

RECORD OF SOCIETY OF ACTUARIES 1985 VOL. 11 NO. 1

ACCOUNTING ALTERNATIVES FOR NEW PRODUCTS

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MR. JOHN W. BRUMBACH: The Universal Life Insurance Model Regulation, adopted by the NAIC in December 1983 includes a minimum valuation standard on universal life. Due to its complexity, companies writing universal life have devoted much time and effort in an attempt to understand and implement it.

Companies view the regulation as beneficial in clarifying what reserves should be held on back-end loaded products and in providing an "official" preliminary-term basis for purposes of the 818(c) election. Although such election is no longer in the tax law, the verdict is still out on its applicability to universal life for tax years through 1983.

The model regulation covers all individual universal life policies other than variable. Although it was designed specifically for individual policies, nothing precludes it from being adapted to group contracts. The regulation provides a definition of universal life. It further defines fixed premium versus flexible premium, as well as those which are interest-indexed. These distinctions, however, are not particularly important within the valuation section of the regulation.

A prospective approach is called for in calculating the Commissioners Reserve Valuation Method (CRVM) reserve. Fund projections are required on each policy on each valuation date, and there are not many short-cuts in generating the reserve exactly the way the formulas specify.

Although the model regulation has not yet been adopted by all states, the prescribed reserves are still necessary for federal income tax purposes. Companies with universal life business have been scurrying to get a handle on the tax reserves in time to file the 1984 return. Some have resorted to outside help while others have managed to develop the reserves in-house.

In GAAP accounting, the Financial Accounting Standards Board (FASB) currently has an American Institute of Certified Public Accountants (AICPA) Issues Paper under consideration, dated November 5, 1984.

This contains advisory conclusions on GAAP accounting for universal life which are summarized as follows:

1. The "composite" approach is recommended, whereby income should be recognized over the term of the contract in proportion to the risks and functions under the contract - those related to investment, mortality, expenses, terminations, and premium collection.
2. With respect to lump sum premiums, the AICPA recommends a limit on the amount of earnings which can be recognized as a percentage of premium. That limit would be an amount which would be recognized if level premiums had been payable for twenty years to provide for the guaranteed death benefits under the contract.
3. The AICPA recommends that no gain or loss be recognized at the time of an internal replacement of traditional life insurance with universal life.

The AICPA Issues Paper suggests the same definition of universal life as that contained in the NAIC model regulation. FASB concluded that accounting for universal life should be addressed in the form of a statement amending FASB No. 60, Accounting and Reporting by Insurance Enterprises. It was further agreed that an advisory group be formed to provide FASB with exposure to the diversity of opinion on this issue and to assist in developing an exposure draft and a final statement. FASB did not discuss its views on the specific issues, nor did it set any timetable for completion of this project.

Currently, FASB is developing more sophisticated models of the universal life illustrations contained in the AICPA Issues Paper. The purpose of the models will be to study the pattern of earnings emergence under the composite approach as well as under the other accounting alternatives described in the Issues Paper. Attention will be given to how the models react when actual experience differs from that assumed, and how well both front-end and back-end loaded products are accommodated.

Current recommendations primarily reflect the efforts of the American Academy of Actuaries, the American Council of Life Insurance (ACLI) and the AICPA. The Security and Exchange Commission (SEC) has provided some impetus in moving the process along, in light of its concern about possible front-ending of reported earnings.

The process of examining the issues and formulating recommendations began with the Task Force on Nonguaranteed-Premium Products of the AICPA's Insurance Companies Committee. Substantial assistance is provided by a task force, with the same name, of the Academy's Committee on Life Insurance Financial Reporting Principles.

Efforts intensified last year and resulted in the Academy's Discussion Memorandum on Accounting for Universal Life, dated September 27, 1984 and, ultimately, the AICPA's Issues Paper, dated November 5, 1984. The advisory conclusions in the Issues Paper are generally consistent

with those contained in the Discussion Memorandum, but reflect some differences such as the twenty-payment limit on lump sums which had been proposed by the ACLI's Committee on Financial Reporting Principles.

