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USE OF GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAP) FOR MANAGEMENT REPORTING

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Recorder: PHILIP K. POLKINGHORN

- What are the advantages of GAAP?
- What are the shortcomings of GAAP?
- What modifications are companies using to make GAAP more relevant for management reporting?
- What practices are followed by Canadian companies?
- What differences are there or should there be between stock and mutual companies?

MR. PHILIP K. POLKINGHORN: Stock companies are going through their second decade of preparing GAAP financials, and it seems that some of the controversy surrounding GAAP has increased rather than decreased. The rules for the products that many of us sell are changing. The three panelists will discuss the types of information that management needs, the ability of GAAP to meet these needs, and some modifications that might make GAAP more meaningful to management.

The panelists include R. Larry Warnock, a Principal with Tillinghast, a Towers Perrin Company in Atlanta, Georgia. Mr. Warnock specializes in designing management reporting systems and has been involved in this type of work for both mutual and stock companies. Robert L. Collett, is a Principal with Milliman & Robertson, Incorporated in Houston, Texas. Mr. Collett has helped design financial reporting strategies for management information. Glen M. Gammill, is a Partner with KPMG Peat Marwick in New York, New York. Glen has been

actively involved in developing GAAP financial reporting methodologies for mutual companies. He will cover some of the considerations for mutual companies, although all speakers will cover the general-type things that they feel are important for a management reporting system.

MR. R. LARRY WARNOCK: The topic which we will discuss is somewhat of a paradox (I guess that is an opinion). It is GAAP for management reporting. Initially, I did not know quite what to talk about and I thought I would discuss GAAP. On reflection, a discussion on management reporting seemed better. Are these two things different? I think so.

In the last year or so, I have developed a reputation as an advocate of the value added approach for financial measurement in life insurance companies. Prior to that, I had been closely identified with GAAP because I had my name on the Society of Actuaries study note on GAAP. I am really kind of torn here and I may be the only person on this panel who looks at it from both sides and who can be completely objective -- no opinions whatever will be expressed. I am not really advocating anything except a full understanding of our financial reporting alternatives. I hope by exploring these, we can gain some better insights into the pluses and minuses of using GAAP as a management tool.

Let's look at our financial reporting alternatives; just a very brief breakdown on what our financial reporting alternatives are. Statutory, of course, has been around forever -- since Adam was a small child. Its limitations are well known so there is not much point in going over them. Whatever bad we might say about statutory accounting, never forget one thing. A poor statutory surplus position can put you out of business or it can send you to the capital markets (if you are a stock company) in search of more capital. The key thing to remember about statutory is that it does determine our capital requirements. It determines the capital that is required to support new business production. It also determines the rate at which that initial capital expenditure or investment is returned to our surplus. Although it does not provide particularly meaningful bottom line results, it does determine our capital requirements.

I might also say that GAAP is often discussed in the context of capital management. Yet at the same time, GAAP does not really directly consider what those statutory capital requirements are so that is one weakness that I would identify

to GAAP. GAAP reporting has been around for some 15 years. Initially, it was considered to be such a vast improvement over statutory accounting that few people were thinking ahead to possibly considering developing additional management reporting sometime down the road, but now companies are considering those things. A key point about GAAP is that it is intended for external reporting. Initially I might call our discussions about GAAP, straight GAAP, that is without modifications to adapt it to a management reporting usage. Since it is for external reporting, it must follow the precepts which are established by the accounting profession.

Management reporting really represents many diverse approaches; it could even include modifications made to what I will call our straight GAAP. The development of management reporting schemes and financial reporting approaches has been receiving a lot of attention in the industry of late. I think stock companies perceive some limitations in straight GAAP, and mutuals are new to anything beyond statutory and they have been developing management financial statements of late.

Now the cracked egg here has some meaning. I just want to talk about some meanings. Do not confuse GAAP with management financials. Very often it seems I will get into a conversation with someone about management financials, and the first thing you know, the term *GAAP* is being used for a synonym for management financials. I just want to say it is not necessarily so, so be sure you get your words straight. As we have already said, GAAP is for external use, subject to the accounting profession's guidelines. Since management reporting is for internal use (we are not giving it to anyone outside the company) it is flexible and it can be designed to display information which is relevant to your way of doing business. So you have a lot more options open with management reporting approaches than you do with GAAP, which must satisfy external requirements that are set by the accounting profession.

How do you look at GAAP? I think you have to take GAAP seriously if you are a stock company because your shareholders are looking at it. You do not want to suddenly take something that you have been showing to the world for 15 years and disavow it. I tend to view it as something which should be managed. I know that makes accountants shudder, but I think you have to know what your earnings have been and where they are going, realize the world will be

looking at them, and take them seriously. I am not suggesting when I give negative aspects of GAAP that it can be ignored at all because it is put in front of the outside world. But what we are talking about is internal for management usage.

I would like to place financial reporting in its proper perspective by looking at the big picture. Let's ask what the purpose is of management financial statements. I think it is for scorekeeping. It is for performance measurement and the way that works best is to assess your performance by comparing actual results against goals, where the goals are predetermined in advance of the game being played. I think that is a normal part of the process we call management by objectives. I want to say that the business planning process should be a top-down process. It starts with a clearly articulated statement of the organization's mission and this leads to the develop of strategies, functional goals, specific programs and operating plans. In the final analysis it leads to budgets. Those budgets then become our goals (which are our predetermined goals) which we are going to measure ourselves against after the fact. So, goals are set as part of this planning process and eventually it is desirable in a company to relate your financial reporting mechanism to the way you did your planning. So you want some kind of integration between your reporting and planning. I do not think you should consider either one of them as a stand alone thing.

We might ask what appropriate goals are for a life insurance company. I have found that the right statement of goals for a mutual company is very complex indeed and I will not even attempt to hit that one, but for a stock company, I think the overriding financial goal should be this one: the real goal of an enterprise is increasing its value to its owners. You might change the word *increasing*. Some people might say maximizing, others might say that the idea is to achieve minimum rates of return that are set by the marketplace, but I think this has to be one of the overriding financial goals of a stock life insurance company.

