RECORD OF SOCIETY OF ACTUARIES
1990 VOL. 16 NO. 3

MUTUAL COMPANY GAAP

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- o What are the objectives of mutual company GAAP?
- o What are the common features seen today?
- o What are the similarities and dissimilarities to stock company GAAP?
- o What have been the experiences of mutual companies using modified GAAP for internal management reports?
- o Should there be a recommended model for all mutual companies? For what purpose?

MR. ARNOLD A. DICKE: We have a distinguished panel with us. Tim Penrose is from Pacific Mutual. Tim has been wearing a ribbon (signifying he has been a Fellow for 35 years). He started his career at the Equitable in 1950, finishing his exams in 1954, and then moved to Pacific Mutual, where he's been since, believe it or not. In September 1990, Tim is going to become one of our honored retirees here at these meetings. I hope he still shows up at all of them. It is a wonderful career that Tim has had, and we look forward to hearing his remarks.

Our second speaker is going to be Sid LeBlanc from Pan-American Life, where he has been for 23 years. We are very fortunate in having Sid here; he said he came really not for the meeting at all, but to watch his nephew play baseball, and he said the Giants were in town, so he could come. I said, "Oh, I don't remember any player on the Giants named LeBlanc." He said, "His name isn't LeBlanc, it's Clark." So, he's probably the best connected person here. We did have a lot of speculation as to why we were in such a low paying career relative to his nephew, but maybe there are things Clark can do that we can't.

And our third speaker is Pete Duran. He's from Ernst and Young in New York. After getting his Ph.D. at the University of Rochester, Pete taught for three years. After teaching, he was at Mass Mutual for 13 years, and has been two years now at the NY in New York and is specializing in GAAP statements, particularly as they relate to mutual companies. So we're going to have our three speakers in the same order I introduced them. Our first speaker, then, is Tim Penrose.

MR. CLEMENT B. PENROSE: My role is to describe Pacific Mutual's system of management financial reporting, which we refer to as GAAP; there should be quotes around that word, GAAP, because it's certainly our own version.

First, a little bit about Pacific Mutual. We're a mid-size company located in Newport Beach, California. Counting the parent and subsidiary companies, we have about 2,400

employees. Our parent company assets at the end of 1989 were $8.6 million. One of our subsidiaries has been quite successful in the investment management business and has about $24 billion of additional assets under management. From the standpoint of products and services that we offer, we have a group pension operation, and we offer individual life and annuity products, both fixed and variable, although the variable is an infant operation. We have group life and health insurance that's marketed primarily through a subsidiary now, and a group administrative services subsidiary. Investment management services are offered through a family of subsidiaries. Our management operation cuts across the lines of the parent and the subsidiaries. We have a small corporate staff, and then three business groups which we refer to as asset management, employee benefits, and personal financial services. Then, under each one of those business groups, there are several units that we refer to as strategic business units, or SBUs. Under asset management, in addition to the parent company investment staff, there is our group pension operation which we call pension investments. And then, in subsidiaries, there is another SBU that's essentially a family of investment managers. PIMCO is the bond manager there consisting of three stock equity managers and one real estate manager.

All of the second business group, employee benefits, is now down in subsidiaries. We have three strategic business units there; one that markets group life and health insurance on a true group basis to groups of 50 or more; a second one that is a multiple employer trust (MET) strategic business unit marketing group life and health products to groups under 50 lives; and then a benefit and administrative services subsidiary.

And finally, the personal financial services business group consists of an individual SBU within our parent company and a group of subsidiary broker/dealers. From the standpoint of the corporate entities, our parent company is a mutual company. We have a downstream holding company at the first tier level and below that, three more second tier holding companies, one in each handling the investment management subsidiaries, the group insurance operation, and the broker/dealers.

Historically, we have reported financial results to management and the board as well as externally on a statutory basis to the parent company and the subsidiary life companies. For fifty years we have had those statutory results audited by a CPA firm and presented to the audit committee of our board. In the 1970s and 1980s, as we formed noninsurance subsidiaries, the financials for those subsidiaries were developed on a GAAP basis, also audited and presented to the audit committee of our parent company board. Since the mid-1970s, we've had a target surplus formula developed internally. It has been refined over the years with some significant modifications in 1983 and 1984, when we picked up the C-1, C-2, C-3, C-4 risk type of analysis to reflect it in that formula. And since the mid-1970s, we have from time to time presented to our board of directors a capital adequacy ratio. That is, the ratio of statutory surplus and mandatory securities valuation reserve (MSVR) to benchmark surplus as determined by our own formula.

