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# AUDITING OF LIFE INSURANCE COMPANIES

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| Moderator: | HOWARD L. ROBINSON |
| Panelists: | KRISS CLONINGER, III |
| | WILLIAM J. SCHNAER |
| Recorder: | HOWARD L. ROBINSON |

o Current developments in the United States and Canada
o Wording of opinions and certificates from accounting firms
o Financial Accounting Standards Board (FASB) draft on interest-sensitive products -- particularly universal life

MR. HOWARD L. ROBINSON: I am Howard Robinson of Coopers & Lybrand in Atlanta, and I will be your moderator. Our panelists are Mr. Kriss Cloninger and Mr. William J. Schnaer.

Mr. Cloninger is the Principal in the Atlanta office of Peat, Marwick, Mitchell & Co. He is a member of the Academy's committee on Life Insurance Financial Reporting and has authored a paper entitled "GAAP for Nonguaranteed-Premium Life Insurance" for the *Transactions.*

Mr. Schnaer is with PennCorp Financial in Santa Monica, California. He is primarily responsible for the company's life insurance marketing expansion.

Our topic is rather broad-based, and we will structure this session into a combination of a panel discussion and an open forum. First, our panelists will make some comments and bring up issues on particular aspects of accounting and auditing, and then we will open up the floor for discussion of various questions and issues. In this way, we can have more input on these unresolved issues.

## PANEL DISCUSSION

MR. KRISS CLONINGER, III: I will briefly discuss six issues.

**I. The Proposed Revision of Financial Accounting Standards Board (FASB) 60.**

During the first quarter of 1986, the FASB and its staff discussed the current accounting for long duration contracts, the accounting problems presented by flexible premium and interest sensitive contracts and proposed solutions. This was in response to the issues paper approved by the American Institute for Certified Public Accountants (AICPA) Insurance Companies Committee. It was forwarded to the Accounting Standards Executive Committee and sent to the FASB for consideration and discussion.

In the first quarter of 1986, the FASB tentatively agreed that accounting for long duration contracts as currently described in FASB 60 should not be reconsidered for contracts with benefits and premiums that are fixed and guaranteed over the terms of the contract and for which premiums are collected on a level basis over substantially the same period the benefits are provided. There are not very many contracts left that fall into those categories. At the same time, the Board agreed that other types of long duration contracts should be addressed. The Board further agreed that accounting methods that result in the recognition of income based on a percentage of premium received are not appropriate for insurance contracts that allow insurers to vary the amounts charged or credited to policyholder accounts, or that allow policyholders to vary the amount and timing of premiums paid to the contract.

In reaching this conclusion, the Board tentatively rejected the "composite method" that had been previously suggested by the Academy and endorsed by the AICPA committees. Preliminary staff recommendations concerning the accounting for these types of contracts will be reviewed with a FASB advisory group late in the second quarter of 1986 with the probable development of a final exposure draft in the third quarter. We still do not expect a final statement until sometime in 1987.

Clearly, the FASB now is leaning either toward the prospective or retrospective deposit method to be used in accounting for Universal Life and Variable Life contracts. Either method would result in a lack of recognition of profit at

the inception of the contract, but instead would result in recognition of profit as the margins emerge over the life of the contract. This may have some effect on companies that are presently following FASB 60, the premium related model, in accounting for their flexible premium products. Some companies disclosed in their 1985 annual report and financial statements that the results that are currently being reported would differ if the accounting changes contemplated by FASB are adopted as GAAP.

**II. Unlocking or Changing GAAP Assumptions After Issue.**

This topic was raised to the AAA committee on Life Insurance Financial Reporting by a member. He asked whether companies should be unlocking GAAP assumptions after business is issued if experience turns out significantly different than expected. He wanted the committee to review this question, and it did in light of existing actuarial literature as well as our exposure to the emerging standards of practice. The AAA Recommendation 1 and FASB 60 are both explicit regarding the "lock-in" concept. Paragraph 21 of FASB 60 states, "Original assumptions shall continue to be used in subsequent accounting periods to determine changes in the liability for future policy benefits, often referred to as the lock-in concept, unless a premium deficiency exists."

I think almost everyone realizes if you have a premium deficiency and you recognize a loss in the financial statement, that loss will have been determined, not on the basis of original GAAP assumptions, but on the most current, realistic basis. There is another type of premium deficiency that occurs when you do not have a currently recognized loss, but instead the present value of future expected earnings is positive in the aggregate with a skewness where you have earnings initially but losses in the future. Literature appears to require current recognition of expected future loss even with future profits remaining in that block, but I have not seen many companies follow this standard. An emerging practice is to prospectively unlock assumptions used in calculating both benefit reserves and deferred cost in a manner that would result in reducing expected earnings in the early years by an amount to at least offset the losses that might be expected in later years. The committee judged that unlocking assumptions in this circumstance is both acceptable and appropriate and intends to communicate that to the Interim Actuarial Standards Board.