The concept of return on equity has been a hot topic in the last several years and it seems impossible to have a discussion on management reporting or financial analysis without talking about return on equity. Normally, when the term comes up, it is as such thrown out as ROE (there are lots of types of ROEs), so I want to start by defining some terms here. I want to do it with a simple

noninsurance example. Just suppose that as an individual you buy a bond, hold it for ten years, and then sell it. If you want to calculate your return over those ten years, all you need to know is what you paid for it, what you sold it for, and how much in dividends you received in each year during those ten years. Your average annual return during that ten-year period is then easily calculated. Now, if you want to look at return on equity for a one-year period, one way of looking at it might be this. You know what your share price was at the beginning of the year, you know what it increased during that year, and you know the dividends you received. So you might define your return on equity, if you will, for that bond as the increase in share price plus dividends, divided by what it was worth when the period started.

The same idea can be applied to measuring financial performance in a life company. First, we have to have a measure of value. In this example, we took share price as our measure of value. It gets a little more complex when you are looking at life companies. I think the alternatives here are stock prices, accounting book values, and economic values. There is a problem with stock prices for a life company. To use an analogy to stereo equipment, you have all heard of the signal/noise ratio that goes along with tape recorders. Well, with stock prices, there is a low signal/noise ratio. In fact, there is so much noise, that is reaction to external events, that the signal of the underlying value of the company may be completely washed out. So I think for measuring how a life company is doing and how management is performing, the use of stock prices is out. Therefore, we need a proxy for the underlying values in this company.

That leaves us with economic values, and accounting book values of which GAAP would be one subset of that. The economic values may represent a good proxy to the underlying values of a company. In fact, actuarial appraisal values, which are economic values of a sort, are often generally used as the basis for purchase price when life companies are sold and bought. So, I think economic values could be that proxy for value. Accounting book values on the other hand are often substantially different than the sale price when an acquisition occurs. The GAAP net worth may be substantially different than estimates of economic value. I think my co-panelists will discuss more about what GAAP is and what it is not. For now, I want to explore economic values a bit more.

I would like for you to forget that you are in the insurance business. I know that is hard to do. Let's simplify the world a little bit. Economic values can be done by a simple formula; this is how they are generally done in the business world. You need two things. You need a projection of cash flows each year into the future and you need a discount rate -- called here the case of E or a hurdle rate. Given those, you can determine an economic value. The application of this formula is generally referred to as discounted cash flow analysis. When you talk about discounted cash flow analysis to business people outside the insurance industry, they understand what you are talking about. I think the economic value concept is pretty well understood within the business world. It has become stylish to refer to that discount rate as a hurdle rate. You might characterize it as a risk adjusted cost of capital. There are all kinds of theory for how you get to that risk adjusted cost of capital and we could take a while going over that and 90% of you would disagree with what I said anyway, so we will just leave it at this. One point about the hurdle rate, for stock companies anyway, is that in theory, it is objectively determined by the marketplace external to the company. It is not really your company management which determines this risk adjusted cost of capital, it is the marketplace. The company management may have a perception of what the risk adjusted cost of capital is. In the final analysis, they have to choose a number. In theory, it is dictated by capital markets.

I have already said that the discounted cash flow analysis is commonly used outside the insurance industry. You also use it in the insurance industry. At least most of you do. If you are using Anderson's method for pricing, I just want to point out that it is just a variation of discounted cash flow analysis. It directly affects the economic value and return on equity concept, specifically considers defined objectives for the investment of capital, statutory surplus, and possibly add to that target surplus if you put that into your calculation, and it considers a hurdle rate or a minimum profit objective. We have to make a few adjustments to our definition of cash flow to make it fit into the Anderson method pricing model. We want to recharacterize it and call it free cash flows or available cash flows. We start with our pure cash flows (money in and money out). The first adjustment that we make is for statutory reserves. Having made that adjustment, we now have statutory earnings. The next adjustment, if we care to make it and if it is consistent with the way we do our pricing, is to factor in our target surplus. In other words, if we have statutory earnings but

we have to set a certain part of it aside for target surplus, then that money is not available for distribution or to invest in new business. These adjustments will get us to free cash flows.

How does a company generate superior financial performance? I think it is fairly straightforward. The way you do it is by having positive spreads of your return on capital over your hurdle rate and combine that with growth and you will increase shareholder values at a superior level. There is evidence that the financial markets assign a premium to the stocks of companies that achieve these. We might look at what I call the rules of profitability which go back to whether this spread over your cost of capital is neutral, positive, or negative. If we have a company that is earning a return on equity equal to its hurdle rate, they are just doing what the market expects them to do. I think the market does not really look at them as doing something fantastic. If the hurdle rate exceeds the return on equity which is being achieved, the market is going to downgrade them somewhat. If there is a positive spread, that is the return on equity exceeds the hurdle rate, there is a positive effect on that company's value. You might take a pencil and cross out the ROEs and substitute IRR (Internal Rate of Return), what we would obtain when we do pricing on a new product. We can see what happens when we price a new product. If we price a product to achieve our hurdle rate exactly, then we add no value to that company by the sale of new business (not immediately). However, if we have an internal rate of return from pricing which exceeds our hurdle rate, we will add economic value to that company by putting more new business on the books.

I would like to look at a formula for return on equity. This doesn't have to be in the insurance business, it can be in any type of a company. Very simply, you get it by increasing economic value divided by the initial economic value. I did leave something out of the formula; if the shareholders took out dividends during the year, then that is also part of their economic return and you should add shareholder dividends into the numerator. I like to refer to this as a true return on equity, because what we are measuring is at what rate our true value went up during the year. If you look at it as an investor, at the beginning of the year you had an amount that you could have sold for x. You did not have to sell it to have that value but that was an economic value. At the end of the year, you had y, so the way you get to this: is y - x over x, and it is a rate of return.

I would like to look at GAAP rates of return. Perhaps one of my co-panelists will expand on this a bit. What do you have for a GAAP return on equity? The numerator is GAAP earnings, which is not a measure of increase in economic value, the denominator is GAAP net worth which is not a measure of your beginning value. You might ask if it is even close to a true economic value-type of return on equity. Well, maybe and maybe not. I think that in a lot of companies, a substantial amount of actuarial talent is devoted to the ongoing analysis of whether the GAAP ROEs are truly reflective of the company's performance, and naturally a lot of judgment goes into that.

