charge of the task force was expanded to cover the whole area of universal life. In 1984 the task force received considerable pressure from various groups. The SEC was interested because of the SPDA accounting problems surfacing from the Baldwin-United situation. The SEC was concerned about front-ending profits on SPDA contracts, and in 1984, it said that if the accounting profession didn't come out with something by the end of the year, it would dictate accounting rules for these products.

The result of the deliberations of our task force is an issues paper that pulls together all the subjects that were covered by the task force from inception. This issues paper was sent to the FASB in November of 1984. Our committee was actually a joint committee with the American Academy of Actuaries' Committee on Financial Reporting Principles. In addition, throughout the process there were a number of industry people and industry groups involved. The four accounting issues covered in the paper are nonguaranteed products, internal replacement, annuities, and universal life.

The nonguaranteed premium product permits an insurance company to change the gross premium in response to changes in what they expect for the key pricing assumptions: interest, mortality, lapse, and expenses. This change could occur every three to five years. For a contract of this nature, does the GAAP principle of locked-in assumptions apply, or do you unlock the assumptions? The conclusion of the group was that the assumptions should be unlocked on a prospective basis, the same conclusion as in the 1983 American Academy's interpretation.

The internal replacement issue deals with the reality that there is a lot of replacement of old products by the new products. The issues here are how the acquisition costs in replacement should be defined; whether those costs should be deferred; if they're deferred, should they be amortized; how should they be amortized; in what period; and then how would you do a recoverability test?

The conclusion was that the new policy acquisition costs would be defined as the deferred acquisition cost plus or minus the difference between the surrender value and the reserves for the replaced policies; there should be no income or loss at the time of replacement; and these costs should be amortized over the term of the replacement contract. There's a recoverability principle in insurance accounting which requires segregation of business into groups of policies or lines of business. This is based upon how a particular company acquires services or measures the profitability of their products or their lines of

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business. The conclusion in the issues paper was that, when doing a recoverability test, all universal life contracts should be considered as a group.

The more controversial issues deal with annuity and universal life accounting. The authors of the life audit guide spent a lot of time looking at the question of how to recognize income, and they decided to do it based on "performance under the contract." But the real issue was how to measure performance. They agreed that performance measurement ought to be tied to some of the predominant functions or services in a life insurance contract such as premium, premium collection, incurred costs, invested funds, and amount at risk. Deciding there was no particular predominant function or service, they picked premiums as the appropriate basis for recognizing earnings. Then they said that the benefits and the expenses should be matched to the revenue so that the earnings emerge as a level percentage of premiums. However, to recognize some of the other services performed, they added the concept of incorporating a provision for adverse deviation in the assumptions; thus, these provisions for adverse deviation resulted in some of these earnings being recognized in relation to the passing of risks.

This approach is fine for the traditional contract, but not when you apply it to SPDAs and universal life. The audit guide literally results in front-ending the profit on SPDAs. You recognize the profit at the point in time that the contract is sold, because it's in relation to premiums. As to universal life you don't know what the premiums or benefits are, or whether the investment feature is the predominant feature, and this accounting model just doesn't fit. So an alternative approach was considered which was described as the "earnings as realized" or "full margin" approach. This assumes that the performance under the contract is more closely related to investment management and mortality experience. Using these as the primary basis for profit recognition results in earnings being recognized as the difference or margin between the actual investment earnings and mortality costs, and those amounts, which are charged or credited to the contract, emerge. Now this does not produce profits as a level percentage of premium. This method is considered to be more appropriate in a situation where the contract is not fixed, and the future economic or policyholder activity is not predictable.

On the "universal life accounting spectrum," we've got the traditional GAAP method, which results in earnings as a percentage of premium, on one end. On the other end, depending upon how much provision for adverse deviation is included, we have the "earnings as realized" where the earnings emerge as the experience varies from what is passed on to the policyholder.

How do those two ends of the spectrum apply to the methods which were developed in the issues paper? On the one end the traditional GAAP method was given the name "premium method" in the paper. On the other end, a method called the "deposit method" in the paper is the same as full margin or earnings as realized. In between, we have the "composite method." The composite method does not fall on a particular

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point on the spectrum; it spans all the way from premium to deposit. Under the deposit method, no income is recorded when the contract is issued, and the earnings are recognized over the contract as the margins are realized. Under the composite method, we have a combination, where some profit emerges relative to premiums and, also, as a margin is realized on investments and as the mortality charge exceeds the actual mortality cost.

So these three methods were considered by the task force. It concluded that the deposit method for SPDA's; that is, no profit at the time of the sale. For universal life, the composite method was determined to be appropriate. In the issues paper, there is some lengthy discussion about the prospective and retrospective methods. I consider the prospective method to be the actuary's method. The retrospective method is the accountant's method.

