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FAS 97 -- WHERE ARE WE NOW?

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- o The panel will look at how the industry has responded to the spirit and letter of Financial Accounting Standard (FAS) 97. The panel will address issues of:
 - Assumption setting and frequency of unlocking
 - Methodology alternatives -- pros and cons
 - Loss recognition/recoverability
 - Perspective of financial statement users
 - Conclusions regarding impact of FAS 97

MR. R. THOMAS HERGET: We will be talking about FAS 97, its past, present, and future. I am very pleased to have an outstanding panel of experts on this subject: Mike McLaughlin from Peat Marwick; Chuck Underwood from Deloitte, Haskins and Sells (DH&S); and Mike Eckman from Northwestern National.

Universal life (UL) was introduced in the early 1980s. For accounting guidance you had the 1972 Audit Guide and FAS 60 which came along shortly thereafter. As applied to universal life, it was fairly easy to find what you wanted in those authoritative sources in the way of accounting guidance. We had a proliferation of fund product approaches that prevailed -- a myriad of methods that nearly manifested mayhem in evaluating consistency between companies. So, in a way, an auditor may have had his hands tied in being able to adversely opine on a methodology -- you really couldn't state a particular method was prescribed. I hope you could still say it was not unreasonable given existing guidelines.

As UL prevailed and proved itself to be a viable product, accounting bodies gathered and decided to start developing standards for its financial reporting. About 1984, the Financial Accounting Standards Board started on this project, and in December 1986, after three years of analysis and study, it issued the Exposure Draft (ED).

The ED had something for everybody to hate. The Board and its staff received overwhelming written response soon after the ED's exposure. There were several unusual items in the ED: the dual accounting methods for traditional and UL, radically different revenue bases, a balance sheet orientation, overlooking of the pooling concept in benefit reserves, a two-step approach to deferred acquisition cost (DAC) (the cash surrender charge component distinct from other sources), no interest on DAC, and capital gains as revenue. The Board had focused on methodology consistent with other industries. We also had a removal of some of the perceived discretion of the actuary for establishing margins for conservatism, a point the Board was concerned with.

The Board received over eight hundred written pages of response; at that point it invited companies to testify. In June 1987, about 20 or so representatives put their best feet forward at Stamford. They made their appeals to the Board, which comprised eight world-class accountants and a staff of four.

The industry representatives started out telling the Board what they felt about the ED. I have gone through the public record and would like to share some comments I felt were very interesting. First Colony said, "We strongly feel that the Exposure Draft, if enacted as written, will have an adverse affect on the insurance industry." CIGNA said it was "quite disappointed with the results finally achieved." American General said, "We think we need a new Exposure Draft." Aetna said, "The amortization of DAC is a living nightmare." And the ACLI, just to make sure no one was confused, said "the Exposure Draft is a mess and ought to be abandoned."

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With that polite start, we had sixteen hours of accounting and actuarial testimony. The Board employed a technique of evaluating testifiers' appraisals in light of the testifiers' own financial statements. The testifier's commentaries would be refuted based on their own presentations, footnotes or lack of disclosure. The Board is a sharp group; if you do ever go in front of it, you do want to be well-prepared.

The only unexpected revelation that I heard there was that the industry, in responding to the Exposure Draft, unwittingly exposed the poor state of its information databases. In pointing out problems with ED compliance, a few actuaries spoke for the whole industry. The Northwestern National actuary said that "present accounting systems simply will not readily produce information that is necessary for the new revenue line." Travelers actuary said, "Many companies' existing accounting systems are not sophisticated enough to produce the data, no matter what effort is required." After the Board got a little tired of hearing this, the meanest, grizzliest Board member looked down his microphone and said, "Tell me, how do you manage your business if you don't have any of this information?"

So, after the Board listened to all the testimony, it went back to the huddle and the drawing board. Seven months later, it introduced FAS 97 as we know it. While there was still something that everybody could dispute, I was pleased to see that the end product was good, and it did reflect the industry's testimony within the scope of due process.

With that overview, we will now start to address the topic, FAS 97 -- Where are we now? Our first speaker is Mike McLaughlin. Mike is a Principal at Peat Marwick and heads its Midwest actuarial practice. The Midwest is basically any place that is cold in the winter. He has worked with several clients on FAS 97 implementations and spends a fair amount of time looking at the results of the implementation. His perspective has been distorted, I mean, balanced, by the close association with the accounting community. Mike recently submitted and published a paper in the *Society of Actuaries Transactions* entitled, "A Comparison of Alternative GAAP Methods for Universal Life." Mike will now address the volatility of earnings and the subsequent need for credibility.

MR. S. MICHAEL MCLAUGHLIN: Someone said that, after all the excitement of the ED implementation of FAS 97 in actuality has been a nonevent. The theoretical inconsistencies have now emerged as less conceptually difficult than originally thought, and the actual financial impact has also been less severe than previously supposed. Later you will hear a cross section of actual company opinions on those subjects.

However, we have come only a short distance since implementation. Most companies that restated in accordance with FAS 97 did so for the first time on March 31, 1989, a short six months ago. We have had only one complete quarter end since implementation, with results from the second complete quarter only just now coming in. We don't really, therefore, have much actual practical working experience with the statement, and so far nothing has been audited.

I believe that there are still some learning experiences ahead of us. Let me give an example. One company did really quite a good job of implementation, using a fairly sophisticated approach. There were some anomalies where the model didn't exactly match experience, but the results had been checked out pretty thoroughly, and overall the model seemed very good to the actuaries.

At June 30, due to favorable mortality experience in the quarter, its gross profits were high compared to what had been projected. The overall value of estimated gross profits increased, so prior amortization was reduced. The beginning DAC was restated, and it showed a change of \$1,000,000 at the beginning of the quarter.

Company management saw the net profits increase substantially for the quarter and concluded that the phenomenon was due to the large amount of prior DAC unlocking. Such a large increase in earnings was not likely to be sustainable, and management wanted to avoid building expectations of high profitability in the minds of the Board of Directors. The management people didn't believe the beginning DAC could have changed so much, so they decreased it by \$500,000, thus having the impact of the change in the current period and bringing quarterly profits much more into line with plan.

I mention this story to point out two things. First, although everyone had been told to expect some earnings volatility, it still came as a surprise. Second, it turned out to be extremely easy to decide that the results of the model couldn't be right; in other words, the volatility was blamed on the model, and so the results "needed" to be adjusted. Most of what I will say deals with these two issues, namely, earnings volatility and credibility of the accounting model.

CONCERNING EARNINGS VOLATILITY

I would first like to address one issue that recurs frequently in the situations I see. Forgive me for using another anecdote, but at one client we were reviewing year end results, and there had been relatively low profitability that year. The actuary examined the situation closely and observed that a large amount of new business had been issued. It was also observed that expenses had been higher than normal. Some of those expenses related to development of new products and computer systems.

This actuary decided that, since recoverability testing permitted it, higher acquisition expenses should be deferred. Never mind that the higher expenses were really not policy acquisition expenses. The higher deferred acquisition expenses brought profits into line with plan, and the actuary and management were satisfied.