In developing the Academy's Discussion Memorandum, current accounting practices on universal life were reviewed and categorized into the following:

1. The "traditional" approach, whereby earnings would be expected to emerge as a level percentage of premiums, prior to the release of normal provisions for adverse deviation.
2. The "full margin" approach, whereby earnings would be expected to emerge as the inherent interest, mortality, expense, and withdrawal margins designed into the product are realized. The benefit reserve would be set equal to the gross fund value. Acquisition costs in excess of additional first-year loads would be capitalized and then amortized in proportion to the expected marginal profits (including any surrender charges).
3. The "full release from risk" approach, whereby earnings would be expected to emerge totally in the form of a release of larger than normal provisions for adverse deviation. Such provisions would be selected to cause the GAAP valuation premium to be equal to the gross premium.
4. The "balanced" approach, whereby earnings would be expected to emerge partially as a percent of premiums and partially in the form of a release of larger than normal provisions for adverse deviation.
5. All other approaches, most of which are relatively simplistic in nature and have been justified in practice primarily on the grounds of immateriality and lack of official guidance.

Under all approaches, the presence of nondeferrable acquisition costs - those costs which fail the test of both varying with and being primarily related to the production of new business - will affect the incidence of earnings, dragging down those reported in the first year and increasing those reported in later years. The Discussion Memorandum recommends the balanced approach concluding that heavy reliance on premiums to represent the performance under the contract is inappropriate for a product with undefined premium and benefit structures. On the other hand, it concludes that premium collection is one of the risks and functions under the contract and should not necessarily be excluded.

The full margin approach, in contrast to the other approaches, is driven by the specific design of the contract. Earnings emerge as the margins designed into the contract are realized. Some believe this is appropriate.

Others believe that such dependence on contract design is not attractive, since the margins may not bear a direct relationship to the risks and functions performed. For example, the cost of insurance charges, which are intentionally loaded to cover expenses, would seem to cause a disproportionate amount of earnings to emerge in relation to the amount at risk.

The AICPA Issue Paper identifies these same approaches using different names. The traditional approach is called the "premium" approach. The full margin approach is called the "retrospective method" of the "deposit" approach. The full release from risk approach is called the "prospective method" of the "deposit" approach. Lastly, the balanced approach has been named the "composite" approach.

At a meeting of the AICPA's Accounting Standards Executive Committee (AcSEC) in late September 1984, the composite approach was adopted as the advisory conclusion on GAAP for universal life. Votes by AcSEC were 13 yes to 0 no, with 2 absent. The Insurance Companies Committee had voted 8 yes to 4 no, while its Task Force had voted 5 yes to 1 no. Those not in favor had voted for the deposit approach.

The advisory conclusions were incorporated into the Issue Paper and forwarded to FASB in early November. Review of the efforts occurring prior to those at FASB is now complete.

In applying the composite approach, the advisory conclusions indicate that the net premium should be determined by first including normal provisions for adverse deviation, and then by including additional provisions so that earnings would be recognized in proportion to the relative risks and functions performed under the contract. The conclusions provide guidance on the relative importance of certain risks and functions. Unless there is evidence to the contrary, the investment risk should be presumed dominant whereas premium collection should be presumed insignificant. Consequently, it would be expected that a good portion of earnings would emerge in proportion to invested assets, while only a small portion would emerge as a percent of premium. All other earnings would emerge in proportion to the remaining risks and functions under the contract.

The conclusions advise that the assumptions used in the approach be reviewed for continued reasonableness. When the assumptions are no longer reasonable in light of actual experience, assumptions thereafter should be "unlocked" and adjusted as necessary.

This unlocking of prospective assumptions is similar to that recommended on nonguaranteed premium products and ideally would result in no gain or loss at the time of the change.

The proposed twenty-payment limit on percent of premium profit to be associated with lump sums, would be a general rule, applicable not only to universal life, but also to other long-duration life insurance contracts including single-premium whole life. The twenty-payment limit would determine the amount of premium, whereas the accounting approach applicable to the particular product would determine the percent of such amount which would be recognizable as profit.

Assume we have two hypothetical products which are otherwise identical except that one is universal life and the other is a traditional life product. The twenty-payment premium limit would be the same on both products. The profit recognizable as a percent of premium, however, would be less on the universal life product (being subject to the composite approach) than on the traditional product (being subject to the premium approach.)