I would like to talk a little bit about calculation techniques that are used for the way we do GAAP these days. GAAP calculations to my way of thinking are effectively done in a black box. What we do is we calculate a whole myriad of GAAP factors for a vast number of plans, issue ages, and durations. It is just a horrendous undertaking to get all of those GAAP factors. I think the print-outs just to list them in many companies stand many feet tall and may get lost in the storeroom after a while. In checking the calculations, about the best we can do is determine a statistical sample and go do sample checks on our factors, hope it all comes out right and do reasonableness checks. Furthermore, I don't think you get much in the way of useful by-products out of the fact that you did all of that myriad of GAAP calculations. Some have said that we can make GAAP more responsive to changing circumstances by unlocking the assumptions and recalculating the factors and redoing numbers. I submit that the selection of those new assumptions and the recalculation of all of those factors and then their application to the in-force business is a fairly large undertaking. Routinely unlocking assumptions and redoing your GAAP is not a small amount of work. Also, I would ask you to realize that your assumptions relative to things which happened in the past and which you might think are irrelevant, actually will impact your future earnings. By the way, we do our GAAP calculations because it is a net premium approach. My personal preference is for development of management reporting schemes which, rather than utilizing factors, use some kind of a model office projection technique where what you are coming up with are projections of cash flows, statutory earnings, and available cash flows. I think those have some merit in this world.

I think we can learn one lesson from Gary Hart's experience. That is that in the future, we are going to make more effective use of models. The utilization

of the cash flow projections at the profit center level offer a number of advantages. First, here we are talking about models which can be more limited but properly validated and it makes the job a lot more manageable. There is a degree of convenience of validations; we can validate against prior experience to fine-tune the models or assumptions. The results are easily communicated because you have an intermediate result that looks familiar. Basically, what you have is an income statement or cash flow projection which management understands. There are some ancillary uses to these things. They can be used in financial planning and surplus management. It is fairly easy to adapt those models to changing circumstances to change your assumptions and redo all calculations. I think it is a lot easier than redoing all of your GAAP factors. It also lends itself to a source of earnings type analysis. This should be obvious if you just realize that you can use models not only to project the future, which we have typically used them for, but we can project the past as well and compare that projection into the past against actual results. To some extent, we may be able to avoid extensive restructuring of our administrative systems because the types of projections we are talking about only need input from the statutory records. In a financial reporting process which utilizes model office projections, you get a lot of other by-products out of the thing, and you have the capability to tie together your pricing, your planning, and your performance measurement. You also have the possibility of developing incentive compensation plans which tie into the whole system. Sources of earnings deviations from a plan may also be identified and quantified by this type of approach. Just one other way of looking at this -- we have heard a lot about control cycles recently. All we are saying to do on a control cycle is tie together the various financial processes in a company. You start with your pricing and your profit tests, from that you go on to a model and assumptions and it develops appraisal values for you. You can analyze your surplus; in other words, plan. The next step then is monitoring. How did you do relative to your assumptions? About the only thing we know for sure when we make our pricing assumptions is that we will be wrong. The critical part of our job is going to be to monitor and determine to what extent we went wrong after the fact, so that we can make course corrections and go back and reprice our products if necessary.

I would like to end up by giving you a fabricated list of what I perceive as desirable features of a management reporting scheme. First of all, I think the results and the approach should reflect the company's economic fundamentals. If

you can tie pricing, planning, and reporting all together so that the same concepts are used in all, then you have done that. I think GAAP has a problem with reflecting the economic fundamentals of the business because it doesn't consider the statutory capital requirements directly. An economic value based approach (or value-added if you want to call it that) will do those sorts of things. I think you need results available by strategic business units. I think virtually any system will accomplish that.

The benefits should exceed the expenses, obviously. You have to do some kind of a cost/benefit analysis before you justify doing any kind of a management reporting system. You have to look at the people in the company, the systems development that is required, and fees to consultants that are outside. I think also as a benefit you have to look at possible by-products that you may get out of the process. If you develop an integrated process which ties together pricing, planning, and reporting, then you have a valuable by-product there, and when you look at the cost of your management reporting system, you should consider that cost in the concept of the overall package.

Understandability and ease of communication are important. The economic value approach uses, as its underpinnings, cash flow projections and discounted cash flow analyses. I have heard lots of folks say that they are going to throw out an economic value type approach because it is too hard to explain. The only things that are involved there are cash flow projections and discounting, which are fairly readily explained. I really haven't had much trouble explaining those to insurance company management. I have found that it is a lot easier to explain that to people outside of the insurance business than it is to explain to them how GAAP accounting works. We need timely results; I think that can apply to virtually any system that you do. We need flexibility and adaptability to respond to changing circumstances.

Lastly, I think this is an arguable point depending on how you look at things, but you have to have useful management information and, in particular, if the management does something good this year, it should surface in the financial results as a visible plus. If management does something bad this year, it should surface in the financial results as a visible minus. That gets back to whether your pricing returns or realistic expectations are greater than or less than your hurdle rates -- visible pluses and visible minuses. That is contrasted to a

GAAP-type approach, where the basic philosophy there is to adopt a spreading approach. Let's take a situation where the hurdle rate is 15% and the actual pricing return is 10%. What GAAP would do is defer the recognition of that underperformance by spreading it over the life of that policy as a percentage of premium. An economic value-type approach would put the pluses and minuses up front. So, those are key differences between those two systems. As I say, I guess the desirability of getting the visible plus and the visible minus is arguable.

MR. ROBERT L. COLLETT: I guess by way of introducing my remarks, you could say that Mr. Warnock really talked about financial reporting as an alternative to GAAP reporting, and Mr. Gammill, who will come after me, will tell us that GAAP is management reporting. So I will try to talk in the middle, about modifications to GAAP, enhancements that might make GAAP more useful in the management reporting process, sort of a bridge between the two.

First, there are a number of modifications, minor alterations, tailorings that are done for GAAP all the time to make it more useful in particular situations. I guess I am thinking of modifications such as perhaps additional capitalization outside the basic deferred acquisition cost (DAC), to better tell management what is happening to GAAP earnings that are very often portrayed in a variety of ways: earnings, growth, return on equity as Mr. Warnock mentioned, earnings in relation to revenue, and displaying GAAP indices for companies themselves and for competitors.