In our review as part of the audit we saw the sharply increased deferred acquisition costs on new business, and we commented that the costs were not properly deferrable. His response was something like, "But isn't GAAP accounting supposed to smooth out earnings? I mean, that's why we use GAAP instead of statutory, isn't it?"

The answer is, actually, no. GAAP is really not intended to smooth out earnings. Perhaps it is my frequent association with the accounting profession, but I have gradually absorbed a few concepts from the accountants. One concept that drives GAAP accounting for insurance companies (as well as everyone else) is that profits are to be reported over the period of time in which they are earned, while losses are to be recognized immediately. Acquisition costs related to new policies sold are not losses and are, instead, spread out. The amortization of those costs is intended to be proportional to the profits (or, revenue, in some cases), although, as we know, amortization at the credited rate spoils the neatness of this a little.

That is the specific case in which spreading of uneven costs is proper. Many other costs and gains are not to be spread. Examples include many costs that do not fit the category of policy acquisition costs in paragraph 24 of the statement, and realized capital gains and losses in paragraph 28.

It is often true that management wishes to smooth out earnings, because the shareholders, that is, the owners of the company, are presumed to want to see steady (if not steadily increasing) profits. But that smoothing can only be achieved by managing the actual operations of the company, and with more than a little luck. It cannot properly be achieved by manipulation of the accounting system. Or at least, it shouldn't.

Consider what would happen if a company really had much larger than normal profits in one period, but failed to properly report them (by adjusting reserves, for instance). Further suppose that you owned stock in that company, but sold it because its reported profits had failed to live up to expectations, and the stock price was underperforming. What would be your reaction if you found out, a year later, that profits were up, and stock prices were up, largely due to the financial results of the period of time in which you held stock? You would be justifiably annoyed at management's concealment of real profits when they actually occurred, even if their intentions were good and even if the higher profits were temporary. The converse scenario, where poor profits are concealed, may be even worse.

The Efficient Market Hypothesis, used by econometricians, says that investors are not as dumb as we think them to be. They know our company and the economic environment, and they make allowances for increased or decreased profit results, based on financial statements and the disclosures therein. We should therefore not try to anticipate their decisions, or modify our results because we think we need to "do this for their own good." Rather we must report with all the accuracy we can reasonably muster, and we must explain what we did in financial statement disclosures. If fluctuations in profits occur, it is not the responsibility of the accounting system to eliminate them, rather the accounting system should report profits for each period as accurately as possible. As actuaries, we are critical to the proper operation of the financial reporting system, so

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we must be very clear on our duties. We should not smooth out profits; we should not eliminate fluctuations. In fact, it is our duty and responsibility to preserve them and report on them accurately, if they are real.

Of course, we certainly don't want to create phantom fluctuations that should not exist. Actuaries are going to have to be the champions of consistency and balance in operating FAS 97 GAAP. We will need highly credible models that are operated very responsibly.

On the subject of credibility be aware that credibility is weakest in the areas where most judgment is used. There are several areas where judgment is required in the setting up of the accounting model. For instance there is the choice of plan types. The deferred annuity product could fit three different categories, depending on its characteristics. A single premium deferred annuity (SPDA) may be a limited payment contract. A flexible premium deferred annuity with non-guaranteed terms may be either a universal life type contract, or an investment contract, depending on the extent to which noninterest related elements (such as surrender charges) contribute to the operation of the contract. The product design may make it difficult to determine just how relatively important the different characteristics of the contract will be. The consequences of mistyping a contract could result in different accounting results. Plan typing should be thought through, decided, and documented. Tests should be run to study the impact of different implementations, so that surprises don't arise later. If a block of business is typed, based on the preponderance of the characteristics of the contracts in the block, and later the distribution of contract types changes due to new business, a change in type of block of business may become necessary. This is a good example of what you don't want to happen, and it indicates that need to model at a sufficiently detailed level so that this will not occur.

Another judgment decision is just how detailed should the modeling be? Is a one-cell model less accurate than a 500-cell model? If the characteristics of a block of business can be examined in total, and a single cell defined, why not use a single cell? I am aware of large companies that decided to take a fairly simplified approach to FAS 97 implementation, and we couldn't find a good solid reason why they shouldn't, at the time. In retrospect, one main reason why the simple approach isn't good is that it is hard to defend when times get tough. It doesn't look as accurate. And perception, oftentimes, dictates reality. And unfortunately this credibility problem will likely arise only at the most inconvenient time. It is when profits are unexpectedly high or low that our decisions are most likely to come under scrutiny.

Other speakers will touch other judgmental areas. In each judgmental area we should test and document our reasoning clearly, to be able to later defend our credibility.

Credibility is the defense you will need when, one cold day, your numbers show that we lost money this quarter, even though we made money the previous quarter. How are we going to explain this to Mr. Bigbucks, the chairman? Why can't we just adjust beginning DAC? You'll be changing it next quarter anyway, won't you, so what's the harm? We had better have a model that can withstand nuclear attack.

In our review at one client, we looked at the FAS 97 implementation results. As it turned out, there was zero adjustment to GAAP surplus after implementation. This was quite a coincidence! The actuaries had reviewed about 90 plans, had used decennial ages, had used all the right assumptions, and after weeks and months of detailed work, had determined that FAS 97 implementation made no difference.

Now that I am a little wiser I would not be as surprised as I was then. But I did ask the actuary if his calculations properly reflected all actual past experience. His answer was that, well, all the assumptions are based on their actual experience or on industry experience. But how could we check that actual results, cash flows for example, are being reproduced? This client had used a factor method to calculate DAC and unearned revenues (UER). Thousands of factor records were generated, and mountains of paper were produced, a set of 25 annual factors for each plan, quinquennial age, sex, smoker/nonsmoker, etc. But the cash-flow items for the income statement were all taken from the administrative system. In other words, the DAC was the result of all input items, with no regurgitation of cash-flow items to check the accuracy of modeling, or even the accuracy of mechanical execution of the model. We asked the client for validation of cash flows implied by the amortization schedules in the model, but so far have seen no results.

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Let me hasten to say that the model may be perfectly accurate. The people at this company certainly put a lot of work into it, and I have no reason to think that there are errors. But they have no way of proving that the input reproduces actual experience. They lack credibility.

The model needs to prove itself not only by reporting DAC and UER but also by giving enough cash flow and other information to permit comparisons to actual experience. Examples include the need to validate fund balance, units in force, deferred expenses, cost of insurance (COI) charges, death benefits paid, premium deposits received, surrenders paid, investment income, interest credited, expense loads received, and expenses incurred. If all of these items can be validated within acceptable tolerances, not only is the model vindicated, but also (as is likely) the validation may occur only at a high level (all UL combined, for example), and thus the detailed analyses permitted by the model are also validated. The profitability by source for subgroups of business is likely a valid and accurate piece of management information that we could obtain from no other source. We can obtain it, believe it and use it in decision making because the model is validated.