The conclusions did not come easy because at issue has been the traditional GAAP model in the life guide. The problem is when to apply that model versus some other accounting method. There are those who would say that the traditional GAAP model applies to all policies - universal life and SPDAs. There are others that would say that the life guide ought to be thrown out and that we should challenge the whole accounting model for life insurance. The composite method is a compromise to a great extent. Some say that the composite method is too broad and that it provides no way to construct a boundary around the earnings recognition.

The SEC has taken a strong position on annuity accounting. There was a flurry of activity about a year ago when the SEC was identifying specific companies that were big annuity writers and called them in to Washington to talk about their accounting methods. The SEC simply believes that front-ending profit is wrong. In terms of universal life the SEC has not made a strong public statement. I think it's happy that there is an issues paper in the hands of the FASB and that the FASB is dealing with it.

The issues paper contains a lot of mechanics, all supplied by the actuarial assistance on the task force, and there are large appendixes in the back covering the various methods and examples; it is more a concept paper.

MR. EDWARD S. SILINS: Accounting models and, in particular, the recognition of profits has long been viewed as the accountant's domain. Accordingly, in its financial reporting recommendations and interpretations dealing with GAAP, the Academy refers to the AICPA audit guide on audits of stock life insurance companies in determining its recommendations and interpretations for practicing actuaries.

There's no magic in profit recognition as it relates to life insurance company products. Profits can be recognized all at issue for a particular policy; at the termination of the same insurance contract when all of the events related to it have been completed; or somewhere in between, that is, ratably over the life of the contract. It appears that the Academy and the Society are not proactive with respect to the

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manner in which profit is recognized on life insurance products. I'm sure most actuaries have their own opinions on the matter.

Since the AICPA audit guide was adopted in 1972, premiums have served as the basis on which costs are to be matched and profits are to be leveled when preparing GAAP financial statements. Until recently, this concept has held fairly wide support within the industry and has not been brought into question. With the advent of a range of new products, primarily interest-sensitive products, this concept has been questioned. For these newer products, a company derives its profits primarily from investment spreads, surrender charges, policy loads, and in the case of universal life, from mortality charges associated with the contract. This focus on sources of profit other than premiums has led to certain subissues inherent in accounting treatment for new products.

These newer investment-oriented products look like bank accounts, which has caused accountants to question the precept that premiums are the source of revenues for income matching. At various Academy of Actuaries/AICPA task force meetings, I've heard the analogy of universal life and SPDAs to banks and savings and loans (S&L) institutions countless times, wherein deposits are not treated as revenue and no profits are recorded at the receipt of a deposit going into a banking institution. Furthermore, even if a bank gives away toasters or television sets, they are not allowed to capitalize the costs of doing so; thus, they merely expense those costs as they are incurred. In the bank scenario, profits to the bank or S&L will emerge over the life of the deposit as the bank earns more investment income than it passes on to its customers. Why wouldn't the same type of accounting treatment carry over to insurance companies when they deal with investment-oriented products? Currently, certain deposit funds of life insurance companies have been treated in exactly this fashion. However, this is primarily in the group rather than in the individual product area.

Several of the official reasons why accounting treatment is being questioned are discussed in both the FASB issues paper and the American Academy of Actuaries issues paper. For example, paragraph 69 of the Statement of Financial Accounting Standards (SFAS) No. 60, which replaced the AICPA audit guide, essentially sidesteps the issue, stating that it of itself is not applicable to universal life policies. The unbundling of the insurance contract has opened a full examination on the components of the universal life contract and other contracts and their appropriate accounting. Nonguaranteed premium contracts require a modification of the locked-in-assumptions concept. This has been accomplished through the Academy of Actuaries Financial Reporting Recommendation and Interpretation 1-1, which was a direct result of the AICPA/Academy task force dealing with nonguaranteed premium products and then with SPDAs, universal life, and other policies.

Statutory as well as GAAP accounting practice varies widely among companies, indicating that if there's not a problem, there's certainly a lack of unanimity among those reporting. In the absence of any authority stating which method is appropriate, many companies have

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chosen methods which are easy to calculate. They rationalize that as long as the method produces results close enough to one of the theoretical methods, its simplicity is justified. Usually the projected incidence of earnings is somewhere between the two theoretical extremes and thus might be regarded as a blended or compromised pattern of earnings. Companies do not want to go to a great deal of effort in developing a method which might be declared inappropriate soon after. Universal life is still a fairly small portion of the in-force business for many of these companies, so the choice of a GAAP method does not impact overall earnings significantly. There are some popular alternatives available for accounting for these new products. Four are GAAP-related, and two are statutory.