The Committee emphasized that unlocking assumptions to remedy a premium deficiency situation is expected to be unusual rather than common, with respect to any one company. In addition, the Committee emphasized that the aggregate effect of all assumptions on both the determination of policy reserves and deferred cost should be considered in evaluating expected future earnings. Any unlocking of assumptions should result in a deferral of future profit recognition, not in the acceleration of profits.

The committee also considered whether assumptions should be unlocked when the expected value of earnings is positive in all years, but the pattern of those earnings does not appropriately relate to expected future revenue. It was our feeling that this practice is not generally accepted, but we wanted to research it and discuss it more fully.

## III. Current Developments and Wordings of Opinions and Certificates from CPA Firms.

The accountants have not changed their standard short-form audit report in nearly forty years. This indicates that they believe investors and other users of these financial statements thoroughly understand the report and its purpose. This is not the case.

In the late 1970s, the AICPA authorized an independent commission, the Cohen commission, to study users' expectations and to evaluate how well the accountants were meeting those expectations. The Commission concluded there was a significant perception gap between the accountants' understanding of their responsibilities and the users' perception of what the accountants were doing.

Shortly after that commission made its report, the AICPA considered proposed changes to the wording of the standard report, but did not take any action. One reason for not taking action was a concern that the proposed changes to the standard report might be considered as an initiative to limit the liability and responsibility of the auditor. The AICPA considered this to be contrary to the public interest at the time.

Since then, accountants have increasingly come to understand that users want auditors to sound an "early warning" that a company appears to be making poor financial or product decisions which may result in a deteriorating financial condition. Accountants do not believe that the current financial statements on which they report contain enough information on risks and uncertainties to address this concern.

Consequently, some accountants propose that the types of risk disclosures required in initial securities registrations under the 1933 Act also be required in the annual statements filed under the 1934 Act and that those types of risk disclosures be subject to audit coverage. These accountants believe the types of disclosures that can enhance a user's capability to evaluate a financial statement and to anticipate future difficulties, which most investors are interested in, include (1) information on the risk concentrations (both external and internal factors that impact the company), (2) information on general uncertainties facing the company, (3) additional information on significant judgments, assumptions, and estimates contained in the financial statements, and (4) an enhanced management's discussion and analysis of the results of operations and current financial position.

Some actuaries may not presently identify with these concerns of accountants, but I think we will become increasingly sensitive to those issues as we are called upon to develop discussions relating to these uncertainties and risk characteristics. In addition, I think those who will ultimately serve as valuation actuaries should already share many of the accountants' current concerns.

**IV. Valuation Actuary Legal Issues.**

There are several areas of concern relating to the proposed opinion to be rendered by the valuation actuary. The General Counsel of the Academy has been asked to address these concerns.

The primary concern of the membership is how effectively the words "the anticipated investment cash flows. . .make appropriate provision, according to presently accepted standards of practice, for the anticipated cash flow

required. . . " convey that we are not guaranteeing this outcome. An additional concern is the definition of terms like reasonable and plausible when used to explain that cash flows are adequate to meet reasonable or plausible adverse deviations in experience. Some are concerned that, with the benefit of hindsight, anything that happens in the future must have been reasonable or plausible.

Finally, the last question the General Counsel of the Academy has been asked to address concerns the personal liability of the valuation actuary. For example, can he be sued as an individual by his employer? Is there any way to protect the individual actuary from liability arising from situations over which he has no control?

## V. General Accepted Accounting Principles (GAAP)

Certain current congressional initiatives would extend SEC jurisdiction to various financial institutions that are deemed to meet a sufficient public interest criterion. Companies with such a public interest that are not presently subject to SEC jurisdiction including nonpublic insurance companies like mutual companies, government securities dealers and certain deposit-taking institutions.

Currently most mutual companies have their statutory financial statements audited by public accounting firms and receive clean opinions on the basis that statutory and GAAP are the same for mutual companies. However, many mutual companies have recently taken steps to develop management basis financial statements and have shared those financials with their board, but not the general public. Those management basis financials are generally based on what I would call "mutual company GAAP" or some other basis like "value-added."