I have seen models that use unit assumptions as input, but produce actual past experience cash flows on a calendar year basis, thus permitting total validation of the model. If modeling has been done at too coarse a level, then compromises must be accepted in the validation process. It is impossible to get a perfect fit unless your company's business is simple indeed. But such a model exposes clearly whether it fits actual history, and if not, how close it is.

This validation of model results to actual experience is essential in establishing credibility. So far I have dealt with credibility from the model office perspective. If we do a thorough, mechanical job, then, we should have credible results.

However, the mechanics of FAS 97 also call for full reflection of actual past experience. There are two issues here: how often do we really have to input actual past experience, and we will come to that; but more importantly, when we do input past experience, if we have procrastinated, we will find the full catch-up effect occurring in the quarter in which we make our modifications. Even worse is the impact of future assumptions on present results, because an assumption change as to experience in the future impacts the entire DAC amortization schedule currently. With regard to past experience, we don't have to reflect actual past experience in future assumptions until we are certain that we have a change in expectations as opposed to a fluctuation in experience, but there is no provision for ignoring what actually happened in the past, except if it has immaterial impact. Therefore, we should reflect past experience each quarter. Remember we want to avoid smoothing out real experience. We cannot simply ignore the fact that, while our assumed mortality table predicted \$10,000,000 in death claims, we had only \$7,500,000. The difference is \$2,500,000 in death claims that will not be reflected in our model if we ignore them. Depending on the policy details, that difference of \$2,500,000 would be partly used up in extra amortization of DAC in the current year. Suppose for instance that one-half of estimated gross profits are needed to amortize DAC. The extra profit on the current quarter will change that proportion, although probably not by much. So let's use one-half. That means that, of the extra \$2,500,000 in profit, about one half, or \$1,250,000 would amortize DAC and the other half would fall through to the bottom line, and we would see higher profits that quarter of \$1,250,000.

Suppose we ignore that temporary change in mortality and do not change our model or our amortization schedule. The full \$2,500,000 would show in higher profits.

In other words, the reflection of all actual past experience in the model is a necessity. Otherwise we will be introducing even greater false volatility, and less faithfulness to actual emerging experience, than there should be.

Let us now assume that we are reflecting past experience as it emerges. We have solved the practical problems, and we are not worsening the effects of experience fluctuations by ignoring them. How often should we change future assumptions? We know that future assumptions must be realistic. But consider what happens when our perception of realism changes. We thought, for example, that we would earn a 160 basis point spread on our deferred annuities, but over the last couple of years we have never earned more than 150, and the average has actually been closer to 145. Maybe we should be a little conservative and assume 140 for all years.

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There are reasons why this is a bad idea. First of all, conservatism is not permitted; FAS 97 explicitly prohibits it. Second, one or two years of experience is a short time in the overall life of a deferred annuity sold at a moderately young age. We aren't sure what long term experience will be. Third, the sudden change of estimated gross profits for all future years by a substantial amount is going to have a huge impact on profits in the current quarter. The actuary will have created a huge, false fluctuation in profits simply by changing the expectation of events over the future years.

Let me remark on why conservatism is prohibited. Is this just some darn accountant, meddling in an area that he knows nothing about? Think again. Suppose we knew perfectly well what future experience would be as to interest rate margins and they will always be exactly 150 basis points. But in our calculations we use 125, to be conservative, on the grounds that we're not absolutely sure of future experience, and anyway we've always done it that way.

Each quarter as we report our numbers there will be favorable profitability, because we will actually experience a 150 basis point spread and we calculated our DAC using 125. So every quarter we will restate beginning DAC, and every quarter we will report profits better than expected. Remember again that we are not supposed to manipulate our accounting system. We should not be understating expectations, or holding back profits, in order to benefit future shareholders at the expense of current ones. Conservatism may be appropriate when testing for solvency, but not when company worth is at stake.

Now let me comment on the need for caution in changing future assumptions. I believe they should be set with cold-blooded realism at the time of implementation or at the time a new plan is introduced, to the best of everyone's ability. Perhaps, I hope no accountants are listening, there should be a teensy weensy bit of conservatism, just to avoid any optimism in the recoverability testing process.

Concerning future assumptions, if the need for a change starts to become apparent, it should be reflected gradually, in accordance with the confidence that you have that a true change in experience expectations is manifesting itself. One way of making the change gradually and in accordance with building evidence as to the need to make a change, is to modify assumptions in the near future in accordance with the recent past, but to grade into the ultimate level of realistic expectations that were originally set. In other words, anchor your most distant future assumption and grade into it from your present level.

I have a brief example: it's hypothetical but realistic:

	DAC (\$000)			
	<u>12-31-88</u>	<u>12-31-89</u>	<u>1989 Profit</u>	<u>Plus Unlocking*</u>
Original Schedule	12,066	11,788	3,104	
Favorable 1989 (only) Expense	12,358	11,057	5,668	163
Continuing Favorable Expense	13,939	13,741	6,191	1,045

* UER not shown.

My remarks about caution in assumption setting do not apply when there is certainty about the need to change future assumptions. If an event occurs that will with virtual certainty change future profits (one possible example: the current scale of COI charges is changed), then when that event takes place and the certain change in future profits is known, it must be reflected immediately. If there is a blip in profits as a result, then so be it, not only because that is what the rules of the game say, but also because that is what your owners and prospective investors believe you are doing.

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In the above example, a company set up an original DAC amortization schedule of \$12,066,000 at the end of 1988. Projecting forward that should be \$11,788,000 at December 31, 1989, and we think that we're going to earn about \$3,104,000 in 1989.

But the second line shows what actually happened. In 1989 there was favorable experience; mortality was about 30% better than expected. So, there was a significant amount, something like \$3 million, of increased gross profit due to favorable mortality experience.

Well, we reflected all that. The beginning DAC number is higher, \$12,358,000; the ending DAC number is a little lower, about \$11,057,000. The 1989 profit that we show is \$5,668,000, based on the new estimated gross profits, plus another \$163,000 because of unlocking of prior DAC. My hypothesis is this is what we should really reflect.

Let's say, though, that the actuary determines that unlocking is necessary and decides to reflect that 30% mortality improvement in all future years. That's the third line I call "Continuing Favorable Experience." Look what happens with the DAC. The beginning DAC is much higher at \$13,939,000. Ending DAC is also higher, \$13,741,000. The 1989 profit is about \$6,191,000 and unlocking is \$1,045,000. The company will earn about \$7,200,000 which is more than double what we originally expected. It is also a whole lot higher than what we "shoulda done."

Now we go to the second example, which takes us from 1989 to 1990.

	DAC (\$000)			
	<u>12-31-89</u>	<u>12-31-90</u>	<u>1990 Profit</u>	<u>Plus Unlocking*</u>
Original Schedule (Assuming Continuing Favorable Experience)	13,741	13,222	7,311	
"Unfavorable" 1990 Exp.	11,057	10,340	4,095	<1,497>

* UER not shown.