Traditional GAAP has been around since GAAP began in 1973. It levels profits as a percentage of premium with certain exceptions including provisions for adverse deviation and nondeferrable acquisition costs. Premiums have been defined as revenue for cost matching.

The composite or balanced approach is a variation of traditional GAAP which incorporates additional margins for adverse deviation to lower the portion of profit which emerges in proportion to premium. In lowering the premium-associated profit, more profit is released over the life of the contract. Again premiums are still defined as revenues for matching purposes. This is the recommended method in the American Academy of Actuaries discussion memorandum entitled "Accounting for Universal Life" released in October of 1984 preceding the current AICPA issues paper.

The full release from risk method is an extreme variation of traditional GAAP, which adds margins for conservatism until the valuation net premium is equal to the gross premium, squeezing out all profits to be reported as percentage of premium. While premiums still remain the definition of revenue, profits will emerge in an entirely different fashion, and cannot be reported at the issue of the policy. This method is also known as the prospective deposit approach in the AICPA issues paper.

The retrospective deposit approach treats the premium as a deposit and generally holds accumulated account balances as the policyholder reserve. A deferred policy acquisition cost would be calculated and amortized in some fashion. Revenues are essentially the inherent interest, mortality, expense, and withdrawal margins of the product.

Statutorily, the commissioners annuity reserve valuation method (CARVM) is the currently understood definition of the method utilizing "greater of" concepts that are defined in the literature. Although there are differing opinions as to how to implement the method, it is currently being discussed at various insurance departments. In those cases where surrender charges are contingent upon interest rates, a reduction for surrender charges would not be implemented.

The traditional commissioners reserve valuation method (CRVM) is the long-time standard definition. Its application for universal life is under discussion, and there's been some recent legislation describing that.

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In regard to unlocking assumptions for nonguaranteed premium products, the Academy, in its Financial Reporting Recommendation and Interpretation 1-I, indicated that it is appropriate to unlock assumptions on a gross premium change date for nonguaranteed premium products. This is done on a prospective basis only, pivoting on the reserve as of the date of gross premium change. The burden of proof would be on the insurance company to show that things have not changed significantly in order to keep your assumptions locked in at a gross premium change date. When the gross premium changes, the assumption is that either interest rates, mortality rates, or one of the other assumptions is no longer valid for the future and that those assumptions should then be unlocked at that point. The key is that you pivot on the reserve and the deferred policy acquisition cost as of that date. You don't take any radical changes to the balance sheet at that point. Particularly, and as a result of the changes in interest credits and mortality charges, the same concepts apply to universal life, as they did for the nonguaranteed premium products.

The tentative decision reached on internal replacement is that no gain or loss should be realized at the time the old policy is replaced. This was carried over into the AICPA paper. The gain or loss at replacement is determined by subtracting the deferred acquisition cost (DAC) and surrender amount paid from the benefit reserve released. This amount typically is a loss which would be brought in as a deferred policy acquisition cost (DPAC) associated with the new policy and amortized in proportion to revenues under that new policy.

The theory in bringing the gain or loss under the old policy into the new is that there is a continuing relationship between the company and the policyholder rather than the company and a particular policy -- a key distinction.

Lump sum premium payments are difficult to identify but are thought of as amounts in excess of recurring premiums. Lump sums are thought of essentially as being deposit premiums or deposits and accounted for as such, using the deposit approach as defined in both papers. That is the recommended approach for lump sums, but there is the question of the mechanical application of the theory, which is inherent in the recommendation. Mechanics are often overlooked when addressing theory. Problems arise because face amounts under the policy can change, thereby causing factors per thousand to become inappropriate in certain cases. Lump sums and varying premium patterns can distort the amount of premium revenue anticipated under these policies. Accordingly, companies have incorporated varying new mechanisms to compensate for these factors. The most common approach is to determine the theoretical ratio of reserves to account balances. These ratios are then applied to the actual account balances as the policies go into later durations.

What have companies been doing in their recent financial reporting when dealing with these new products? I've taken an informal, unscientific poll to get a rough idea of how companies handled their 1984 accounting. For universal life GAAP reporting about 90 percent of the companies were using the deposit approach on a retrospective basis.

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That is, they were holding the accumulated account balances as the reserve, plus an unearned mortality charge if that was applicable, plus a DPAC generally computed on a worksheet basis and amortized over a wide variety of revenue sources. The remaining 10 percent of the companies used a method in between the traditional and composite approach. I know of only two companies using a pure composite approach for 1984, probably because there was no single source which required that method; indeed, it seemed like the AICPA was discouraging the composite approach pending a resolution of the issue.