I want to try to go well beyond that and talk about more ambitious modifications. Mr. Warnock finished with the desirable features for a financial reporting system. Let me begin with a variation on that theme. Let's talk about what I think management wants to know from a financial statement in order to better carry out its function. I am certainly going to focus on the income statement. There are many issues related to a GAAP balance sheet, and GAAP net worth, but those are beyond the scope of my remarks.

So, what do I think management wants to know? I would say to begin with, management hates surprises, so before the fact, they want to know how much money we expect to make during a fiscal period. As soon as the period is done, of course, they want to know how much money we did make. Since those two

never match up, they want to know where and why we missed the target. Were there experience deviations? Were there production deviations? Were there other sources of extraordinary things going on that can help answer that question? Next I would ask, what sorts of things, good or bad, are not revealed by the income statement? In other words, does the income statement tell all? And, very importantly, when talking about management, as a manager, what things can I or what things must I address in order to more nearly optimize the operating results for my company? Finally, we end with the first question -- what is my updated expectation for the next financial reporting period? We can see the whole as white instead of blue and white.

Now, let's look at what a GAAP income statement does and does not show. Clearly, it is responsive to how much money we made, and maybe it is responsive in an implied way. As far as the implied question, what will happen next time?, the implication is that what happens next time will be something like what happened this time.

So, what are some of those ambitious things that we can do to increase the number of answers we have for these questions? Well, obviously, a really good place to begin is with a GAAP plan or GAAP projection. I don't mean a back-of-the-envelope projection, I think you do that at your peril. I mean a thoughtful one, a good serious actuarial projection. As soon as the results are in for the period, it becomes terribly important to do that comparison of the actual results back to the plan. Again, no plan is ever going to turn out to be right on target. One of the things that we probably need to do as a part of that comparison would be a recast of the plan. This actually is kind of fun. Production changes and production volume changes do not require that the cells be reopened if we are doing a cell based model. Many sorts of things can be reexamined if we are dealing with an aggregate or noncell based model.

As far as another direction the analysis may go, there are the sources of profit or the analyses of earnings by source. This is currently a popular topic in many actuarial circles and I will have more to say about that shortly. Next we have what I will describe as an extension of and a combination of several of these items. That is a comparison back to the plan by source of profit. Finally, Mr. Warnock has talked about the value added method. I will have a little bit more to say about this as well.

Let's go back to the recast of the plan. As I indicated, I think this is quite important to any analysis, particularly an analysis of profits by source. As an example, I think it is well and good to compare actual claims to expected claims, whereas everyone knows there are two elements involved: one is the deviation that has occurred from assumed mortality rates, the other is the deviation from the assumed exposure. The way to sort these out is first to recast the plan and then compare to actual. There is first a comparison which indicates the extra claims that derive are expected to derive from the extra production. Second, the claims deviation from the assumed mortality rates is based on the recast plan and the recast expectation.

Now, let's talk about analysis of earnings by source. Think of the GAAP income statement and the items that are involved there. They are mostly straightforward, but the tricky ones are the last two. The GAAP reserve change is the increase in the benefit reserve less the change in the deferred acquisition cost. I think we want to go into more detail on these two items. The increase in the benefit reserve less the increase in the DAC equals the anticipated premiums under the GAAP assumptions, the GAAP interest on the net reserve less the GAAP claims. In this case, since we are talking about actual increase in GAAP reserve we will see an alteration on account of reserve release for extra deaths, if any, and then in addition to the GAAP anticipated surrender premiums going against those GAAP premiums, we will also see a reserve release on any extra lapses. Finally, out of that will come the forecasted projected GAAP expenses.

Now, I would like to go back to the GAAP income statement and substitute these items for the reserve increase and get to the point of where I want to be. We have a rerepresentation of the GAAP profit as a difference in premiums, or the loading, the difference in expenses, investment income versus GAAP interest, and we have an adjustment for extra deaths and an adjustment for extra surrenders. Expressed another way, we have loading gains, investment gains, mortality gains, and surrender gains.

Finally, if we have done our projection, including by source expectations, we can see the deviations, not from the GAAP estimates but from the best estimates. If we have done that recast, we can see the production gains or losses as well. Now we have profits by source compared to plan or compared to best estimate expectations and we have deviations in this case from five sources.

I promised you a word or two more about value added. Mr. Warnock really talked about it as an alternative to GAAP, and I am choosing to present it as an addition to GAAP. That is, as he indicated the value added is a change in the value of business. This, of course, can be computed as an increment to the GAAP results or the GAAP balance sheet so that we have adjusted profits as the GAAP profit plus the value added computed from the GAAP starting point. The question before us at this point is what will be the impact of the new FASB exposure draft on the use of GAAP for management information purposes? I guess without getting into that in any detail I fear that if the new exposure draft is adopted as promulgated, it likely will mean less reliance on GAAP and probably more interest in the value-added additional piece.

Finally, let us look back at my list of management wants. I would say if we have done all of the work I have alluded to, and we get the kind of information I was describing, at that point we have done rather well against this list.

MR. GLEN M. GAMMILL: I plan on being just as objective as Mr. Warnock was. I can't address all the questions that Mr. Warnock raised during his presentation. I am glad I do have some written remarks because you can take Mr. Warnock's and substitute GAAP for value added and you will have my presentation; so that will work out nicely. I do agree with Mr. Collett that the value-added approach could be used very effectively as a secondary reporting tool.

We are going to use financial reporting as a communications tool. It doesn't have anything to do with economics. No matter how hard you try, there is always going to be deviations, it is always going to be scratchy as to how actual emerging experience, however it is reported, looks like versus the economical situation. So there is no perfect accounting model. The value-added or pricing accounting model may be the perfect accounting model. In the United States and maybe even in the world you have to deal with practicalities of how you communicate financials.

I think from the standpoint of what is understandable and practical to the CEO who may not be an actuary, to the investment officers, to the marketing people, to the folks that run these business units in our companies, we have to look at the real world of communications. In my opinion, GAAP does ride very high on this financial communications line as I call it.

USE OF GAAP FOR MANAGEMENT REPORTING

One of the major activities of a company that we are interested in ultimately, (in fact, if you get really carried away you can almost make it fit anything), is the capital management process. This is where the checks are signed, where people decide how the organization is going to be run financially. If it is not financially viable, you are in big trouble. You are out of business, you have to pay attention to statutory accounting, you have to pay attention to the underlying economics of the pricing event. How you choose to monitor that can be translated with a bridge between your financial reporting and economics. There is no reporting system where a bridge does not have to be built.