No gain or loss should occur at the time of an internal replacement of traditional life insurance with universal life, unless there is a recoverability problem. Amounts to be deferred on the new policy would consist of the unamortized acquisition cost balance on the old policy, plus any difference between the cash value and the benefit reserve released on the old policy, plus any additional acquisition cost on the new policy. The advisory conclusion indicates that costs deferred should ordinarily be recoverable by most universal life issues of the current period.

Now that we have gone over the major points contained in the advisory conclusions consider a few questions:

1. How quickly might we expect FASB to act in amending Statement No. 60 to incorporate GAAP on universal life?

No date has yet been set, but guesses range anywhere from late 1984 to sometime in 1985.

2. Will the amended statement apply only to new issues of universal life or to inforce business as well?

Since this question has not yet been addressed, little insight can be provided. Due consideration will be given to the financial impact on companies before FASB reaches any decision on this matter.

3. How much flexibility in technique is intended under the composite approach when, on a particular contract, the premium collection function is viewed as so insignificant that it is ignored for purposes of apportioning income to the various risks and functions under the contract?

The advisory conclusions imply a preference for "prospective" techniques. Additional provisions would be appropriately included in the assumptions related to the other risks and functions to cause the net premium to equal the gross premium. In effect, the composite approach becomes the prospective method of the deposit approach. There appears to be some question whether the retrospective method of the deposit approach would also be acceptable under this situation.

4. Is there a distinction between lump sums arising from internal rollovers associated with a replacement program and those arising from all other sources?

PANEL DISCUSSION

There is a distinction. The advisory conclusions indicate that no gain or loss should occur at the time of replacement. That implies that no profit should emerge as a percent of premium on the amount rolled over. Other lump sums, however, may have some profit emerge as a percent of premium subject to the twenty-payment limit.

5. How might the advisory conclusions be implemented in practice?

The Academy's Discussion Memorandum offers a couple of techniques regarding valuation mechanics for implementing the composite approach. Both call for developing ratios of benefit reserve factors to projected gross fund value factors and applying these to the actual gross fund value on the valuation date. With respect to deferred acquisition costs, one uses factors while the other uses the worksheet method.

With respect to lump sums, all portions which are not to have any profit recognition as a percent of premium can be handled by modifying the reserve factor formulas. These amounts feed directly into the reserve buildup rather than by way of the normal premium entry.

Realistically, lump sums over the life of a contract will be virtually impossible to predict at time of issue. Consequently, companies will be using up to a year's worth of hindsight in ascertaining the reasonableness of their lump sum assumption. If an adjustment is necessary, the reserves would be recalculated from the beginning of that year.

6. How would the pattern of earnings on universal life be affected under the composite approach? Relative to the premium approach, earnings will generally be lowered in the early years and higher in the later years as more income is recognized in proportion to the other risks and functions, particularly the interest element. Relative to the prospective method of the deposit approach, earnings under the composite approach should produce a pattern of earnings which is comparable to its prospective counterpart, provided the margins designed into the product bear a reasonable relationship to the risks and to the functions performed.

MR. DENNIS L. STANLEY: Four aspects of reporting GAAP earnings on annuities are:

1. the AcSEC recommendation for GAAP reporting for annuities;
2. the implications of the AcSEC proposal upon your company's reported earnings pattern;
3. application of the AcSEC recommendation;
4. issues related to GAAP patterns of earnings for a company attempting to control the C-3 risk associated with annuities.

The AcSEC Recommendation

The recommendation in the AcSEC's Issues Paper can be summarized by two points:

1. Release no profit at issue, particularly for a single premium plan.
2. the revenue base for amortizing acquisition costs and releasing earnings is largely the interest spread - the difference between the investment earnings rate and the credited interest rate.

The AcSEC recommended method for GAAP reporting of an annuity is called the deposit approach. The Issues Paper identifies the prospective and the retrospective methods of the deposit approach. In many instances, these methods give similar results.

The prospective method parallels the traditional approach to calculating GAAP reserve factors. At policy issue, one chooses assumptions regarding the credited interest rate(s), lapse rates, expense levels, and so on. Using those assumptions, annuity account values, cash values, and cash flows are projected. To avoid releasing earnings at issue, the GAAP interest rate equates the present value of the projected cash flows to zero. Provided the GAAP interest rate is less than the assumed credited interest plus the anticipated interest spread, the deferred acquisition costs are fully capitalized. Assumed GAAP earnings emerge as the actual investment earnings exceed the assumed GAAP interest.