For statutory reserves under universal life policies, almost all companies were holding accumulated account balances for front-load products. For back-load products, it seemed most companies were using accumulated account balances, but in some cases, less an expense allowance of some sort per thousand dollar face amount. Approximately 5 percent of companies attempted to use CRVM reserves according to the recent model regulation.

For SPDAs on a GAAP basis, nearly 100 percent of the companies were using the deposit approach for all years of issue. Some companies may have been using a different approach for 1983 and prior issues, but for 1984 issues companies universally were using the deposit approach as forced upon them by the SEC and their external auditors. For SPDA statutory reserves, there seems to be an even number of companies using account balances and those using some form of the CARVM reserve calculation. There are several possible interpretations of the CARVM method, specifically as it applies to interest guarantees, bailouts, and the associated surrender charges under the various alternatives. My informal poll was not able to form any percentages in this area since it seemed that practices varied widely.

There are few companies selling single premium whole life and it was difficult to get a feel for the accounting treatment in 1984. It seemed that companies were using the deposit approach for GAAP and accumulated account balances for statutory reserves. The accumulated account balances generally were set equal to the present value of future guaranteed benefits under the contract. In some cases, the cash surrender value was used as the reserve, where the cash surrender value was greater than the present value of future benefits.

MR. SCHREINER: In December, the AICPA delivered its issues paper to the FASB. Because of the SEC interest in this particular issue, there was little doubt that the FASB would consider this a high priority project and take it onto their agenda. One of the first things they did back in January was to have a meeting between the FASB staff and a number of Board members with a delegation of life insurance company representatives. The FASB's purpose in the meeting was to get some understanding as to what the industry's reaction was to the AICPA's issues paper. The industry's objective was to make sure that the FASB understood the industry's position on the AICPA paper.

It's difficult to talk about an industry containing two thousand life insurance companies as unified. I'll speak in terms of the American Council of Life Insurance Financial Reporting Principles Committee.



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There are companies that believe the deposit approach is an appropriate method for the profit recognition for universal life and annuity products. However, the dominant view is that it is inappropriate to foist a dual standard of accounting upon an industry. Regardless of what a company may think is appropriate for its specific products, there is a great deal of concern about having two accounting models that are applicable to life insurance products when those products may be alike. For example, many companies sell both whole life and universal life in the same markets and by the same agents. The universal life product is bought for the same purposes as whole life. Those companies are concerned about putting a different accounting model on universal life when the actual construction of the policy, its operation, and the way people are going to use it is virtually identical to whole life insurance. There are some annuity products which were difficult to distinguish as life insurance or annuity products. The industry has not favored setting up dual accounting in those situations.

The industry has recognized that the existing accounting model, which otherwise has worked effectively, has one serious problem. It permits profits to be recorded as a level percentage of premium for a single premium product that produces inappropriate results. The industry's fundamental response has been that the problem with single premium products ought to be fixed. If it had been fixed in the original audit guide, the SPDA issue would have disappeared, and no one would be concerned about lump sum payments on universal life.

Some companies believe the deposit approach is appropriate for their business and are trying to make sure that if the composite approach is adopted, it does not exclude that end point which is the deposit approach. Originally, the FASB staff seemed favorable to the deposit approach because of its clear analogy to bank accounting. After discussion, though, the staff became aware of the potential practical problems of adopting that method and having, in effect, a two-tier accounting method for the life insurance industry.

In February, the FASB met to decide whether or not to take this particular issue and a couple of other SFAS No. 60-related issues onto their agenda. The other two issues that they considered were loss portfolio transfers and premium deficiencies. The board agreed to take on those issues. They also considered briefly whether or not to add consideration of the issue of GAAP for mutuals to the agenda because this is an existing hole in SFAS NO. 60; they decided against that, feeling no great pressure to do it and that it was complicated and difficult. The FASB also decided that it should have an advisory group to investigate the three insurance accounting issues and to go directly to an exposure draft rather than to issue an invitation to comment. It felt that the past experience of the AICPA working with the Academy and with the industry assured that all of the issues and various arguments had been exposed, or would be presented to the FASB to evaluate via the advisory group.

The FASB advisory group is made up of representatives of the American Council of Life Insurance; the American Insurance Association, representing casualty companies with respect to the other two primarily

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casualty issues; the Reinsurance Association of America; and the American Academy of Actuaries. Additionally, there are a large number of representatives of the AICPA's Insurance Companies Committee -- people who had worked on these issues over the last few years. The SEC was asked to send an observer. The FASB was unsuccessful in finding someone to represent the investment community.