It will be interesting to see what happens if the SEC is granted jurisdiction over nonpublic insurance companies' financial statements. The SEC sets the rules as to how those financial statements should be prepared. Consequently, the SEC might be willing to accept statutory as GAAP for mutuals. On the other hand, it seems likely that the accountants, the mutual companies, or the SEC could force a reconsideration of the question as to what generally accepted

accounting principles for mutual companies really are. This is particularly relevant because of the current movement by the FASB to redefine accounting for interest sensitive or experience oriented life insurance contracts. Participating products could very easily fit within a retrospective or prospective deposit type accounting methodology.

**VI. Alternative Minimum Tax**

The proposed 1986 Tax Reform Act has a provision in it that may affect life companies whose taxable income is significantly less than their GAAP basis income. The bill provides that the alternative minimum taxable income of a corporation would include one-half the amount by which the company's adjusted net book income exceeds its alternative minimum taxable income before adjustment for these untaxed reported business profits. A tax rate of 20% is applied to yield this alternative minimum tax, and the greater of the regular corporate tax and the alternative minimum tax is the final tax liability.

The Act says the book income is the net income disclosed in the "applicable financial statement." The applicable financial statement is determined in accordance with a set of rules that give highest priority to financial statements filed with the Securities and Exchange Commission. Thus, for stock companies, GAAP net income may become a factor in the calculation of Federal Income Tax for the first time. Many people ask us early in the GAAP era if GAAP income will ever be considered for tax. In the past, the answer has been "no," but I think the possibility for this now exits.

MR. WILLIAM J. SCHNAER: The majority of what you will hear from me is opinion, and I will start with one on Mr. Cloninger's last subject. I think that the current form of the life insurance tax bill almost guarantees that some other basis for life insurance tax has to be found. In my opinion, you cannot get three actuaries to agree on what commissioners' reserves are for any product that does not have level premiums and benefits. That will lead to some very interesting audits on products such as Universal Life and renewable term. We will all be re-reading Menge's paper.

I will cover several subjects. One subject is recoverability and recoverability analysis. Because of the plunging interest rates, many lines of business that were recoverable several years ago might not be anymore. For this topic, I discovered that all I could come up with is questions. I thought I would read them and discuss them with you and later generate some discussion. After that, I am going to give a little more detail and a few opinions about GAAP for Universal Life.

Under recoverability, one of the key questions that occurs in any company that sells more than one product line is, "What is a line of business?" The answer can be very difficult to determine. A line of business can range from, for example, all life insurance, with no concerns as to how it is sold or who sells it, to being divided by separate marketing entities.

What about companies that have been purchased? Is insurance issued prior to the purchase date a different line of business from insurance issued afterwards? Some auditors would say yes. That is a very difficult question. What about multicompany environments, which are gaining in number, and are very complex auditing situations? Multicompany environments can occur under common or different management. In either event, the line of business is vague. Often you may have different sets of auditors at different companies, and the communication between them may occur only at the very top level.

What about planned internal replacements? This is a concern of many companies today. A company attempting its own internal replacement program, in order to keep the interest sensitive money inside rather than sending it to the competitors, may find its auditors saying that the old fixed premium, guaranteed-interest life insurance is no longer recoverable. This can become prohibitive. You might be better off watching your money flow away if your auditors will force you to write down deferred acquisition costs. Many companies have insisted that life insurance is life insurance, a continuous flow. They have had internal replacements before and will have internal replacements again. That is my opinion, and it tends to follow common sense as long as the company can maintain some profitability in the entire stream.

When you do a recoverability analysis, what expenses should be included? This can affect even a single-line company. I spent a brief period as an auditor, and I had one small client whose expenses and benefits, on any basis, exceeded the premiums. I had long talks with the partner on the case. We concluded that variable expenses were low enough, that the line was still recoverable, and that the client would worry about whether the company was a going concern. This brings up the question, should an actuary get involved with a going concern question? It is possible for a company to exist where each line of business is technically recoverable or generating future profits, but all of them, in the aggregate, are not sufficient to cover the overhead. There are many companies that are not growing. Should the actuaries bow out from that, or do they need to get involved when they see a situation like that?

A question of determining recoverability of interest sensitive life is, "What kind of interest margins do you forecast in the future?" It is currently very rare that companies will come with a teaser rate on mortality because nobody will know that it is a teaser rate. Companies will not come in with teaser expenses because few have less than guaranteed expense level. However, many companies have teaser rates on interest rates. Some are currently running negative margins, but ignore the problem because there is no money coming in as of yet to pay interest on. Then you need to really think if you are doing a recoverability study. If you projected those negative margins going out forever, obviously the business in force is not recoverable. So what do you do? Do you take into account what the company says the interest margins will be once it actually gets some assets on hand to manage? That becomes a very tough question, and I am glad I am not an auditor-actuary right now.