The prospective method is based upon discounted future cash flow whereas the retrospective method accumulates past cash flows. Under the retrospective method, the benefit reserve is the annuity account value. The acquisition costs (generally the excess of deferrable acquisition costs over the first-year expense loadings) is amortized over the life of the business. The amortization schedule for acquisition costs uses the interest spread as the dominant element of the revenue base.

While the issues paper does not discuss the mechanics necessary to implement the prospective or retrospective method, the reserves need to reflect actual premiums paid, actual interest credited, and actual surrenders. A typical approach is to express reserve factors as a percentage of the account value.

Implications of the AcSEC Recommendation

Under the AcSEC recommendation, we can characterize the slope of earnings patterns:

1. Traditional whole life. Earnings are reported as a percentage of premium plus the release of margins for adverse deviations. Because of lapses, the total premium for a block of policies declines over time. Since a large portion of the profit is released in proportion to premium, whole life has a

declining earnings pattern.

2. Single premium deferred annuity (SPDA). The earnings on an SPDA would be released as a percentage of the account value. Depending upon the lapse rates, the aggregate account value for a block of SPDAs may be level for several years. Assuming the target interest spread is achieved each year, the earnings pattern would thus be a level dollar amount. If acquisition costs are amortized over ten years, the reported earnings would increase when the amortization was completed.
3. Flexible premium annuity (FPA). The expected asset base for an FPA increases for several years after issue. Assuming the target interest spread is being achieved, the reported earnings would increase for several years.
4. Single premium immediate annuity (SPIA). Since the asset base of an SPIA declines over time, the earnings pattern would decline over time.

Historically, the earnings pattern of many companies has been related to whole life plans. New sales have a significant impact upon reported earnings.

For annuities and other interest-sensitive products, the earnings pattern will be level or increasing rather than declining. Assuming a traditional plan and an interest sensitive plan produce the same total profit, the early year earnings will be lower for interest-sensitive plans. This implies that new sales of interest-sensitive products will have less impact upon current earnings. Even with successful marketing of interest-sensitive products, a company's reported earnings may not increase as rapidly as they have historically.

In addition to a change in GAAP methodology resulting in a pause in earnings growth, company earnings may be under other pressures. Competition makes it difficult to initially achieve the interest spread assumed in pricing products. High lapses eliminate the future profit potential for those policies and cause the immediate write-off of the deferred acquisition costs. The loss of the 818(c) deduction has eliminated the powerful tax-deferral aspect of writing new life insurance.

Combining a pause in earnings growth, higher taxes, and higher after-tax capital requirements for issuing new business implies that some companies may need additional capital to sustain their target growth. Stockholders and security analysts emphasize earnings growth. You may find it worthwhile to project GAAP earnings for your company to inform management of the expected earnings pattern during the next few years.

Practical Application of the AcSEC Recommendations

Many companies have put considerable pressure on their computer

systems and personnel to facilitate the introduction of new products. Most GAAP systems were not designed with interest-sensitive products and the AcSEC recommendations in mind. Modifying systems is necessary, and you may strive for a balance between theory and practice.

Be careful in developing your GAAP systems. I worked a simple example using the GAAP approach that a client uses for their flexible premium annuities. Their GAAP factors are based upon an assumed level of renewal premium, which translates into a certain amount of acquisition costs to be amortized over the life of the business. If the actual premiums are the same as assumed, the earnings pattern is a smooth, increasing pattern.

If the actual renewal premium is lower than assumed, but the same expense acquisition cost amortization factors are used, earnings will be overstated. For example, if actual renewal premiums are 20 percent lower than expected, the total GAAP earnings over five years would be 11 percent higher than if the GAAP factors had assumed the lower premium.

Since predicting premium level and other assumptions is difficult, it is important that we challenge our GAAP methodologies to assure that deviations between experience and assumptions do not significantly distort reported earnings. Sensitivity analysis may assure your method produces reasonable results under deviations between assumptions and actual experience.

Impact of C-3 Risk Management Upon GAAP Earnings

Because of the fluctuations in interest rates in the last few years, companies have been more aware of the financial risk associated with those shifts.

Many companies have considered product design changes, investment hedging, and investment trading strategies to manage the C-3 risk.