At the May 7, 1985 meeting of the advisory group, the FASB staff stated that it had reached the point where it believed that the adoption of a new accounting model for life insurance products would have to be predicated on a demonstration that these new products were sufficiently different from traditional products and, thus, required a new accounting model to handle them appropriately. Interestingly the staff quoted industry critics who had warned against universal life as being the same as traditional products but in a new package. The staff thought that it was impressive that the industry critics were fundamentally saying the same thing that the industry was saying.

However, the accounting results of these new products are more sensitive to plan designs and experience assumptions. We can demonstrate that the deposit method, which appears to be straightforward with no earnings emerging at issue, can be manipulated by plan designs to produce large earnings in the first year. The most obvious example is that you get select mortality in the first year, and if you're charging a big 1958 CSO mortality charge, you're going to make a lot of money with respect to that component. Life insurance companies are being surveyed on what accounting model they currently use for annuities and for universal life. The advisory group expects to get some insight this way into what's actually going on in the companies.

The advisory group discussion was wide-ranging but mostly covered universal life and annuities. A strong case was made that universal life, in particular, was a variation on whole life rather than a totally different creation. With respect to annuities, the AICPA paper indicates that the AICPA's Insurance Companies Committee, and the Accounting Standards Executive Committee each believes that the deposit method is most appropriate for annuities. The industry made a strong case for retaining the existing model even with the problem in its application to SPDAs. The industry's expressed point of view was that the problem with SPDAs was not that they are investment products but that they are single premium products. The AICPA paper proposes to "take care of" single premium products. It was proposed by the ACLI and adopted by the accountants that no premium can be considered as an element of earnings that exceeds the premium that would provide the policy benefits under a twenty payment scheme. In other words, you've got to discard all the single premium that's greater than the premium that would pay for the benefits under a twenty payment plan. It's felt that this proposal would solve SPDA problems. It would also go a long way toward solving "dump-in" problems on universal life.

The FASB has asked the AICPA to prepare a presentation for the Board in June on the current audit guide model in order to sensitize the

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Board to exactly what the current model is, its implications, and its results in practice. Later in the month, the ACLI has been asked to prepare a presentation on universal life, SPDAs, and other potential exotic products that might be developed. In order to make a change in the accounting model, you ought to be aware of the potential existence of future products.

The FASB staff hopes to prepare an initial draft of the exposure draft by August for its advisory committee to review, criticize and comment on. If they get the initial draft out by August, they hope for a fourth quarter publication, and there would be an exposure period. There'll probably be provision for a public hearing some time in mid-1986 before a final document could be prepared by the FASB.

In regard to the statutory side of universal life, the NAIC adopted a model universal life insurance regulation in December of 1983. The purpose of the regulation is to fill in the gaps of existing regulation -- the standard nonforfeiture law, the standard valuation law, the cost disclosure regulations, and so on. It's intended to address only those issues that are unique to universal life insurance and covers a wide spectrum. It includes guidelines for minimum reserves and nonforfeiture values; requirements for disclosure in advertising and solicitation; requirements for periodic reports to policyholders; mandatory policy provisions; and requirements for an actuarial certification of universal life insurance policies. There has been considerable discussion about this particular document within the NAIC, since it was adopted. A number of people have had questions and concerns about it -- mostly nonforfeiture issues as opposed to valuation questions. The major valuation question is the bailout issue. What do you do on reserves? Are you allowed to take account of a surrender charge when there's a bailout provision? Most of the regulatory actuaries have concluded you may not if it's a contingent surrender charge, and many states have already promulgated that position.

We've gone quite some time talking about SPDAs and have yet to mention Baldwin-United. One of the other problems that came about as a result of Baldwin-United's sale of SPDAs was when the NAIC sat down to figure out what the exposure of the industry and their various guarantee funds were to Baldwin-United. It found out that it did not know the amount of annuity business in the various companies. Some companies report annuity business as premium, some as deposits, and some put it as a change in liabilities. The NAIC was disturbed about that and set out to try to make some order out of the accounting for deposit business. The NAIC will consider a proposal for the 1985 annual statements which would require a company to classify all their annuity reserves by withdrawal characteristics. It would show the amount of reserves, those reserves to which a withdrawal at book value is attached, and those reserves to which a withdrawal at book value less some surrender charge is attached. Additionally, it would show reserves for which withdrawal at market value is required. The fourth line balancing the whole equation would be for those annuity reserves that have no withdrawal value. A summation and ratios to the total would be shown for each of these items. Moreover, disclosure of where each of those dollars of annuity reserves were reported in the annual

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statement would be required. It is hoped this will permit the regulators to identify the amount of business that companies are doing and where they can find it in the company's annual statement.