What about lapse rates when the company does bring its interest rates down? What is going to happen to general interest rates in the future if interest rates start climbing up? Then maybe everyone will be rescued because they can just latch onto the rising rates as they increase. If they do not, then there may be a large bail-out soon.

How do you allocate the assets by line of business and by year of issue? Those of you who have to sign the checks to the auditors can see that costs are getting higher and higher. This is getting to be a very complex issue, and yet

those who are auditors are beginning to wonder how you can do this and still keep the bills down.

Finally, the question I have is, "How do you actually do a recoverability study?" Very few companies actually do mortality studies of their own business. For companies with large amounts of term insurance, the only thing that really matters is mortality, and most companies do not know what their mortality is. In addition, how do you actually do the mechanics? Do you compute gross premium reserves? How do you forecast the future? Do you go through a full, long projection? We are faced with the same kinds of problems ourselves and are trying to address them.

Next, I will touch on the controversy over GAAP for Universal Life or GAAP for interest-sensitive products in general. Mr. Cloninger told you what is happening. Just in case some of you have not read the AICPA exposure draft that has now been tentatively rejected by the FASB, I will spend a few minutes going over that. The exposure draft from the AICPA discussed the various methods of accounting. It discussed the premium approach, which is what we are doing now and which the audit guide prescribes now. It also described the composite approach, which is the old release from risk approach recommended by the actuarial professional back in the early 1970s, and the deposit method which is basically statutory reserves plus some sort of amortization, more or less. The FASB ended up recommending the composite approach, which was not a great surprise on the Academy's part since it had recommended that approach about 15 years ago. It was a surprise for the AICPA since it had rejected the approach 15 years ago.

Basically the methodology of the composite approach is to derive the sources of profits, premiums, interest margins, mortality margins, expense margins, and surrender margins, and divide the earnings among them. There is a circular definition here. You are supposed to divide earnings among the sources of earnings, and there was not a clear way in the exposure draft to do this.

One approach that seems to work is to actually look at earnings that emerge by ignoring acquisition expenses, and then take those acquisition expenses and divide the amortization of those expenses among, and in proportion to, the

various elements of earnings that you establish. It is not an easy thing to do. For a company to be theoretically correct, one set of factors is required for each element of profit that is being used for amortization. If a company decided to divide its earnings among premiums, interest, and mortality, it would require three sets of factors in order to be done properly.

The AICPA recommended the composite approach for universal life insurance and flexible premium life. The retrospective deposit approach was recommended for annuities. In this method, the reserves are equal to the accumulative value, and the Deferred Acquisition Costs (DAC) asset is calculated by taking whatever acquisition costs in excess of front-end loads and amortizing them off somehow. As Mr. Cloninger mentioned, the FASB has tentatively rejected the AICPA's recommendation. There was a letter from Mr. Wayne Upton to Mr. Dick Robertson, which has received circulation, explaining that the FASB did not like any income recognition in proportion to premium, and it wanted further study on limited pay and guaranteed benefit policies. Mr. Upton made some additional comments at the Boston meeting. The FASB felt that the composite approach had too much discretion, and "the accounting method must focus on the liabilities and on the contractual relationship between the company and the policyholder and the extent to which there is discretion for either party." That is a quote, so I am not sure I can explain exactly what it means. But the accumulated value is the absolute minimum of the level of liability.

There seems to be some indication that the FASB is looking at the deposit approach for both annuities and life insurance. There is a retrospective and a prospective deposit approach. The prospective deposit approach is incredibly complex as far as I can tell. It requires you to choose an interest rate so that the present value of all future benefits and expenses exactly equals the present value of future gross premiums at issue. I doubt if very many people have a program that can actually do that. So there will be a lot of employment for programmers, if that path is chosen. There are many people who hope that if the deposit approach comes through, it is going to be the retrospective deposit approach which I have already described.

There were some other comments at the Boston meeting by Mr. Bobby Dunn, of Peat, Marwick, Mitchell & Co., that his intelligence sources tell him that FASB

is looking for a faster write off of DAC than is currently the case. FASB will not allow interest on deferred acquisition cost. As a matter of fact, one of the problems with the exposure draft, according to Mr. Dunn, was that it showed an example of increasing DAC caused by interest. The benefit reserve was also increasing and the net liability was going more in the direction of greater liability. The FASB just saw an increase in DAC primarily due to interest and reacted immediately. It said there will be no more interest on DAC. It will not allow surrender charges to be a part of the revenue stream, but as I will explain, I think this is going to become confusing.