What we are saying is that in order to achieve consistent profitability and growth, the company needs to set financial targets, which would be more of interim financial objectives. There might be returns on equity or various other performance measurements and, also, longer term objectives.

In terms of capital management you are attempting to develop a structured approach. Some of the key words in talking to a chief executive officer are due diligence. You want to exercise due diligence of the management of your capital. I know I am departing a little bit from financial reporting because I think that is still largely an accounting exercise.

So we want to look at the management of capital, we want to bring as many investments to the table as possible, we want to have a very methodical approach to the selection of those investments. This involves either hurdle rates, average cost of capital, or whatever other dialogue you use in your company. You want to be able to monitor the capital management process. You need to walk over the bridge between economics and your financial reporting model, and understand the dynamics of that, where the financial reports produce return on whatever equity that happens to be in there. There could be a lot of different equities for each accounting model. You need to know what those interim targets that you need to meet are and what your objectives are. There was a comment made in Chicago last year, in a capital management session. You can't turn this oil-tanker around 180 degrees and it is the same thing with a business today. You have existing business, you are not going to be achieving your ultimate performance objective now. So what you have to do is come to grips with where you are, what your ultimate objectives are, and then move towards financial targets that will get you towards those objectives.

The process of selection is important and there may be different selection criteria used. Hurdle rates were mentioned. Other selection performance measures may be more appropriate. One thing that needs to be considered when you are evaluating and starting to have dialogue about hurdle rates, returns on equity, and the like, is the idea of risks, if you have a portfolio of assets or you are into just one mild line situation where you have one type of asset or business unit that is returning a certain rate of return. The next investment that comes down the pike doesn't necessarily need to meet that particular return's objective. There is no one hurdle rate. There is a series of hurdle rates. The hurdle rates vary by risk.

So in the capital management process, or in any other process involving financial matters, you need to take into context in your decision making the risk of your investment alternative you are looking at versus its return. If the return is there and you can become well diversified, and I won't get into high-yield bonds and the like, you can make some inroads in terms of how you run your business.

Now the company can understand its business well. It can look at its past performance and analyze it up one side and down the other, it can look at plans, it can prepare plans that are very detailed that are understandable, it can compare the actual results against and reconcile to, it can prepare for future financial projections based upon your company, and it can have internally focused objectives.

Start looking towards the future. Because of what has happened, you can learn from your past mistakes and try not to repeat them. The interest is on the future. One of the elements of capital management is going to be to look at various business units with the company and prepare future financial projections; projections of future financial results under an accounting model cash flow all different ways. You will have to be smart enough to do all the bridges between those, but you have to prepare these future financial projections because we are looking forward. There are lots of things that you have to worry about: control and the ability of management to manipulate the future financial projections. I have done a little bit of that with my cash flow analysis and my personal finances, so I am an expert at that. You have got to look in terms of preparing future financial projections that have a certain macroeconomic

environment that all those projections will be based on, or maybe a high/low and expected microeconomic scenario. You need to know how those microeconomic assumptions affect the business unit assumptions or microeconomic assumptions; what algorithms, what relationships apply. You need to have very structured, consistent, controllable, and systematic types of projections by lines of business or else the poor guy or gal that writes the checks to make these investment decisions is going to be comparing apples and oranges. It is going to be one financial guru against the other. So, the idea of consistent financial projections, and the idea that the managers of capital can rely on and give credibility to these financial projections is essential.

Now even though we understand our company and we understand how much value we are adding to our company, there is some noise out there. There is a perception of how we are being run. And for those companies, not only stock, but also mutuals that seek capital, they are going to have to deal with some other folks. The other folks' perceptions of the risks and of what target surplus requirements are, are going to be extremely and vitally important. Your ability to communicate with those people is going to be extremely and vitally important. If they do not understand what you are talking about or they feel that it is not controllable or comparable to other companies, you could be in for major trouble. The rating agencies are going to look at a lot of things. They are going to look at your financial structure, your equity ratios, your operating leverage, all kinds of things that the Standard & Poor's folks would talk about. If you want to get to the capital and you want to toss something that you can hurdle added value, you have to understand how they are going to rate your organization. They have to appreciate that you know how to manage your capital.

To promote consistent profitability in the growth bin and to in fact increase corporate wealth are what we are talking about when we say we are meeting these financial targets. We have set our financial objectives and we are in control. We want to price our products consistent with capital management and the economics. We want to report our financials that have bridges to the economics. We want to monitor our performance against objectives and targets that we have set. If we are not meeting those we want to manage our business towards those goals. We want to put the company on a glide path. We want to look at reasonable, rational, financial targets. Because if we have no credibility

in the targets or cannot make management people who sign the checks understand how the targets were set or what they mean, or we cannot achieve those targets, we start to lose credibility rapidly. Loss of credibility is a major, major issue. So, we want to set financial targets that we can glide towards. Ultimately, we want the dollar signs to get bigger on the way to meeting our objective.

So, you want to go through the process of meeting financial targets, going towards your goal. You want credibility, you want people to understand what the heck these financial reports mean. These would be the real economics. The marketplace is going to look through financial reporting. There is going to be someone up there who can either blow so much smoke to confuse people where your values go down, whether they have gone down or not, or there are going to be people out there razzling and dazzling folks, convincing them they have the best financial accounting model in the world. Really there is no perfect accounting model. I think that the most perfect accounting model is the accounting model that is best communicated to those people evaluating it. If we could talk about cash flow, pure out, and we had the discipline to set aside assets where we did not reserve for future contingent events, and we could deal with what I call Walden Pond accounting cash flow, (the simpler it is, the better), and we could communicate and control and provide consistent and creditable information to the people that review performance, the better off we would be.