The top line is the new original schedule. This assumes that mortality experience will continue at 30% better than originally scheduled. The beginning DAC scheduled here at December 31, 1989, is the ending DAC of the prior year (that's \$13,741,000); at the end of 1990 it is \$13,222,000. Profit in 1990 is about \$7,311,000. Look at what happened in 1990. In fact, mortality experience went back to exactly what it had been in the more distant past.

So the 30% improvement was a 1989 phenomenon only, and our amortization goes back to what we should have used. The beginning of 1990 value should be \$11,057,000; end-of-year value should be \$10,340,000; 1990 profit should be \$4,095,000, reduced by an unlocking of \$1,497,000. I might mention I didn't show unearned revenue on this line. If you try to tie some of these numbers out, they are not complete, but they are all consistent.

The third example is just a quick summary of what we actually did.

	<u>TOTAL PROFITS REPORTED (\$000)</u>		
	<u>1989</u>	<u>1990</u>	<u>Total</u>
Favorable Experience 1989 Only	5,831	4,095	9,926
Continuing Favorable Experience	7,236	2,598	9,834

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Favorable experience occurred in 1989 only. If we had known that, we would have showed a profit in 1989 of about \$5,900,000.

There are some rounding problems in this example. But by making the incorrect assumption that we should unlock all future assumptions, the continuing favorable experience scenario caused us to report about \$7,200,000 in profits in 1989 and only about \$2,600,000 in 1990. So we've shifted about \$1,400,000 or \$1,500,000 from one year to the next. I think this a fairly realistic example of the magnitude of fluctuations that can be introduced into earnings if assumptions aren't set carefully.

I will just conclude by reiterating that as actuaries we have a big responsibility to report earnings, whether level or fluctuating, as accurately as we can. We have to operate our model accurately, consistently, and in an auditable manner. We need to take pains not to create any greater volatility than what is really there.

MR. HERGET: Our next speaker will be Chuck Underwood, from the Cleveland office of Deloitte, Haskins and Sells. We're proud to have this consultant here who is one of the reigning authorities in the Cleveland area on FAS 97. Chuck has been with DH&S for about 3 years; he has a fair amount of experience with audit clients who have reported under FAS 97. He has also had some experience working with about ten clients who utilize purchase accounting.

Chuck is also pleased to report that his firm will soon be the third largest accounting firm today under the proposed name of Deloitte and Touche.

But, what's new? We're going to have Chuck come up and talk about annuities, purchase accounting, and alternatives when you encounter negative amortization.

MR. CHARLES M. UNDERWOOD II: The first topic is investment contracts. In accounting for investment contracts, the first thing you have to do is decide whether a particular policy is an insurance contract or an investment contract. FAS 97 tells you to treat an annuity as an investment contract if there is not a significant insurance risk involved. Unfortunately, FAS 97 doesn't specify what constitutes a significant risk. I've seen people define the risk as being significant if anywhere between 5% and 20% of the reserve is on life-contingent payments.

But, in any event, once you've determined that there is not enough insurance risk to qualify an annuity as an insurance contract, it is defined as an investment contract. The statement basically tells you that you have to treat the contract like other financial instruments. You do not book premiums as revenue, but instead you credit them directly to the liability account. You account for them the same way you account for other financial instruments.

A financial instrument is defined in terms of what a financial asset is. A financial asset is either cash or equity or, and this is somewhat oversimplified, the right to receive cash or equity. A financial liability is the obligation to deliver cash or equity. A financial instrument is defined as something that is a financial asset to one party, and a financial liability to another party.

To qualify as a financial instrument, the contract has to have both of those characteristics. Ready examples of financial instruments would be an installment loan, a savings account, a checking account, a bond, or an insurance policy.

DAC is not a financial instrument; the statement is totally silent on what you do with DAC. In accounting for the policy reserve itself, you normally go the account balance approach, just as you would with universal life, if there is an account balance. If not, you can effectively manufacture one by using present values on the same basis as originally used in setting up the contract.

Now, coming down to DAC, there are effectively two choices readily available. First, you can look at the retrospective deposit method and treat it in exactly the same manner as for universal life. Second, you can look at it from the interest method standpoint -- analogous to what banks have to do with loans under FAS 91. The interest method is very similar to net level premium valuation except you're solving for the break-even interest rate rather than the break-even premium rate.

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Choosing between these two methods can be something of an art. There are situations where one or the other is clearly the best choice. If you 1) have an account balance, 2) have policy variables that are not fixed at issue (like the interest credit rate) and 3) have significant revenues other than interest receipts (like surrender charges), then the obvious choice is to use the retrospective deposit method. You effectively have the same process as you would for universal life, including periodic unlocking exercises.

On the other hand, if you have 1) no account balance, 2) fixed contract terms, and 3) interest is your primary revenue source, it would seem logical to solve for the break-even interest rate using the interest method. Your profits would then emerge as the constant spread on your net liability at the beginning of each period.

Now if you have a contract that falls in between these two extremes, sometimes you have a choice. For example, an immediate annuity certain does not have an account balance but does have a cash surrender value. You can very easily manufacture an account balance by discounting it at the guaranteed rate on which surrenders are charged, or by taking the surrender value. The one variation from the textbook methods that I've seen applied to insurance contracts is that some companies have chosen to ignore maintenance costs in setting up their liability or their DAC amortization schedule. For a single premium deferred annuity with an increasing account balance, ignoring maintenance costs would normally be slightly conservative. There is some support for ignoring maintenance costs, if the company chooses to do it, in that FAS 91, which applies to loans, says that all maintenance costs shall be expensed as incurred. On that basis, leaving them out of the valuation formula would be appropriate.

Of the various products that fall under this category, the easiest one is the supplementary contract not involving life contingencies. These contracts are generally easy because they usually don't have any DAC. If you ignore maintenance expense, you'll come out with the same answer, whether you use the retrospective deposit method or the interest method.

Supplementary contracts involving life contingencies can still fit into the investment contract category if the survival risk undertaken by the company is not significant. And here again they usually don't have any deferred acquisition costs. The first test is getting a set of criteria and deciding which of these contracts are limited pay life and putting them in that slot. The rest would go under the investment contract category. Normally here you'd be using the interest method.

SPDAs normally use the retrospective deposit method since they usually have account balances and, in most cases, an annually-declared interest rate, rather than having a fixed guaranteed rate to maturity. So you set up your DAC and amortize it in precisely the same manner as you would with universal life, amortizing on the present value of expected gross profits, discounted again at the credited rate, just like universal life, and reflecting surrender charge revenue, as well as other contract charges, with periodic unlocking. When you have significant surrender charges, your persistency assumption can be very important in setting up the amortization schedule.

With single premium immediate annuities and structured settlements you have the same considerations as supplementary contracts involving life contingencies. You first have to choose limited pay or investment contract. These contracts may have deferred acquisition costs. Whether they turn out to be limited pay contracts or investment contracts, you're going to start off by coming up with a net policy reserve that gives you break-even result at issue. If you are using the interest method, you're treating them as investment contracts.