The really good part of the retrospective deposit approach is that it is easy to audit. That is the end of the list of the good parts. As for the bad parts, I fail to understand why a guaranteed benefit product should have accelerated earnings compared to a product in which you can pass along actual experience to the policyholders. As I see the literature and the way that universal life is being priced and sold with the commissions that are being paid, I do not see much difference between the old whole life and universal life. I also think there was great emphasis (Mr. Cloninger even used this phrase) on not allowing income to be recognized at the time of issue. It seems to me the AICPA used this several times, and I have often heard this phrase. I think many people are using this phrase to be synonymous with not recognizing any earnings in proportion to premium. That is obviously not the case.

My feeling is that this error arises from several sources. One is the paper that the SEC released several years ago about the single premium annuities in which it felt the audit guide, as the SEC interpreted it, prescribed no income being recognized at the time of issue. There are some companies who are recognizing income in proportion to pour-ins on universal life and front-ending premium earnings in relation to those. That strikes me as being the problem that, until recently, people were talking about. My feeling is that the proposal, both the composite approach and the deposit approach, is equivalent to using an atom bomb to kill a fly. There are other ways of getting around it.

I also feel very strongly that this is not the time to change the way we account for life insurance. We, the actuarial profession, fought this battle. It was a big battle, and we lost. There are companies who have reported and

forecasted earnings based on the current audit guide. Wall Street is in love with five year forecasts. As Mr. Cloninger pointed out, it may very well be that companies will have to report much lower earnings. It must have been material, or they would not have had to report it in their annual statement. I do not feel that is the right thing to do. There is a quote, attributable to the FASB from the Boston spring 1986 meeting, that the FASB is not so much concerned with stability and conservatism of earnings as it is with other things. I find that somewhat of an unbelievable statement. I asked Mr. Dan Kunesh, who was also at the Boston meeting, if I could repeat some of his statements because they expressed very succinctly what I feel.

Quoting Dan, "I think the deposit approach defies logic in that it does not by any definition match profit and revenue. It is totally balance-sheet driven and will produce erratic earnings. It defies product economics and will lead to manipulation of product design."

I have done some work and am convinced that under the deposit approach, if you manipulate your design appropriately, you can end up with faster recognition of earnings than you can under the percentage of premium approach.

In conclusion, I would like to say that the current audit guide was constructed in defiance of the mass of the actuarial opinion back in the early 1970s with results that the accounting profession does not seem to be totally happy with, and I suggest the same thing may very well be happening again.

MR. RICHARD S. ROBERTSON: Last week in Worcester, Massachusetts, I shared a podium with Wayne Upton of the Financial Accounting Standards Board. During the panel discussion, I told the audience that FASB was making a very serious mistake pointing out that it was acting against the unanimous advice it was getting from the accounting profession, the actuarial profession and the industry. Mr. Upton's comment was very interesting. He basically said that FASB is now balance-sheet driven rather than income statement driven. It does not really care about matching income and revenue anymore. It wants to get the balance-sheet right. My reaction is, "Who asked the FASB to do that?" It claims its constituencies are investors and creditors, who do not want that.

They are interested in projecting future cash flows, which is an income statement driven attribute.

MR. CLONINGER: Can you give us any more update on the status or process of how the FASB advisory group might give additional input?

MR. ROBERTSON: I can only tell you what Mr. Upton has been saying. He says that the FASB is going to a series of staff meetings and meetings with the board where it is trying to articulate what it has decided in principle. It needs to do some more work on DACs. Mr. Upton says that the FASB will expect to have an exposure draft in the third quarter. He said that means the very end of the quarter at best. I interpreted that to mean that we would probably not see it before Christmas 1986. He said that there will then be an exposure period. No one asked him how long. I suppose these things will go probably sixty days. He is not very interested in the kind of criticism that I have been giving, but I think it is appropriate if anyone feels as I do or, as you have expressed. Once the FASB gets something specific on the table, I think we need to help it understand what will happen when applying what it is proposing. I think the FASB will be surprised and see some very unusual and disturbing results. That might help the case.

MR. CLONINGER: So for this year, its going to be business as usual. That will be interesting.

MR. ROBERTSON: It is kind of disturbing knowing that the FASB expects to make a basic change in our accounting and not knowing what it is. But I guess we cannot do anything else in the meantime.