MR. MARK D. J. EVANS: My company's valuation department has reviewed the NAIC model regulation on universal life and has concluded that the calculations required for statutory and tax reserves are unnecessarily complicated. We do not wish to remove the approach in the model regulation or deny other companies from using such a refined approach. However, there should be alternative approaches defined for calculating statutory and tax reserves, which meet the spirit of the model regulation but rely on less extensive calculations. For instance, a possible alternative for back-end load universal life would define the reserve as the greater of the cash value or the accumulation fund less an approximate calculation for the existing unamortized CRVM expense allowance.

My company is interested in pursuing the inclusion of alternative approaches in the model regulation. If a significant number of actuaries have similar concerns, we will support amendments to the model regulation.

MR. SCHREINER: Does anybody have an immediate reaction to the complexity of the existing requirement?

MR. DAVID B. ATKINSON: We've been trained to use approximations all through our working lifetime, so I don't see any reason why we couldn't use some approximations here without the law specifically saying which ones. I have no problem with doing that in our company.

MR. STEPHEN D. BICKEL: It would help tax-wise to have alternatives spelled out, and I'd certainly hope that some companies will proceed with such simplifications.

MR. WM. LYNN TOWNSEND: How many companies, if any, have implemented the CRVM for universal life?

MR. RICHARD S. MILLER: We implemented it, over the extreme objections of the complete actuarial department under me. I don't think that anybody who didn't implement it has a chance of claiming 818(c).

MR. ANTHONY F. CROCKER: We implemented it. We bought a program and just finished the tax reserves, and it is extremely complex. We wanted to make sure that our tax reserves could not be disallowed. There are a lot of provisions since the Internal Revenue Service (IRS) has said that they could potentially determine you weren't a life insurance company if your reserves were not calculated exactly. That's disturbing when you've got the amount of universal life business that we have.

MR. TOWNSEND: We also calculated CRVM reserves for universal life at the end of 1983 to try to hold up the 818(c) deduction, but for the

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annual statement for 1984, we just used cash values for front-end loaded products. We have not completed our calculation of tax reserves yet and have not yet decided whether we're going to completely implement the CRVM for universal life or use cash value for year-end 1984.

MR. DAVID JOEL FISHBAUM: You're saying 90 percent of the companies use deposit retrospective. Basically that's the same as statutory because you show your accumulation, and your DPAC is more or less on the side. It basically is the same, except for the DPAC income earnings outcome.

MR. SCHREINER: That's exactly right. The reserves would be equal under the two.

MR. FISHBAUM: If everybody's using deposit retrospective, Mr. Sonderby, does that meet the composite definition?

MR. SONDERBY: The composite is a broad range which goes from the premium or traditional method all the way to the deposit method. It depends on the results.

MR. SCHREINER: Strictly speaking the composite approach does not include the deposit approach on a retrospective basis at least. The Academy Committee on Life Insurance Financial Reporting Principles had some concern about that and considered whether or not to write a letter to the FASB. It ultimately sent a copy of the Academy paper, which deals with that issue specifically, to the FASB.

MR. SILINS: The composite approach is a prospective method, similar to traditional GAAP. You project out future benefits. The deposit approach that we've discussed here is a retrospective approach and represents an accumulation up to the present.

MR. FISHBAUM: If 90 percent of the people are using it and are comfortable with it, I don't understand where the problems come in.

MR. SILINS: I think people have used that approach as an expediency, because it's easy to do and there is no formal guidance.

MR. FISHBAUM: You keep saying that whole life and universal life are basically the same product.

MR. SCHREINER: I do not say they are basically the same product. I believe that there are circumstances under which their economics make them look much the same.

MR. FISHBAUM: The actual legal contract is very different, and the accounting should reflect those differences under whole life.

MR. SONDERBY: Traditional accounting has tried to follow the economic substance of a transaction rather than the legal contractual words that surround that transaction.

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MR. FISHBAUM: But the economics of a whole life contract is that the company is expecting a level premium every year from the policyholder and for that it's guaranteeing life protection. There's a cash value, but that's not as important, and therefore, income must match revenue. Expenses increase every year but revenue doesn't; therefore, you get the reserves, the CRVM, and the traditional approach. Under universal life, the company holds the policyholder's money every year without getting any revenue because it's sitting in a fund. The company takes it out, matches its expenses, and its mortality charge comes out every month. That's increasing as well. In short, the company matches expenses and revenue, which is what the accountants like. That seems to be appropriate, and therefore, the universal life products are different from a profit recognition review.

MR. SCHREINER: Consider the universal life product that is sold to somebody who wants a level premium whole life plan, but this particular company only sells universal life. The economics of that product, from the standpoint of premiums received, termination experience, and mortality experience, is the same as a traditional whole life policy. There is nothing to choose between the one form that has a required level premium and the other form that has an expected level premium. Now I'm not suggesting that one cannot argue that the deposit approach is appropriate or useful or helpful in certain circumstances, I'm merely saying that you have to look at what you're comparing it with. You would have a two-tiered system if you had a deposit approach for certain products.