I do not care what you call it. We want our financials to provide us with a road map to tell us where we are going wrong. We do not want to fall off the cliff. We want to get to the money tree. Capital management is going to drive the pricing process. You are where you are today because that is where you are. The only way you are going to get to where you want to go, if you have a good capital management system, is to start to price your products in sync with the capital management system, unless you want to rely on luck or fate or whatever. You can cut expenses and increase profit, but you may not be doing the right thing for capital management. So you have to have a much broader view and I think that the actuarial mind is capable of understanding this because in a lot of cases we are sitting around and saying we cannot look at this individual entity. We have to aggregate them in order to deal with this risk. The same thing applies with financial management. You have to diversify, you have to

understand aggregates. You cannot just deal simplemindedly with line items on a financial statement and approve profitability. You are going to have pricing and you are going to have financial reporting and you are going to use those to monitor and measure your performance. You need to align those. You are almost going to be forced to do that.

In the pricing of most of our products in the past, maybe the dim past now, we have used conservative assumptions; hopefully, when we knew what business we were in. We have relied on those to provide for the margins for adverse deviation, or if you do like those words, the conservative or explicit profit margins or whatever in our pricing event. Now we are starting to see a little more thought in analyses; what the underlying volatility is within our particular business units. At least there is some glimmer of that. We are starting to look at C-Risk reserves, although rating agencies might have already got an idea as to what those risk reserves should be in the form of target surplus objectives. I think at least we are creating a situation where we can start to have dialogue with them in terms of negotiating at what level particular surplus should be relative with the business. So we have a game going on between the past and the deltas on the assumptions, and a little bit more Finance 101 and basic financial management or capital management on the other. I will not tell you who is winning right now. And I could go either way on that and make it work out right. So we want to have an interface between pricing and capital management. If those things do not come together, if we do not consider the discipline of capital management in our pricing process and begin to compare where we want to, it will not be because we have managed the company well to do that. We have just been operating in a sort of knee jerk-type approach. It takes a while to even get there. It is not a six month project or even a nine-month project. It is a lifetime project. The concepts are more important than the specific structure of any given company of the capital management system.

So, C-Risk, asset/liability management systems, and virtually all other activities that revolve around money and/or capital are part of the capital management system. They are just a part of it. It is a people system. People write checks, people spend money and people make money. We want to evaluate investments, select investments, and monitor and manage towards our objectives and targets. In terms of a capital management system, what we want to do is to make sure that the very best from our business units contribute to some sort of

a steering committee. Maybe we will call it the capital management steering committee, maybe we will call it something else and really work on behalf of the board and the CEO to develop a capital management system. I think it at least should be given a strong consideration in terms of a system development life cycle approach. We need to know what our system requirements are, and what it is we are trying to do. We need to understand capital management. I maintain that most of us really do not understand capital management that well. The best of us understand maybe 60%. If you put us all in a room, we could collectively understand about 80%. If you gave us ten years, we would understand about 90%. No one will ever understand all of it.

So, we take the requirements of the company and the corporate entity, whichever level you are at, and develop a conceptual design to support those requirements straight up. The capital management steering committee or resources within the company review progress, and the development of that plan contribute mightily to that plan. You have your best resources communicating right up front. You are developing a concept and an approach to your management that is really tailored to your company. You are talking about a company somewhere, with a certain level of management expertise, philosophy, and culture, so the system is going to look different in different companies. Call it "a" system. After the conceptual design we have a detailed design that would be straight up, in terms of deciding whether it is coding in terms of a data processing situation, or a specific structure in terms of procedures and the like. The detailed design still applies in any type of SDLC approach. We never stop learning about capital management. We've got our business and hopefully we begin to understand it very well. We are trying to relate it to how we continue to do our business through pricing, and how all of that is going to come together in terms of a financial result. So we are always going to be adding to our base knowledge. We are always going to be learning about capital management. It is a never ending process, just with the fact that there is dialogue within a company. Even if there is not one additional system added, just the idea that you talk about it and start to get serious about what it all means is extremely important. Whether you use decision trees or not in the whole process, you are trying to create a discipline in the management of capital and exercise due diligence. We want to mirror our capital management process. What we are going to get is a bridge in this mirrored event so that when things are going

good, the financial statements are going to look good. When they are going bad, the financial statements are going to look bad.

I might interject that as a CEO, I would hate to compensate business unit heads on their projection of future profits and discount it, too. What we have got, if we are talking about general purpose financial statements, is whether they are the best thing since sliced bread or not. We have a body of users, a body of preparers, new issues that are emerging that get acted upon, and new methods developed.

Now, we might talk about the FASB exposure draft on the interest-sensitive products. It is my opinion that cannot possibly be issued as it now stands without modifications. We talk about those things, but I can tell you that in the real world GAAP was already out there. GAAP was already out there the first day these products hit the fan and there was a materiality issue. Now depending upon your accounting firm, you had different versions of GAAP, but by and large I think there was movement in the right direction. GAAP exists whether there is any FASB pronouncement or AICPA pronouncement. When the audit partner signs an audit report, not an audit opinion, for your company he has said that GAAP has been applied to the best of his assessment. So, GAAP has existed all throughout this history of whole nontraditional products. In some companies it may not have existed in as good a form as in other companies.

Comparability is an issue. If you are going to look outside other companies or if people on the outside are going to look at you, you better have comparable financial information. If you are going to want to tailor your presentation and be a lone ranger in terms of your financial reporting, because of the unique characteristics of your company and its approach to internal management reporting, and if you want to use that as a basis to determine crediting and to get your capital, then you are going to have to do a sales job so some mighty smart folks will understand what you are talking about. I think that there are a number of us here that would have difficulty in understanding some of the financial statements that might be produced from that type of activity. The idea of having comparability across a time line for a particular company, we might call it intracompany interperiod, or across various companies for a particular period or between periods, is extremely important. Comparability is important. Nothing is perfect. Of course, the line on the management financial statement is

above zero at the XY intersect, because no matter how bad things are I am sure that we can get the line just a little above zero. Provisions for adverse deviation will do it. You do not want to be talking to the board of directors about how good profits were because you had really nifty provisions for adverse deviations or release earnings. You don't want to do that. So you want financial statements that generally go up when things are going up and generally go down when things are going down.