MR. CLONINGER: One thing I am curious about is retroactive application and the extent to which insurance companies might end up restating previously issued financials because of this new interpretation. That involves issues about being out of sync between the timing of reported profits on new business versus the timing of reported profits on old business. It is likely that very few users of these financial statements will understand them for years to come if these kind of changes are implemented.

MR. ROBERTSON: Very few preparers of financial statements will understand them for some time to come.

MR. ROBINSON: In these days of volatility, is the locking principle a valid measure for the emergence of profit? Is fixing benefit reserves of DAC to be considered a true reflection of the emergence of profit? Can we develop reasonable and consistent criteria which can justify measurement during these times of changes?

Then there is also the issue of the cost of the alternatives. Currently this method is mechanical with a more dynamic process as a requirement of readdressing the factors in the light of changes and assumptions. Or is the cost prohibitive enough to prevent these changes?

MR. SCHNAER: Although I once was a fan of the gross premium reserve method, I have come to believe in the lock-in principle, if only for economic reasons. Doing gross premium valuations every year could be ruinous. If a company has done a reasonable job of estimating future experience, then you should have expected some regularity of earnings. Most companies would prefer to have regularity of earnings because that is what keeps stock prices up, which makes management and everyone else happy.

Predictability is often a much better thing. So I do not think that companies would like unlocking every year. I am sure that Wall Street would not like unlocking every year. It does give you some basis for understanding the course of future profits. I am not saying that, in using GAAP for mutual companies or for some internal reporting, unlocking might not be a more appropriate disclosure of the changes. However, I think for public financial reporting there should be some built-in predictability.

MR. CLONINGER: There were some remarks made about unlocking earlier. A discussion in the issues paper said that under a deposit methodology, if your projected margins against which you were amortizing DAC turned out to be significantly different from those you originally assumed, it would be appropriate to make prospective adjustments to those assumptions and to change the expected amortization to meet your current expectations. Apparently, those

kind of statements disturb the FASB. I have heard that it would prefer that assumptions not be unlocked prospectively, both with respect to amortizing DAC on universal life and perhaps with respect to prospectively adjusting assumptions on non-guaranteed premium contracts where you actually change the gross premium. I am not sure where that stands. Look at the current tax law being considered. The IRAs are in, then out. You cannot know unless you are there at the moment. It will be interesting to see what appears in the exposure draft.

MR. ROBINSON: How much independence should there be between the GAAP assumptions and the pricing assumptions for a product? Should assumptions be based on actual realized experience, or should they be based on measures found in pricing? Should the valuation actuary or the auditing actuary be responsible for commenting on the validity of optimism of the pricing actuary. How does an actuary for both reconcile the conflicts of interest?

MR. CLONINGER: I think accounting assumptions always need to be driven by real economic expectations which you assume reflect pricing assumptions, and therefore I see a linkage between them. The expected level of profitability has two different views. That is something that needs to be reconciled. Hopefully your accounting assumption should result in a more conservative evaluation of expected profits than your pricing assumptions.

I found it helpful in dealing with companies to try to do analytical reviews of the way profits are emerging on blocks of business and to compare those to pricing expectations. If the pricing actuary tells you profits should be 15% of premium pre-tax, and you do an analytical P&L based on your GAAP assumptions, and you are showing 25% flowing through a pro forma P&L, then you are out of sync one way or the other. Maybe it's experience deviation or an error. It could be distorted relationships between GAAP assumptions and pricing assumptions. Suppose you used select mortality in your pricing and aggregate mortality in your GAAP, and you got more relief from your benefit reserve in GAAP than you did under pricing. Therefore, you might be front-ending.

Analytical reviews are great tools. You adjust allocated investment income with investment income allocated on a statutory basis to a method where you

deal with required interest on the GAAP net liability. This shows you what should flow through and can be compared to what is implicit in your valuation premiums. Another way to evaluate the need for recoverability is by reconciling the difference between actual financial statement results and what you expected to see from your pricing model.

MR. STEVEN H. MAHAN: In reading AICPA's issues paper, one of the underlying philosophical problems is that we need to decide what the definition of revenue is for these products.

One definition of revenue under the premium approach is that revenue is premium. Under the composite approach, revenue is partially premium and partially margins. Under the deposit approach, revenue is all margins. Once having decided what revenue is, you now know what you are going to amortize your DAC against. However, it occurs to me under the prospective method of any of these three methods, DAC is always being amortized against premium. I was wondering if you agreed with that observation?