MR. SONDERBY: In certain respects, whole life can be viewed as a special case of universal life. Then if you have one accounting model for universal life, one argues why wouldn't you have the same model for special case within that range of products called universal life?

MR. FISHBAUM: Your mortality expense is so much different because you have select mortality in the earlier years. If you're taking a large premium from the policyholder, what are you going to do with it? You can't recognize it as profit because you need it later on and that's what reserves are all about in the traditional reserve process. Under universal life you leave it in the fund, where the customer can actually take it away from you and as such there's no need to build up a reserve.

MR. SCHREINER: There's no question that some people in the accounting profession wish they had a chance to do the life insurance accounting model all over with the benefit of hindsight.

MR. SONDERBY: GAAP really addresses income recognition. Clearly, the existing accounting model permits you to recognize income as premiums are received, and the deposit approach does not let you do that. It is a major decision.

MR. OWEN A. REED: I don't understand what you said about the single premium problem with the FASB. You said that a possible solution was to discard any premium in excess of the annual premium for a twenty payment life. Is that right?

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MR. SCHREINER: Based on whatever the benefits provided under the contract were, instead of paying for them with one premium you calculate what the premium would be if you paid for them in twenty annual installments and that becomes your limitation on how much of a single premium you can take into the income calculation.

MR. SILINS: You don't discard the whole premium, just the profit associated with it.

MR. REED: What happens to the excess premium?

MR. SILINS: It would go right to the reserve.

MR. DOUGLAS C. DOLL: Ninety percent of companies aren't using the retrospective deposit approach because they feel it's accurate but because it's the easiest method to calculate. I suspect at least some of those 90 percent are also not using the method theoretically in the sense that they're not amortizing the DAC over the source of the profit but perhaps over some other pattern such as projected level premiums. Someone mentioned earlier some of the simplified methods that were being used.

MR. SILINS: Yes. The 90 percent applied to the retrospective approach where the reserve was the accumulated deposit. The deferred policy acquisition cost was amortized in a wide variety of patterns all the way from premium to investment spreads to a mixture of the two. The uniformity was in the benefit reserve side.

MR. DOLL: There's a brand new ACLI task force to address the question of variable product tax reserves. Some of the issues involved have to do strictly with tax accounting. But one of the issues that has been discussed is what is meant by CARVM reserves for variable annuities and what is meant by CRVM reserves for variable life insurance.

MR. THOMAS F. EASON: I offer sympathy to the accountants who are struggling with some of the GAAP accounting questions. I've spent a lot of time working with universal life products and watching the market and the changes. The changing environment does complicate things extremely and the interesting question to explore with an accountant might be what the company is trying to do with this product. The answers range all the way from selling single premium life insurance to selling single premium annuities to selling whole life insurance. In fact the product may not have required premiums, but we're getting more premiums on a regular basis than we used to on whole life insurance!

MR. RALPH H. GOEBEL: Vanishing premium whole life is often called irreplaceable life, with a premium almost equivalent to what an old fashioned, whole-life, nonparticipating policy had, but there's a direct crediting of interest and direct recognition of mortality. A policy like that with the current high interest rates could stop premiums after about five to eight years. What do you use on that as far as GAAP accounting, the deposit method, the composite method, or the traditional method? We started with that product using the traditional method and

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decided we didn't want to face the consequences of writing off all the DAC when the premiums cease at the end of eight years.

MR. BERNARD RABINOWITZ: My understanding is that after five years the excess of the cash surrender value over the guaranteed value is used to pay the premiums. Premiums are paid, just not in cash by the policyholder.

MR. SCHREINER: Mr. Silins, have you come across accounting issues at all relative to vanishing premium?

MR. SILINS: I haven't seen very much on vanishing premium products. In some cases, I've seen it reported as a universal life reflecting the fund accounting, and in another extreme case, it was reported as a nonguaranteed premium product where the assumptions would be unlocked when the premium changes.

MR. PETER T. LECLAIR: You've indicated that the FASB may not resolve this universal life issue until perhaps mid-1986. In the meantime, we have to continue to report our financial results annually, quarterly, or monthly. What happens if there's an abrupt change from what companies are currently doing to what they need to be doing in the future, effective some time in 1986? Do we then go back and restate prior year's earnings?

MR. SONDERBY: The FASB stipulates the method of changing from one accounting principle to another. Whether that's a retroactive or a prospective change is up to the FASB. That's part of their conclusion.