Normally you would be using the interest method, but the results between limited pay life treatment and investment contract treatment can be very similar. In fact, you could, if you chose your assumptions properly, make them turn out to be virtually identical, which would obviate the affect on your balance sheet. The only difference between the choice of limited pay versus investment would be that, if it's limited pay, your premiums are revenue; if it's investment contract, they are not.

Again, a limited pay contract would be subject to FAS 60, locking in your original assumptions. Under an investment contract treatment, if you're using the interest method, you'd be obligated to unlock for persistency assumptions, as prescribed by FAS 91. I haven't had much involvement with guaranteed investment contracts (GICs), but it would seem logical that your typical

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investment contract is going to have an account balance, or something pretty close to it, and a lot of revenue sources other than interest. So it would seem more logical to go the retrospective deposit method with guaranteed investment contracts.

The last point on investment contracts is that FAS 97 specifically excludes them from the statement that loss recognition (required under FAS 60) applies. That does not mean you don't write down DAC when you've got a loss coming. But it means the specific loss recognition requirements under FAS 60 do not apply to investment contracts.

Now there are two areas in accounting literature that mention loss recognition. FAS 5 requires a loss to be recognized if the loss is probable (probable is defined as likely), and if it's reasonably estimable. And there is a lot of feeling that this requirement means you'd have to have more than just a best estimate (that a loss is coming) in order to take your loss recognition.

However, FAS concept statement 5 brings out the concept of asset impairment, which basically says if the value or future utility of an asset is impaired or eliminated, you should write down the asset. So if you have an investment contract with a DAC and you expect some future losses, it is definitely appropriate to write down the asset under the concept of asset impairment. The issue of loss recognition and a number of other issues regarding investment contracts as a whole are still unresolved. This is partly because FAS 97 specifically says to account for them the same way as for other financial instruments. The FASB itself has recently begun deliberations on what it wants to do with other financial instruments. It has appointed a task force which has had one meeting, as I recall, and is supposed to produce a discussion memorandum sometime in the second quarter of 1990. So the final word on investment contracts under FAS 97 will likely be a year or two away, because whatever it decides for banks will apply to insurance companies.

Purchase accounting was affected more than I thought it would be by FAS 97. The first piece of purchase accounting (it's really a two-step process) is you have to come up with a balance sheet as of the acquisition date. I'm talking accounting for an acquisition by the purchase method now. The balance sheet as of the acquisition date is not affected by FAS 97. That's ruled by APB 16. The rules basically say you break down the purchase price into the individual asset and liability components.

What you would normally do for an individual insurance contract is to calculate a net liability for the contract, based on currently applicable assumptions as of the date of acquisition. This valuation can have provision for future profit in it, but it should be based on current assumptions. Once you've calculated the net liability, you implicitly or explicitly allocate assets with the same fair value to back up the contract. So in accounting for each contract as of the acquisition date, you don't have a gain or loss on the contract itself. And then from that starting point, using the net level premium method or what Interpretation I-D calls the "defined initial reserve method," you calculate the net premium which will mature the policy from that starting point. Thereafter it is relatively routine.

But, with FAS 97, particularly with universal life contracts, the rules have changed this procedure, because under FAS 97 you have to hold the account balance as your policy reserve. This means, if you have, for example, calculated a net liability as of the purchase date as \$800 and your account balance is \$1,000, you've actually allocated \$800 worth of assets as of the issue date, but you have to put up \$1,000 in liability because of the provisions of FAS 97. The \$200 difference has to be reflected as an intangible asset on your balance sheet, commonly called present value of future profits on business in force, or value of business in force, or something of that nature. Once you set it up, the \$200 is primarily related to the acquisition of new business, and it is obviously going to vary with the new business, so it is actually an acquisition cost as defined by FAS 60, paragraph 28. This means for the universal life contract you have to value it the same way you value DAC for new issues. Use your post-acquisition estimated gross profit, discounted at the contract rate, as the basis for amortizing this asset.

As I said a couple of minutes ago, this value of business in force we are treating as a DAC was not necessary under FAS 60, because you were allowed to start with a policy reserve equal to the net assets that you allocated to the policy. Along with the retrospective deposit method, you are required to periodically unlock the same way you would with new issues. You are required to use loss recognition if it's called for. Because of the nature of purchase accounting, materiality may play a more important part in your deliberations of accounting procedures than it might for direct

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issues. First of all, by definition, when you buy a company, policies in force as of the purchase date automatically constitute a closed block which will be declining. If you continue to write new business, which you would normally expect to do, new business you put on the books, combined with the decline of the existing block that is subject to the purchase accounting, will make that block less significant relative to the enterprise as a whole as time goes on. As a result, it may be feasible to use approximate methods, or simpler methods to approximate the results you want from purchase accounting, without fear of the distortions becoming material.

For example, a company might use the regular defined initial reserve method, even though it's an interest sensitive product, or the so-called "return on investment" method, where you take the statutory reserve minus the present value of future profits discounted at a high risk rate of return. That's a perfectly appropriate method for calculating the balance sheet as of the purchase date, but it's not the prescribed method for accounting for that liability after the purchase date. However, if your interest rate is low enough, it will be close to using the true retrospective deposit method in the early years. It's only after 5 or 10 years when the results start to get distorted, and by then the whole block may be immaterial. So you can defer the problem and hope that it goes away. In many cases it will.

One thing to remember when you use any approximate method or deviate from what is prescribed by the standard, you have to periodically go back and rejustify the method you are using, to make sure it hasn't strayed too far from the mark. Goodwill is of course not policy related, and therefore not affected by FAS 97 or FAS 60. I would like to close this section with a couple of examples of what some companies did in adopting FAS 97 under purchase accounting.

One company was bought in 1988 and adopted FAS 97 at the time of purchase, to get both purchase accounting and FAS 97 as a single adjustment, rather than have to do the work twice. The people there set up a policy reserve equal to their historic GAAP net liability calculated just as they had before the purchase, minus a value of business in force calculated on the ROI method, with a 15% discount rate. That was as of the purchase date. For traditional contracts they effectively used the defined initial reserve method. For universal life and single premium deferred annuities, they used the retrospective deposit method textbook style as stated in FAS 97.

Another company, which also was purchased in 1988 and which had adopted FAS 97 as of its purchase date, valued its purchase GAAP balance sheet using statutory reserves minus present value of future profits at a risk rate of return yield. It was a relatively low risk rate of return, but it was the ROI method the people there used. They are continuing to use the ROI method for future policy liabilities, having demonstrated that the distortions will not be material for at least 5 years and probably beyond that.

A third company that adopted FAS 97 in 1989, this year, had no universal life in force at the time it was purchased, and had a 15-year amortization schedule for the value of its SPDA business in force. On examination, when the people there adopted FAS 97, the FAS 97 rules did not require any adjustment at all. They didn't have to make any adjustment to their purchase GAAP valuation. They had to do a lot with their post-purchase universal life issues, but as far as purchase accounting was concerned, they didn't have to do anything special.