How do these strategies affect GAAP earnings? Assume a company sells investments at a capital gain or loss to control the C-3 risk and to increase the expectation of achieving the target interest spread. The capital gains and losses can be characterized as "shock spread" that is reflected immediately in GAAP earnings. However, the C-3 risk control strategy is to realize the capital gain/loss today with the anticipation of lower/higher investment earnings (and hence interest spread) in the future. Should earnings reflect the "shock spread"?

Consider the impact of a market value adjusted surrender value on an annuity. The concept of the market value adjustment is to adjust surrender values for the capital gain or loss that a company would realize if the assets supporting a particular policy are liquidated. Suppose the market value adjustment surrender occurs, but the company chooses to fund the surrender from cash flow. Should the market value adjustment flow through to the current year's earnings?

Our accounting model should be challenged to assure a reasonable result is achieved.

CHARLES CARROLL: Discussions involving GAAP for other new products, such as universal life and SPDA's go out of their way to make clear that fixed premium variable life insurance (VLI) is not covered.

Despite this lack of public discussion, there is a substantial body of "industry practice" involved with GAAP reporting of variable life products dating back to the publication of the Audit Guide. United Kingdom (UK) life insurance subsidiaries of publicly held U.S. corporations have been reporting GAAP earnings on unit-linked policies for over ten years. Several U.S. stock companies now issue VLI, and several of the large mutuals issuing VLI are restating results on a GAAP basis for internal measurement purposes.

My main purpose is to explore some possible approaches, describe how they might be implemented, and briefly consider their implications - all in the hope of furthering (or initiating) an open discussion that might lead to more formal guidance.

History of the Product

When the Audit Guide was being written, VLI was still a glimmer in the eyes of a few innovative actuaries. A landmark paper by Sternhell, Fraser and Miller in 1969 had described a VLI design that appeared to fit the U.S. market and regulatory scheme. Much product development research was being carried on in the 1969-73 era. People knew what the product would look like if they could ever get approval from the SEC. The SEC proved a stumbling block for most of the industry and only Equitable Life came out with the product in the mid-seventies. Initial sales results of the product were not overwhelming.

A big change took place, however, in the late seventies and early eighties. Stock market performance picked up, some new investment options were offered, and the market was sensitized to the low returns on traditional permanent insurance. Sales of VLI began to take off. John Hancock and Monarch Life entered the market and, in just a few years, VLI has become a significant force.

Across the Atlantic, the successful introduction of variable products was much less problematic. Unit-linked endowment policies have been a staple of the U.K. market for many years now. Three principle reasons for this difference are:

1. lack of a tradition of guaranteed minimal cash values;
2. lack of strict, detailed regulations which restrict product design and increase expenses;
3. special tax benefits of life insurance policies under U.K. tax rules.

Most of the successful unit-linked companies were smaller, younger companies, much like the companies which pioneered universal life in this country. They were almost all stockholder owned, with some owned by publicly traded U.S. corporations.

The Audit Guide for Stock Life Insurance Companies completely ignored the subject, primarily because there were no U.S. VLI products at the time. On page 82 of the Audit Guide there is some discussion of variable annuities, from which two major conclusions can be derived:

1. Premiums are not revenue for variable annuities, but rather expense loads and asset charges.
2. Asset charges should only be used as a source of revenue to amortize costs if all other sources are insufficient.

What else was available? Bob Posnak's book, GAAP: Stock Life Companies, has a chapter on variable products which contain an extensive discussion of VLI. Much of his material for this chapter was influenced by the experience of U.K. actuaries in applying GAAP to unit-linked products. It is a comprehensive treatment of the subject covering all of the major relevant points. Mr. Posnak carefully qualified his comments to avoid the impression that what he was saying was GAAP for VLI. However, reading between the lines, we can come up with several tentative opinions:

1. VLI is sufficiently different from variable annuities so that the Audit Guide statement shouldn't be carried over directly.
2. Premiums probably are revenue for VLI.
3. Great care should be taken in setting assumptions for VLI, particularly assumptions for unit-account growth rates.

Financial Analysis of VLI

To analyze the financial impact of VLI operations, it is necessary to separate transactions involving the insurance company's general account and the separate account which contains the investments backing the VLI contracts. The separate account is a separate legal entity which is involved in transactions with the general account. Exhibit I displays the most important of these transactions.