You are always going to have to draw a bridge between financial reporting and economics. These are three words that were used in 1972 when I took the CPA exam and are still being used today: prepare reports in a *consistent, systematic,* and *rational* way. You have to show folks that write checks and that control and have power in your industry and many other industries that the financial reporting is prepared in this way to achieve credibility. If you do not have credibility then you are in deep trouble. You want to do this over a long period of time. I am not saying that you cannot take a sophisticated reporting system and find a set of managers somewhere that can manage with that set of financials and maybe even convince rating agencies and the like what that means. The problem is as you look over a horizon of three, five, ten, or fifteen years, you may be doing future generations a disservice by assuming that. The people who are running the business are going to have the same capacity. You are using managements financial statements to balance targets and objectives. It is a balancing process that is a constant process. It is a never ending process. The numbers are not irrelevant. I am not saying that at all. What you really want to do is have a sense for what is going on beyond just the numbers themselves. You can always avoid the system. You can say the system tells me to do X but I am going to do Y because of thus and such. Or you can say you do not know exactly what the underlying numbers are, but you do know that if you do this it is going this way. You have to have a sense of direction and I think that is what this system would convey to managers of the company. You want management statements, you want to have reliable, credible information, and you want to be able to respond quickly to changing business in a circumstance. The financial statements are an underpinning of the capital management process. GAAP, value added or whatever, is what you want to deal with. You have to decide what world you are going to be in and who the participants are in the world, who the peer companies are in the world, and who

the people are who are going to be determining what your cost of capital is and accessing what the price of your stock is.

Okay, so we have financial statements and those have been constructed by a lot of us. Then we have the checkwriters, the users, and the various business unit heads, and they are starting to check off our progress over time. We need credibility. We do not need things that are confusing. We need some straightforward financial reporting, and need to admit that there are frailties and we need to build bridges between the economics of the company and the capital management process.

MR. GAMMILL: I made a list of things that I think need to be emphasized. Mutuals are going to need capital, too. So, you have to worry about the capital markets in a mutual company. You have to worry about them in stock companies. I think that management financial statements in many cases can be functions of GAAP. They do not have to be GAAP. Accounting systems do not impact the cost of capital, economics do. Any type of ROE is a financial reporting by-product. You always have to look at your underlying cost of capital and your economic capital management process and then see what that translates into in terms of accounting ROE.

MR. POLKINGHORN: Mr. Gammill, you talked a little about comparability between companies, from one company to another. Is it that the public or the outsiders who use these statements perceive that there is comparability? Or, do you really believe that there is? For example, I see companies where the provisions for adverse deviation are not consistent; companies who are much, much, much more aggressive on the amount of expense they defer versus another company. And so, from an insider's perspective I get the feeling that perhaps there is not that much comparability, but I can understand how the outsiders, the investment world, might think that there is.

MR. GAMMILL: Well, first of all, perceptions are the most important thing. Second, all financial statements are not equal. Just like all partners at Peat Marwick are not equal. If anyone wants to play the game of investing and making major capital infusions into these companies, they are dealing with them in any financial way that is material. They better get some pros, and the pros do not look at these financial statements from a naive perspective. You can

rank them, you can take every element of conservatism or whatever else you want to do and put them on a scale of one to ten. If you do not want it in writing, you may even get the professional to tell you exactly what he thinks about a particular company. If you want it in writing you have another story. No, the perceptions are extremely important. All companies are not created equal. The decisions you make on financial reporting may not always be done rationally even though you have tried your best. But, the idea here is what is managing capital or evaluating financial reporting is that you put as much structure as you can between yourself and the ultimate outcome of the decisions. I think that is the proven thing to do. I think it is proven to have a systematic way to manage capital, to do financial reports, or whatever. Because, when things go wrong it gives you a chance, wrong or right. There are always going to be deviations, as Mr. Collett mentioned. You have an opportunity to reconcile your decisions with the system. If you've got no system, you've got no ability to reconcile.

MR. WARNOCK: Actually, I think I agree with most of what Mr. Gammill said; however, I think that many of the advantages which Mr. Gammill referred to in using GAAP or something very close to GAAP are really only relevant if you are talking about reporting. I would hope that we would not confuse what is good for internal reporting with what is good for external reporting. I do not think that rating agencies are terribly relevant in respect to statements that we are doing for management purposes, that are not going to make their way into the outside world. They are going to be used for management only. Now it may well be that if you have two sets of statements and one is for outside consumption and one is for inside consumption and the world has found out there are two sets that have different results in them, perhaps there is a credibility problem and maybe that is something we would rather not deal with.

MR. MAX KLICKER: Mr. Warnock, in your presentation, the hurdle rate assumes a fairly important role or discount rate. If that changes from year to year, am I correct in assuming that you would show any change in value, because of the change in that discount or hurdle rate as a separate item?

MR. WARNOCK: I might back up to a bond analogy again. Look at what happens in the bond market. Let's say that you are in a time of 10% interest rates and you invest in a 30-year bond. You are a bond manager. One year later

those rates have gone from 10% to 15%. You now have an asset which if you sell it, you take a capital loss on it because you are discounting that fixed stream of income, the 10% coupons, at a 15% rate; so you have an implicit loss there. If you were an investment manager and you had incorrectly guessed about what would happen to interest rates during the coming year, I think it would be reasonable to say yes. You look at the capital loss which is implicit in the higher hurdle rate that you use at the end of the year.

Now, let's try and take that and contrast it to the insurance business. Do you want insurance company management making decisions about what is going to happen to the risk adjusted cost of the capital hurdle rate during the coming year? Do you want them to make decisions based on what their expectations are, especially if they are getting paid for it? Let's go back to the bond analogy and say they thought their hurdle rate was going down during the year. What makes sense to do is stay out of the insurance business for a year. Put your money into something short term and wait until the end of the year when rates are up. You can get higher profit margins on a business you will put on the books a year later, and invest all of your capital at that point in time. I do not personally think that we want management playing that game. So, I think for a device to measure management performance, I think that we have to have consistent assumptions -- including hurdle rate -- between the beginning of the period and the end of the period. Now, that does not say that we cannot true up those assumptions periodically. If we get several years down the pike and we realize that our assumptions are out of whack with reality, we can revise those assumptions. A way of doing that to the extent that those experience deviations from assumptions are outside the control of management (say as in a hurdle rate change because of economic circumstances) we basically do two valuations at the same point in time and qualify that differential, and that amount of change in economic value is forgiven -- so to speak. On the other hand, certain types of assumption changes you might not want to forgive.

Let's say you had set up an economic value of in-force business for the current year's issues based on optimistic lapse assumptions. Pricing actuaries said that they were great. The lapses were lower than anything the company had recently been experiencing, but they were using them anyway. So, if you did that sort of thing you would set up an extra value which would not eventually

be realized. What happens is that you go down the pike year by year as the adverse experience comes in; you bleed a little every year.