The last company, also adopting FAS 97 in 1989, set its benefit reserve equal to the statutory reserve. It used the ROI method for present value of future profits, but it discounted the future profits at the yield rate, so the results were a very close approximation to the defined initial reserve method.

The last subject on my agenda is negative expected gross profits (EGPs). I'm going to read what the statement says: "If significant negative gross profits are expected in any period, the present value of estimated gross revenues, gross costs, or the balance of insurance in force shall be substituted as a base for computing amortization." That effectively is giving you three choices.

Before you try to decide whether you're going to use gross revenues or gross costs or insurance, first look at aggregate results. You're almost certain to run into negative EGPs in a number of valuation cells no matter who you are. But what really counts is whether they show up when you combine them at a higher level. If your negative EGPs are covered by positive EGPs in other cells, you don't have a problem, and you can continue on with the same formula.

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Use as high a level aggregation as you can be comfortable with. I think at the very least, calendar year of issue and plan should be the lowest level of aggregation to use for this purpose. If aggregating your results doesn't take the negative EGP away, I think the next thing to look at is your expense assumption.

The key to expense assumptions is to make sure that your calculation of EGP includes only policy-related maintenance costs, the policy-related acquisition costs specifically defined in paragraph 24 of FAS 97. No other costs should be included in your calculation of estimated gross profits.

You don't want to include overhead costs which are not policy related. You obviously don't want to include deferrable acquisition costs, and you particularly don't want to include policy procurement costs which are not deferrable under FAS 60 because they're not primarily related to or don't vary with the acquisition of new business. If a cost doesn't vary with the acquisition of new business, chances are it's not a policy related cost. It should be treated as overhead expense and should not be in the formula for estimated gross profits.

Some of the kinds of cost you want to make sure you have gotten rid of are advertising, home office marketing costs which aren't policy related, renewal commissions in excess of the ultimate level, executive salaries and some other office costs which really belong with corporate overhead rather than being policy related.

If revisiting your expenses doesn't help you, another place to look is the other assumptions. Particularly, are your mortality expectations consistent with your mortality charges? And are inflation assumptions for your maintenance expenses consistent with your assumed yield? Those are two areas to work with. You should review all the assumptions while you're in the process of revisiting.

And while you're at those assumptions, if the negative EGPs still persist, you may want to adjust the policy charges or credits that you have some control over. If you think you can increase mortality charges or lower your credited rate in order to increase your spread (if you can get away with it without having a dismal persistency experience), this is one of the reasons you might want to do it: because of running into the negative EGPs.

If you can't cure it with the policy charges and credits, and you still have significant negative EGPs, you certainly should do a gross premium valuation to determine whether you have a loss recognition problem. You may or may not, but it should be looked at. If you do have a loss recognition problem, the alternate amortization schedule for your deferred acquisition costs is an academic affair. You are subject to the FAS 60 rules for accounting for the loss recognition for premium deficiency situation.

And finally, if you notice that you have negative EGP, you may wish to determine whether the effect is material or not. In many cases it may be relatively small. Ignoring negative EGP (or just zeroing it out in your calculation) may not materially distort the results, saving you the trouble of reverting to the alternate amortization schedule for this one block of business. I have seen a lot of negative cells. I realize it is early in the game for FAS 97, but I have not yet seen a situation where the company actually reverted to the alternate amortization method. If you do have to, the statement gives you three choices: you can use insurance in force, you can split your estimated gross profit into its revenue and expense components and total up the revenues, or you can total up the expenses and use either one. With any of the three bases, present values are calculated using the contract rate, and the formulas are the same as with EGP as the calculation base.

MR. HERGET: That was an amazing display of versatility. You handled three diverse topics very well.

For our final speaker, I would like to introduce Mike Eckman from Northwestern National. Mike's insurance experience has been about 15 years with two large companies. Before that he was with the Pentagon in Washington. We figured this would make him well qualified to interpret and understand some of the FAS 97 options in front of us. Mike will be talking to us about some recent experience he had explaining FAS 97 results to securities analysts and talking about a unique way his company has managed to implement FAS 97 that really makes the most out of it.

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MR. MICHAEL V. ECKMAN: I think it is fitting that I, who work for a life insurance company, should speak after representatives of a software vendor and a public accounting firm, because in the end, once FAS 97 has been installed and once the auditors have passed on the implementation, it's the employees of the company who have to explain it to the management, stockholders, and securities analysts. So I will talk about how a company and its owners might utilize FAS 97 statements and how a company can cope with the significant changes in revenue and earnings, and I will review a survey of companies with experience with respect to FAS 97. I'll also review a number of issues that might arise either while FAS 97 is being implemented or when a company first reports FAS 97 earnings.

Before reviewing how a company might utilize the FAS 97 statements, I'll give you a brief description of the implementation of FAS 97 at my company and its subsidiaries. We defined a valuation block using plan of insurance, marketing method, and years of issue. More than one year of issue or plan of insurance may be included in a valuation block. The estimated gross profits and deferrable expenses are projected for each block. The amortization period varies from 25 to 50 years depending upon the plan of insurance, projected experience and any systems limitations. We elected to use the original interest crediting rate for the calculation of the present values and the accumulation of the deferred acquisition cost balances. We referred to the percent of the estimated gross profit required for amortization as a k factor. I'll be using the term "k factor" throughout the rest of the presentation.

At each quarterly valuation we substitute actual experience for that estimated. Since actual experience may affect the amount of business in force or the amount of policyholder account values in the estimates of future years' experience, substituting actual for expected may affect the future expected gross profits. At each quarter the DAC is recalculated from inception and any catch-up or difference between the DAC reported at the end of the prior period and the one being calculated for the same time now is identified. The new revised estimated future gross profits are stored for future valuations.

We've decided to take advantage of the volume of information created by our FAS 97 systems to develop an earnings by source capability. We want to be able to compare actual results of the financial plan and those of the prior periods. This requires that the financial plan calculations be done at the valuation block level. It also requires that assumptions in the plan and the valuation be made on a consistent basis.

In the analysis of earnings by source the estimated gross profit elements for mortality, expense, interest and surrender charge are analyzed. We plan to identify how each variance of actual to expected affects amortization directly and by its influence on the k factor. The impact on the expected gain should be $1 \text{ minus the } k \text{ factor times the variance}$. In addition, the very fact that actual experience differs from that assumed will give us an end of the period k factor different from the value at the end of the prior period. Changes are small from period to period. Separately, we identified a contribution to the current gain caused by the truing up. That's what we refer to as substituting actual experience for expected. We compare the reported and recalculated DAC for the prior period.

We have also used FAS 97 to help us develop corporate audit capability. We've created a corporate database which includes definitions of valuation blocks and the assumptions used. As new products are developed, we will require that the assumptions for these new blocks and projected results be furnished to the database. To keep the database up to date we require quarterly supplemental information from business units which give the detail of the amortization of the DAC by valuation blocks. Supplemental information includes policy count, insurance in force, policyholder account values, deferrable expenses, estimated gross profit elements, and the reported and recalculated DAC amount. With this information we can review the characteristics of the valuation block and verify that FAS 97 is applied consistently across blocks of business and business units.