MR. SCHREINER: Have they shown any continuing inclinations?

MR. SONDERBY: No. It depends upon the issue.

MR. SILINS: That's part of the reason why most companies are taking a conservative approach rather than reporting a lot of profits with things being reversed later.

MR. SONDERBY: I think the accountants are asking the actuaries what the earnings result of the method is as opposed to what the method is. If you go through the mechanics of this issues paper, you'll find that you can come up with about any results you'd like and if you want to call it the composite or deposit method, that doesn't tell you anything about the results.

MR. DOLL: If a company has a vanishing premium product in seven years and sets up a GAAP accounting method so that all the earnings emerge over seven years, many accountants would deem that an unreasonable earnings pattern. The ways that some companies seem to approach these products are similar to approaching flexible premium universal life. They're looking for a current set of mechanics that gives a reasonable earnings pattern and is fairly level by duration.

MR. TOWNSEND: We've been selling universal life for about three and a half years now. When we first started selling it, we used the



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simplistic deposit method approach. How appropriate or inappropriate would it be for a company to implement the composite method when the in-force universal life business nears, say, 35 or 40 percent of the in-force business but represents, say, 95 percent of new business?

MR. SONDERBY: I prefer the conservative approach, pending a resolution. The danger of making a change is that FASB will say that its not appropriate and you'll have to restate and, perhaps, take back some of those earnings that were reported. I'd much rather be faced with having conservatively reported earnings, so I have the potential to accelerate those once a decision is made.

MR. BRUCE D. BENGTON: We would take a look at the actual facts, circumstances, and results and look for materiality or lack thereof. The crux is what kind of prospective assumptions you do have and how has your actual experience been fairing compared to those assumptions. If there is a very strong correlation, we would probably be able to consider using composite approaches, where a deposit approach had been used in the past.

MR. BICKEL: I would expect that, no matter how the FASB decides, 90 percent of the companies will want to use some kind of retrospective approach with the benefit reserve being something like a statutory reserve and the deferred acquisition expense item being used to do the rest of the GAAP adjustment. There are many ways of doing that amortization. Your projected statutory profits in the future have gains from mortality, interest, loading, surrender, positive or negative in that projection, and you can think of many ways of amortizing that expense. You can design things so that what's left over can emerge as a percentage of premiums, percentage of investment income, or a percentage of all those sources. The practical result of what the FASB decides will probably not change our practices as far as the mechanics of doing the job.

MR. STEVEN H. MAHAN: I'd like a little clarification on where the SEC fits in the picture with the FASB.

MR. SCHREINER: The FASB is permitted to establish GAAP accounting principles fundamentally at the sufferance of the SEC. The SEC has a statutory right to tell companies what to do, but it has chosen not to exercise that right, preferring to let the private accounting profession deal with those issues. However, when it seemed as though the project on universal life and single premium deferred annuities was not moving, it revealed that it might consider resolving the issue on its own if the FASB didn't move quickly enough.

MR. MAHAN: Is it safe to say that FASB will make sure that anything it determines is in agreement with the SEC?

MR. SONDERBY: Yes and no. The FASB cannot help but know the SEC is there. In fact, the FASB invited the SEC to be exposed in the same kind of information that the FASB is going to be exposed to. But

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the FASB takes its job more seriously than just trying to guess what the SEC feels about the subject.

MR. ALBERT K. CHRISTIANS: Could you give a brief summary of a good approach to take in approaching this GAAP valuation on a block of universal life or flexible premium annuities? We're trying to sell and need to determine how much profit the purchasing companies will get to report. We need to go through the same kind of calculation that they're going through to figure out what a fair price is.

MR. BENGTON: Does the real issue boil down to what is the field force going to do with those old policyholders out there?

MR. CHRISTIANS: I'm sure that's part of it.

MR. BENGTON: It's tough to come up with a specific answer. Obviously, you've got the additional variable of the policyholder being able to pick and choose how much premium he feels like paying and when he feels like paying it, on top of all the other things that go into trying to do a purchase GAAP valuation on an existing block of business that's about to change hands. I don't know of any particular pronouncements or opinions that the AICPA has taken in that area.

MR. SONDERBY: It's a valuation issue and you wouldn't expect to find specific guidance from the AICPA.

MR. SILINS: Was the question related to appraisal or to accounting?

MR. CHRISTIANS: On post-purchase income, how do you determine how much acquisition cost there is, how much good will and how to amortize the balances of the reserve and deferred cost?

MR. SILINS: The literature is perfectly silent on it. The American Academy of Actuaries Financial Reporting Recommendation and Interpretation 1-D, on purchase accounting, is pending a rewrite, but only subsequent to when the AICPA comes out with a position paper on post-purchase accounting.