MR. KLICKER: Mr. Gammill and Mr. Collett, how would you view the effect of a change in this hurdle rate even though you perhaps did not use that term in your presentations? How do you view that as affecting your reporting system results?

MR. COLLETT: I guess my response would be that I think I am hearing a difference in some of what Mr. Warnock is saying about the purpose of the reporting system from what I was choosing to emphasize -- that is a distinction between evaluating management performance and reporting information to management that it needs, to do the things that it is going to do. I guess in particular I am thinking that GAAP exists as Mr. Gammill says. The reporting to the outside world exists. A lot of the information that management needs relates to what my GAAP earnings are likely to be. Why are they different? I was talking about a system of reporting information to management that management needs to do its job.

On the question about the hurdle, it seems less of an issue to me. When I think of value added, I am really thinking of it as the economic incremental value and the addition -- the performance in the current year -- is not so much locked into a system of evaluating, possibly compensating, management in lieu of the external objectives; I guess I view value added as most likely a year-to-year benefit and I want the beginning of period and end of period hurdle rates the same. If I have a before and after, I do not think I have a great deal of trouble deciding from time to time to alter those numbers. In fact, I guess I see them being surprisingly constant in spite of the interest market from period to period.

MR. GAMMILL: The essence of what I was trying to say is that the underlying economics of the company are in this capital management process and for example there are debt equity ratios. There is a reason why that is calculated. You don't borrow money unless you have equity -- except some real estate people have done a little bit of that and have gotten in big trouble. Normally, there is some debt equity. You borrow money because there is equity. The company has an overall cost of capital. In a particular time element with a particular

construct of businesses, its cost of capital is related to that overall risk. As you take on a new line, a new product, a new company, or whatever, the hurdle rate for that product has to be measured against what the cost of the capital is for the existing corporation. Once you start to use hurdle rates that are inconsistent with that determination, you start to impact the overall cost of capital for the entire company. That is essentially no investment. I think the marginal cost of capital is probably not as accurate as looking at how, if you borrow money at 10%, your hurdle rate is not 10% or greater. Because when you borrow that money, you are influencing that percent to the cost of capital across the entire company. You are really looking at all of your business units and their cost of capital may be changing over time. So it is a very complex situation.

MR. ALBERT GUBAR: I would like to comment on the last issue because it seems to be symptomatic of a lot of what is happening in American business today. I will state my specific and then I will get to what I perceive to be the more general issue. I believe that the hurdle rate should be something that is relatively immutable and the company should judge it on the basis of long-term expectations. As a matter of fact, I believe that almost all of the assumptions should be on that basis. How does it relate to what I started with? Because there is a great tendency -- and I see the insurance business doing this -- of going in the same direction to use short-term performance measures. One of the indentations to using it is that when you do not like the way things are going, you pick another set of assumptions and everything suddenly starts to look better. So, it becomes extremely dangerous, I believe, to change your assumptions too frequently. If you really goofed, then I guess I am backwards, you either take a lump gain or a lump loss and you don't count it; but it seems to me that the very important usage of all this is to judge management's performance. That is my statement briefly.

Now my question is, do we feel comfortable with this situation? Maybe it is a question of being able to communicate properly to management. GAAP reporting became the "white knight charging in on his beautiful horse" to solve all of our problems. All of a sudden we start talking about how GAAP is not really the right way to manage a company. Now that in itself starts to create, to me, significant questions. First, how do you assure comparability from company to company? (If you think that is important, I do, too)? Second, how do you

prevent the board of directors, or trustees, from getting a different basis of management accounting every year and swallowing the new basis as being better than last year's, so there is practically no continuity in what is going on? Third, how do you justify to the public that we think that internally we are going to manage on a basis that is such that we think it means something, but why should we tell them about it because they are going to be satisfied with something that we don't think is good enough for ourselves?

MR. GAMMILL: Those are good observations. You don't want to be changing the system a lot because that negates the credibility issue and you have to have credibility. Comparability exists between companies only because there are folks between the companies looking at financial reports that are publicly available or otherwise that can compare the two with some discipline and some sense of professionalism. Comparability will never exist between companies under any accounting model. Probably even under statutory because it in some cases is so far off of reality it is just difficult to understand what is going on between companies. It still comes down ultimately to people. Whether you are comparing financials, whether you are getting capital, whether you are communicating financial results, whatever you are doing, if the people can't communicate then you will be talking to yourself.

So you really need to talk to other folks. Everybody has a perception (that is the most important thing) and you have to come to grips with the perception and get a consensus. If you can't do that then you are in trouble.

MR. POLKINGHORN: I have a comment. It seemed that you were assuming that management's primary goal wasn't to determine how we are really doing, but to say that we look really good at all costs. I guess you have to take as a given that management wants to know how they are really doing and have an accurate picture or else all of the work that would go into any of these systems is not worth the bother.

MR. WARNOCK: I would like to make a couple of short comments. On the comparability issue, I think you have to balance flexibility and comparability. If you try and make the systems show what management believes ought to be shown up in the numbers, then you have to give up some on comparability. On the issue of when do you change assumptions, if you remember back to that control

cycle slide, one of the components in that was monitoring doing experience studies and seeing how you did. When we do our pricing, about the only thing we know for sure is that we are going to guess wrong. As soon as we have data in that tells us that we guessed wrong, then we probably ought to reprice our products if it is a significant difference. I do happen to agree that you do not go making small changes in assumptions every year. You ought to require significant deviation and experience from assumptions before you change those.

MR. GUBAR: I just want to clarify something. At no point was I referring to pricing. I was referring to the basis on which financials are reported within the company. Anybody that doesn't change his prices when he thinks things are changing is wrong.

FROM THE PANEL: Still, even on an in-force block of business, you could end up with lapse assumptions that are substantially different than your experience has been and it is clear that you have got the wrong assumptions in there. If you are tying together planning and reporting by using some kind of integrated process, you are going to be ending up with financial planning which is based on distorted lapse assumptions. So I think it all goes back to how material the deviation is and if the deviation is very material, recalculate it. I think that is one of the big problems with GAAP. I think the accountants stuck with the concept of "lock-in" too long.