This consistency was one of our primary objectives when we became involved in implementing FAS 97. We will also be able to perform an independent review of the results to identify any blocks requiring unlocking or loss recognition. In the event of an unlocking, which is the changing of the future assumptions in the calculation of estimated gross profits, each business unit affected must prepare a proposal. The proposal identifies the need for unlocking, specifies the new assumptions, and quantifies the financial results.

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Shareholders, except for institutional shareholders, have not demanded much explanation of FAS 97. We've reported significant revenue drops, we've disclosed the effect on earnings (which has been positive), and we have not received any questions to date. Securities analysts and institutional shareholders, however, have been interested in the implementation. Compared to the reaction to the Exposure Draft, FAS 97 is somewhat of a nonevent. The analysts and institutional shareholders have seen that most companies have reported modest equity write-downs and some earnings changes. Some analysts are concerned about the loss of premium revenue as a convenient index used to project earnings. We've continued to publish new annual premium information as a transition step.

All analysts and institutional shareholders are interested in the earnings impact. Also, all of them want capital gain/loss information so they can modify reported results to get a "true" gain from operation. In order to assist the analysts in their understanding of FAS 97 we held an educational session. The educational session was put together to assist management and the analysts in coping with the significant revenue drop and change in earnings. The need for such a session was indicated by the reaction of one analyst last year. The analyst became very excited upon seeing that, under FAS 97, earnings, as a percent of revenue, were much larger than under FAS 60. Unfortunately, the analyst ignored the fact that the greater change was in revenue, or the denominator, and was not in the earnings, or the numerator.

In this session we reassured the analysts that we are selling the same products as before, universal and interest-sensitive life, individual annuities, and group annuities (or GICs). Using premium revenue as a measure, we gave an indication of the amount of our business affected by FAS 97. Among our companies the affected products accounted for 64-100% of premium revenue. At risk of confusion, we gave quite a bit of detail concerning earnings and revenue impact. We reviewed revenue and earnings patterns on a major product-by-product basis and compared the results to the prior accounting methods. In addition, we illustrated how earnings, and the balance sheet impacts, vary by duration since issue.

For example, for all products there is a large negative revenue impact. For group annuities, however, there was no balance sheet or earnings impact. For universal life and flexible premium annuities, the balance sheet impact varied by the age of the business, and the earnings impact was positive. For interest-sensitive whole life, there was a large negative balance sheet impact, and the earnings impact will be negative in the next few years, eventually catching up.

We reviewed the 1988 revenue and earnings impact and gave projections for 1989. In our presentation, we gave a detailed description of our implementation of FAS 97 and illustrated that the GAAP gain, ignoring federal income tax and any target surplus, is one minus the k factor times the estimated gross profit. Using information that we already supply the analysts, they may find a substitute for the premium revenue to project earnings in an estimated gross profit figure. Using numerical examples, we showed the results of truing up, that is, the substitution of actual gross profits for those estimated.

I will next consider a variation in lapse experience (Chart 1). As the numbers show, the bad news of additional fourth year lapses actually causes an increase in gain. The \$82,000 additional surrender charge leads to an additional amortization of \$59,000. The restatement of the prior year's DAC is small (less than \$1,000), and the fourth year gain increased by \$23,000. So the result of the lapse variation is a higher profit. Of course, there is a price for this increase in gain. Gains in the fifth year and later will be reduced. Because of the lapses, less business is in force. Also, more of each future year's gross profits will be required for amortization. In effect, the FAS 97 methodology allows the spreading of a loss due to the extra lapses.

I chose to use the lapse example because it gives an unexpected result. Other experience variations act in more expected ways. For example, higher mortality will give lower gains.

Finally, we identified where companies may differ on the implementation of FAS 97. This was to aid the analysts in comparing us to other companies. First, companies may use a different amortization period. In general, the longer the period, the lower the amortization. Second, companies may define their valuation blocks differently. In general, the broader the definition, the slower the amortization. Third, amortization is affected by the choice of assumptions. If a company does substitute actual for expected, as we do, this truing up effect does encourage one to

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CHART I

FAS 97

Estimated Gross Profits and Resulting Before-Tax Gains
Flexible Premium Universal Life
Lapse Variance in Year 4
Per \$1,000,000 Minimum First-Year Premium
(\$000)

Current Year Only

<u>Year</u>	<u>Estimated Gross Profits</u>	<u>Gain</u>
1	73	18
2	413	115
3	303	85
4	335	93 see below
5	232	64
<u>Derivation of Gain</u>		
Original Gain		70
Additional Surrender Charge		82
Increase Amortization		(59)
Catch-up		0
Total		93

use best assumptions to avoid large adjustments. But as Mike has pointed out, it is going to lead to some variation from year to year. Fourth, we quantified the effect of capital gains and losses on amortization and fifth, the timing of any unlocking and the choice of new assumptions. I will talk about these two items later.

Our presentation to the analysts was favorably received. In addition to providing them with information about what our company was doing to implement FAS 97 and the impact on our financial results, we believe it armed them with some knowledge and some questions to be better able to compare us to other companies.

I'll now briefly review some of the questions that came up during the implementation of FAS 97 or as a result of putting together and reviewing the first financial statements on this basis.

First, there was an extensive discussion of recoverability testing. We agreed that, when a new product is added to the valuation system, a calculation should be made to determine a benchmark k factor. If in future valuations the actual k factor ever exceeds the benchmark, a recoverability test is done on a block of business. Recoverability blocks, however, may differ from the valuation blocks in that they can be made up of several valuation blocks. The recoverability test itself compares the present value of future cash flows to the net GAAP liability held. Assumptions in this calculation will reflect realistic expectations for expenses and other factors, and the interest rate used for discounting will be the earned rate, not the credited rate.

Second, we include in the definition of estimated gross profits the reinsurance costs and benefits, if reinsurance is on a yearly renewable term (YRT) or co-insurance of cost of insurance bases. We believe that this was in the spirit of FAS 97 and simplified the accounting by including calculation of GAAP for reinsurance ceded with that for the total block of business. Rider premiums and benefits, however, were not included in estimated gross profits. The amounts are often small, there is some difficulty in gathering the information, and there was a lack of direction in FAS 97.

Third, for bonus interest products the additional liability which falls under the definition of prior assessments that are refundable in FAS 97 was provided for by setting the benefit reserve equal to the account value accumulated with the bonus interest rate. Therefore, the benefit reserve held is higher than the actual account value. The DAC for these products is amortized

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using an interest spread reflecting the bonus rates. This produces smaller estimated gross profits than would otherwise be calculated, but the slower amortization matches the higher benefit reserve held.