MR. SCHNAER: I think I alluded to this and did not follow up on it. As you mentioned, I think there is a great deal of confusion about exactly how to amortize DAC on a prospective, retrospective or any other kind of deposit approach. For example, if you just consider DAC as a separate animal (which I am not ready to do), then the revenue base switches around in terms of what is conservative and what is not. If you use only premium as a revenue base to amortize, you defer earnings because you are amortizing faster and earlier. If you use only mortality margins as your base for amortizing, then you are accelerating earnings because you are amortizing slower. I do not know if FASB reached this conclusion on its own or, as Mr. Robertson pointed out, someone mentioned it to the FASB. I am sure you will probably find amortization totally unrelated to anything except time. You might find a Rule of 78, a method of double-declining, or even amortization of life insurance like a building. In the deposit approach where you define a liability and separately define a DAC where existence is not tied into this liability, you are not free to amortize it any way you want.

MR. CLONINGER: Under the prospective deposit method, amortization relates to premium. I am not sure that makes much difference if you consider that your valuation premiums have to be approximately equal to your gross premium. The way you are funding your benefit reserve may be out of sync with what is in your deposit account. You still get down to the bottom line. Under the prospective deposit approach, your profits will emerge as these provisions for adverse deviation are released. The way you build provision for adverse deviations into your valuation assumption will govern your earnings pattern. The issue of amortization and the increase in future policy benefit reserve is a lot less meaningful under the prospective deposit approach than it is under the current accounting model. However, I am a supporter of the retrospective deposit approach where you use fund values for benefit reserves. If you measure the margins that you are actually realizing from the funds the policyholder has placed with you and you use those margins to recover your costs, I think you will have a reasonable representation of the economic reality of the product.

I do not have the level of objection to the retrospective deposit method many people have. The issue of giving up computing interest on deferred cost bothers me. You can measure what I will refer to as your sources of earnings under a retrospective deposit approach -- your mortality gains, interest gains, net expense loads and perhaps surrender charges. You can define those as revenue, and amortize deferred cost or net deferrable cost against those margins. Then if you use interest in the amortization of deferred costs, your earnings emerge as a level percent of what is defined as revenue or your sources of earnings. This is parallel with the current accounting law where earnings emerge as a level percent of premium except for the deviations or the releases of the provisions for adverse deviation. I find that somewhat appealing.

MR. SCHNAER: The timing of your margins probably has much more to do with the front-ending of earnings than almost anything else you can do. I am thinking of the typical universal life product which uses an aggregate mortality charge and yet you are almost already building in a tremendous release of margin in the early years.

Relating to your comment about pricing assumptions versus GAAP assumptions, it does not matter in pricing assumptions if I, as a pricing actuary, move all of my heavy adverse experience up to the early years. I am going to come up with the same premium, but I will have a delightful GAAP result over the next couple of years. That does not seem to be addressed and again relates back to how do you really know?

MR. CLONINGER: Many people have indicated a concern over the contract structure influencing the way profits were reported. You may have two contracts whose present value of future profits is identical at issue. Why should earnings emerge any differently under the two contracts? It seems to be a valid question. On the other hand, it is somewhat appealing that deviations in the pattern of reported profits between those two contracts are influenced by the contractual relationship with the policyholder. I think Mr. Robertson used that expression earlier, and I was somewhat surprised to hear that because it is one that I like to use. It does not bother me if you report those profits, as long as you realize those expense gains and interest margins. You always have to be cognizant in a mortality situation in evaluating your future expected earnings from mortality gains. You have be sure that you do have earnings to realize. However, that is all a part of the ongoing process of evaluations.

MR. ROBINSON: Should there be standard assumptions for the measurement of profitability or any means to determine these standard assumptions? Can we find reasonable objective assumption criteria that we can define? Can the standardized assumptions be derived from a table somehow based on objective observations of each company?

MR. CLONINGER: No.

MR. SCHNAER: My answer is also no. I am a great believer in full disclosure and not so much a believer in an enforced standardization. I think this is my own suggestion for an actuarial full employment act. If companies had to make a full disclosure of their actuarial assumptions, I think you would find the major stock brokerage firms hiring actuaries to analyze them. They could write up in their reviews of life insurance companies whether the

companies' earnings were sustainable or what kind of conservatism for the future the companies had. I think that is something we should have to do. I think it is a great mystery to everybody. As Mr. Cloninger pointed out, perhaps it is even a mystery to the company actuaries. What level of conservatism over the next twenty years or five years is built into the inforce block of business?

MR. ROBINSON: Is the actuary responsible for developing a degree of conservatism? What levels are reasonable?