Theoretically, the transactions involving the separate are controlled by the basic equation of equilibrium:

Separate Account Net Cash Flow = Separate Account Net Change in Reserve

Thus the separate account assets and liabilities are continually in balance, and there is no element of gain or loss to the company in this account. (In reality some funds not representing policyholder reserve balances do build up in the separate account. These funds could represent seed money or surplus not transferred to the General Account. For analysis purposes, it is valid to think of these funds as

general account funds.) Because of this equilibrium, it is unnecessary to make any GAAP adjustments to the separate account.

The transactions involving the general account are of a different nature. The typical pattern of general account net cash flow for a hypothetical, traditional, fixed premium VLI policy is quite similar to that for fixed dollar policies. Cash flows are negative in the early durations reflecting high early year acquisition costs. The cash flows gradually increase mainly because of the effect of the management charge. With this resulting pattern, it is clear that some adjustments must be made to reflect income uniformly in proportion to revenue.

Alternative Methods

Since the existing literature doesn't provide authoritative guidance on the proper approach to GAAP reporting of VLI policies, we have illustrated the effects of three different approaches:

1. Full GAAP - Under this approach, all cash flows are leveled as a percent of premium, based on best estimate assumptions. This approach is consistent with methods applied to traditional, nonparticipating long term contracts.
2. Source of Earnings - Under this approach, acquisition expenses are deferred and then amortized in proportion to the gains from other sources (mortality, management charge income, etc.). It is similar to the deposit approach as described in the AICPA's Issues Paper on universal life and SPDA accounting.
3. Composite - Under this approach, all cash flows except management charge income are leveled as a percent of premium. The result is that management charges are reported as income when realized.

Exhibit II summarizes the important features of the three methods. Exhibit III shows the resulting net income produced by applying the three methods to a hypothetical policy. It is assumed that actual experience is the same as that assumed in computing GAAP adjustments.

Obviously, wide divergence of results is possible under the three alternatives. One can only hope that some more definitive guidance will be forthcoming.

EXHIBIT 1

VARIABLE LIFE INSURANCE
TRANSACTIONS INVOLVING SEPARATE ACCOUNTAdditionsNet Premiums
New Investment IncomeDeductionsReserve on deaths
Reserves on Surrenders and Lapses
Tabular Mortality
Asset ChargesVARIABLE LIFE INSURANCE
TRANSACTIONS INVOLVING GENERAL ACCOUNTAdditionsGross Premiums
Net Investment Income
Reserves on Death
Reserves on Surrenders and Lapses
Tabular Mortality
Asset ChargesDeductionsNet Premiums
Death Claims
Surrender Benefits
Expenses

EXHIBIT II

VARIABLE LIFE INSURANCE
GAAP ACCOUNTING ALTERNATIVESFull GAAP

Premiums are revenue.
Separate Account Reserve is unchanged.
General Account benefit reserve levels all cash flows as percent of premium.
DAC amortized over premiums.

Source of Earnings

Revenue is sum of "loading" in contract.
Separate Account Revenue is unchanged.
No General Account Benefit Reserve.
DAC amortized over Sources of Earnings.

Composite

Revenue is combination of asset charges and premiums.
Separate Account Reserve is unchanged.
General Account benefit reserve levels all cash flows except asset charges as percent of premium.
DAC amortized over premiums.

EXHIBIT III

GAAP ACCOUNTING ALTERNATIVES
REPORTED INCOME PER ISSUE

<u>YR.</u>	<u>STATUTORY</u>	<u>FULL GAAP</u>	<u>SOURCE OF EARNINGS</u>	<u>COMPOSITE</u>
1	(518)	139	6	27
5	25	117	30	54
10	158	100	75	88
20	276	77	131	162
30	498	56	237	215

GAAP ACCOUNTING ALTERNATIVES
INCOME AS PERCENT OF PREMIUM

<u>YR.</u>	<u>STATUTORY</u>	<u>FULL GAAP</u>	<u>SOURCE OF EARNINGS</u>	<u>COMPOSITE</u>
1	(37%)	10%	.4%	2%
5	2	10	3	5
10	16	10	8	9
20	36	10	17	21
30	89	10	42	38