Fourth, we decided that capital gains and losses should not be included in estimated gross profits. Paragraph 77 in FAS 97 seems to require a direct tie of capital gains and losses to policyholder benefits to allow a liability to be held to offset capital gains. By including capital gains in the expected gross profits, amortization would be accelerated, and the resulting lower DAC would provide an effective liability. We did not think this treatment of capital gains was appropriate. If a company wants to do this, we believe there should be evidence of the tie of performance to the contract and a willingness to explain the financial results to management and analysts. Also, if a company wants to include capital gains and losses in the gross profits, it should recognize that capital losses may trigger a negative estimated gross profit, so a plan to handle this situation needs to be in place.

Fifth, the question of deferral of level renewal commissions consumed quite a bit of our time in implementation. Despite the statement in paragraph 24 of FAS 97, there are arguments to defer all or some of renewal commissions and premium taxes, which are a level percent of premium. One consideration is that the products, especially annuities, are really a series of single premium products, each with its own acquisition cost. A second consideration is that under FAS 97 premiums are not revenue. And the reasoning in FAS 60 for nondeferral does not hold up. Finally, what I call the spirit of FAS 97 is to treat the product as an investment upon which a return is made. Renewal commissions and premium taxes are expenses of acquiring the product. In particular, not deferring such expenses for flexible premium retirement annuities leads to earnings results which are not in line with what we believe is the intention of FAS 97. One solution, and the one we came up with, is to determine the dollar amount of the ultimate renewal commission and premium tax taking premium and policy persistency assumptions into account. If this dollar amount is zero, we defer all renewal commissions and premium taxes. If the dollar amount is not zero, we use it as the ultimate renewal expense, and that's the amount we don't defer each year.

Sixth and finally, we have discussed the disclosure required at unlocking. Unlocking is a change in future assumptions. As this example shows (Chart 2), mortality worse than expected leads to reported gains which are lower than expected. The reduction is due both to the reflection in the current gain of the higher mortality, partially offset by reduced amortization (which I label current mortality) and the catch up effect of reducing the DAC in prior years (which I have labeled as catch up). Upon unlocking at the end of the fourth year, the company suffers an additional loss of \$27,000. This write down reflects the amount of DAC which should have been amortized by the use of the higher k factor on past profits.

CHART 2

FAS 97
 Profit Comparison: Illustration of Unlocking
 Flexible Premium Universal Life
 Per \$1,000,000 Minimum First-Year Premium
 (\$000)

Experience mortality is 110% of that originally assumed. At the end of each of the first three years, the company assumes that future mortality will be at the original assumption level. At the end of year four, the company changes its future mortality assumption to 110% of the original assumption.

The table below illustrates how reported gains will differ from those originally expected.

<u>Year</u>	<u>Actual/ Expected</u>	<u>Current Mortality</u>	<u>Catch-up</u>	<u>Reported Gain</u>
1	7.8	(0.4)	0.0	7.4
2	69.7	(0.9)	(0.7)	68.1
3	53.3	(1.2)	(1.3)	50.8
4	47.4	(1.4)	(27.0)	19.0

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The amount of this write down is under the company's control. If the company chooses to unlock at a different time or reflect only a portion of the higher mortality, the amount of the write down will be different. The subjective nature of this unlocking leads to many questions. Will all unlockings require disclosure? Materiality may be a factor here. Also, we could imagine unlocking two blocks with the financial effects offsetting. Does this eliminate the need for disclosure? What should be disclosed in an unlocking? We can imagine that the block affected, the reasons for unlocking, and the dollar amount of the impact in the current period should be disclosed. Should we also give the projected dollar amount of impact in future periods?

The difficulty in considering the answers to these questions, and just the thought of answering any questions about unlocking at all, should encourage a company to use prudence in assumption setting and system design. This concern with what must be disclosed upon unlocking brings us right back to the beginning. How do we define valuation blocks, assumptions, etc.? The fact that we have to explain the financial results to management and the investing public needs to be taken into account in the design and implementation of systems in FAS 97.

I'll now review the survey results (See Chart 3 and 4). Our survey was sent out to members of the Financial Section and registrants of the New York meeting. It produced 35 usable results. One of the survey responses we received asked, "What is FAS 97?" I have to admit I was somewhat envious of that person.

CHART 3
FAS 97 Survey Results

Number of Companies: 35

Impact on:	Average	High	Low	Median
Book Value	-6%	+20%	-100%	0%
1988 Revenues	-34%	0%	-92%	-32%
1988 Gain	-1%	+30%	-75%	0%

Cost:	No. of Companies
\$0 to \$25,000	6
\$25,000 to \$100,000	11
\$100,000 to \$500,000	14
Over \$500,000	4

Computer System:	--- No. of Companies Using ---				Total
	One Method	Two Methods	Three Methods	Four Methods	
Purchased	3	2	3	0	8
Wrote	17	5	3	0	25
Had	4	3	2	0	9
Not Used	1	0	1	0	2
Other	<u>2</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>2</u>
Total	27	10	9	0	46

CHART 4
FAS 97 Survey Results

	<u>Yes</u>	<u>No</u>	<u>Undecided</u>
Design Products Differently	7	23	5
Significant Benefit	22	13	0
Significant Disadvantage	25	10	0
Other Comments	22		

There was a wide range of effects due to the implementation of FAS 97. For book value, 1988 revenue and 1988 gain figures, we asked for percentage changes. Therefore the average figures

PANEL DISCUSSION

are averages of percentage changes. The median figures are more meaningful. The average decline in book value was about 5.7%. The largest decline reported by a company was 100%. The median value was 0 and that was also the mode, reported by 8 companies. The average revenue impact was -34%. The median value was very close to that, at -32%. Only three companies reported no revenue reduction. Their explanation was that they had primarily limited payment life. The average impact on gain was -1%, which is a little misleading because it is heavily influenced by one company which reported a negative 75%. Eleven companies reported zero or small increases. Implementing the systems required was rather expensive with only 6 companies getting by for less than \$25,000. Forty percent of the companies spent somewhere between \$100,000 and \$500,000.

Most companies used one of the methods listed under computer systems. The method most often used, by 25 companies, was to write their own software. Five companies used two methods, and three companies used three methods. Often the methods varied by the product.

Only seven companies responded that they would design or market a product differently due to FAS 97. Five other companies didn't know or were still evaluating whether FAS 97 would affect product development. Somewhat surprisingly, 22 companies identified significant benefits from FAS 97.

The one benefit cited most often was the development of management information, probably similar to the description I gave at the beginning of my talk. This was followed by the ability to write down current DAC or clean up a balance sheet. Eight companies said that. Since the write-down improves future earnings, they saw it as an advantage.

Not surprisingly, 25 companies identified significant disadvantages implementing FAS 97. Most of the disadvantages had to do with the time and expense to implement the system. Seventeen companies complained about this. Also, this effort distracted companies from other projects. The required explanations to analysts and the ongoing workload were cited as additional disadvantages. Many companies saw the results as not justifying the time and effort they put into it. From the variety in the survey results, you can see that companies started from different accounting methods and probably interpreted FAS 97 differently, thereby coming up with their different financial effects.