MR. SCHNAER: I think that the actuary is responsible for reporting to senior management what the implications of various assumptions are. Obviously, it is not the actuary's judgment, unless he happens to be the CEO of the company, what level of conservatism to put in. It should be an actuary's responsibility to analyze the earnings effect of various levels and report to his management.

MR. CLONINGER: Yes, I would certainly agree. It has been my experience that companies have been concerned that they have been reporting more profits than they should. To the extent that they have made adjustments one way or the other, they tended to hold back on profits. They do analytical reviews of what is coming through the financials. At more than 10% of premium they panic, and make adjustments to amortization to lower profit. Both the actuaries and the financial people in the company are generally concerned about over reporting profits. That has been my observation. It is a joint responsibility.

MR. LEER LAMBERT: We have noticed this shift from emphasizing profit as a percentage of premium to profit realized through the sources of profit, mortality, interest, and loads. How do we view the percentage of premium load? That could be a source of profit if we were doing a retrospective deposit method. Would we then say that you could not legitimately use the percentage of premium load as a margin because it would cause profit to be realized as a percent of premium, or how do we view that?

MR. CLONINGER: I do not know how the FASB views that, but I view that as a legitimate source of earnings. Since it emerges from the premium and therefore has a profit associated with it, I am not bothered in the least. That is

a relationship with a policyholder you have achieved, and you will have some profit coming out. I am not sure exactly how the mechanics have to work if you have to totally eliminate net expense loads. I am not sure what you do with that source of revenue. You would have to somehow arbitrarily force it to 100% amortized cost. In most of the mechanical models I have seen, that is not a natural outcome. You could use it for immediate recovery of renewal commissions and premium tax and apply it first to those. You could apply it to maintenance expense depending upon whether you deduct maintenance expense from revenue in your model. If you count it as revenue, some profit would emerge as a percent of premium to the extent that you have revenues as a percent of premium. If you have costs, like premium taxes, that were once a level percent of revenue or premium, they would no longer be a level percent of revenue and are not amortized in the same period that they are incurred.

MR. LAMBERT: Then you would get a deferral out of your level percent of premium?

MR. CLONINGER: Exactly. You would get a deferred out of your level percent of premium expenses. You might get a net deferral if you define revenue as your margins. Has your company actually done something?

MR. LAMBERT: We have done some tests to see how things might look.

MR. SCHNAER: As I understand the retrospective deposit approach, it takes the amount equal to your statutory earnings plus whatever expenses you are capitalizing less whatever amortization of those expenses you make. If you are just concerned with amortizing DAC by some method, I agree with Mr. Cloninger and I cannot see it. You would have to get convoluted in order to eliminate all traces of some cash revenue or cash earnings that resulted as a percentage of premium load. If I read the FASB right, it says that you do not construct your earnings pattern or this write-off so as to produce in any way percentage of premium load. However, I do not think the FASB is looking for an artificial elimination of the cash earnings that are inherent in the product.

MR. ROBINSON: As an auditor, what is the level of assurance regarding interest margins of products and annuities? The current premise by many companies is that there is little asset, so interest is not yet a big factor in profit.

Must we establish a program now before a crisis situation starts hitting us? Can we take a loss in margin as a deferrable expense? High interest rates could be viewed as an acquisition tool, so why not consider it deferrable like premium discounts?

MR. CLONINGER: I do not like the concept of deferring a current loss because you need to credit more than you can earn to write the business. Is that an acquisition cost to the extent you lose money currently? That will be really difficult to sell to me. As far as the old story about how can this company credit 15% when general market interest rates are 6%, the answer is that the company does not have any money in the house yet, so it can credit wherever it wants to. Those practices are currently moderating in the market to the extent that companies really have sold contracts and yet have not generated assets. The only thing you can do is look at the trend in current market yields as to what interest rates are going to be once they actually do generate assets. Certainly a lot of discipline is going to be required to reach a proper conclusion as to where they are going to be prospectively. That is a tough question to answer.

MR. SCHNAER: As a company actuary, I go by several maxims. One is that the public loves a bargain and always seems to recognize one. If it does not, there is always a broker who is willing to tell the public what the bargains are. Many companies are selling in the brokerage market. Unless everyone lowers their rates, there will be a lot of switching. You may come up with a loss leader that allows you to get the customers. This may allow you to sell them your nice profitable product. My feeling is the customer will buy your loss leader and then buy someone else's loss leader. If I were an auditor of a company currently crediting more than they were earning, I would feel very bad about it. I would feel very doubtful about the ability to recover the DAC.