From 1963-1983, we used an investment year method to allocate investment income and realized and unrealized capital gains and losses by major line of business within the parent company. As of January 1984, we changed that approach to an asset segmentation approach with four segments; one each for pensions, individual, group, and

corporate. We struggled with the definition of the corporate segment when we first set up that approach. There was some feeling that it would be nice if we had corporate segment assets exactly equal to statutory surplus, or statutory surplus plus mandatory securities valuation reserve (MSVR), but we came down in a different direction. We decided that the corporate segment assets would be those assets on which the investment decisions would be made from a corporate perspective as contrasted with the perspective of any of the business units.

Why did we convert to our version of GAAP? We did so primarily because of management dissatisfaction with statutory reporting as a basis for planning and controlling financial results. The secondary reason was that as we formed noninsurance subsidiaries, with those subsidiaries reporting on a GAAP basis and having financial results that were significant to our total, management wanted to move to a reporting basis that would enable us to report consolidated income results. And finally, there was some feeling in the management group and the board that we should compare financial results in our company on a consolidated basis with the published results, particularly on a return on equity basis, of publicly held corporations.

When did we launch our project? Our project started in mid-1985. Even though the progress seemed slow at times, by September 1986 we had reached the point where we felt we could prepare financial plans for the year 1987 on our version of GAAP and we did so. We started reporting to management and the board on a GAAP basis effective with results of the first quarter of 1987.

How did we handle the project? We retained a consulting team of actuaries and accountants from a Big Eight firm, represented on our panel, to educate us and help us define our management basis financials; to develop GAAP results for our parent company on the defined basis for 1984, 1985 and 1986; and to train our people in developing similar results for future years. As it turned out, we still had the consultants on board as we cut over, in the first quarter of 1987. In fact there were several follow-up projects on which they came back again to help us with various facets of analyzing and interpreting our GAAP basis results.

When we started our project, the accounting model for stock life companies was FAS 60 and our approach is built around that standard, although there are certainly differences in details for the traditional individual life business. We based deferred acquisition cost (DAC) and benefit reserves on pricing assumptions without any specific provision for margins for adverse deviations. We have some people in the audience who know more about the details than I do; we can cover that in the question period, as necessary. For interest sensitive individual life products, we adopted a method referred to by our consultants as the composite method, again, keying off of pricing assumptions. For individual and group annuity products, we adopted a retrospective deposit approach, keying off of the pricing basis interest margins.

For capital gains we adopted the FAS 60 approach of including realized capital gains and losses after tax in the income statement as a second step in arriving at net income. As called for by FAS 60, unrealized capital gains are included in GAAP equity but not in

net income. We were aware that some of the mutual companies that were either working on a similar project at the same time or had already completed it were spreading capital gains over several years. There were some people in our management group who found that attractive; I think they were thinking of impact on incentive compensation, primarily. We decided not to spread and adopted the FAS 60 approach for recording purposes.

While we have recently modified the details of our benefit reserves for interest sensitive and investment products to move closer to a FAS 97 approach to the pattern of emergence of profits, we still follow the FAS 60 approach in the income statement; with revenue including premiums and deposits, and the two-step income statement with capital gains brought in on the second step.

One of the things that we did just before we moved to a GAAP basis, or in the year or two after we had moved, was to change a number of our allocation methods. I will touch on five items on which we changed our allocation approach. First, with assets, we moved to an approach under which we true up the amount of assets in asset segments, as of the beginning of each calendar year. It is actually done in March, after we complete the prior year's annual statement reporting, but retroactive to January 1 with some adjustments in interest credits. We do that in two ways. We transfer cash as part of that true up. We also issue deemed internal debentures, either from corporate to the product lines or it could be in the other direction. I will come back to this when I talk about allocation of investment results.

The second thing we changed was our formula for benchmark surplus. We changed, at the beginning of 1988, from our own internally developed formula to Moody's formula, and there were several reasons for that. One reason was that our president then, now our CEO, felt that there would be advantages from the standpoint of presentations to the board to be using an externally developed formula for benchmark surplus. Second, using Moody's formula had the benefit of Moody's development of capital adequacy ratios for a number of companies on the same formula. And third, we had been spending a lot of time negotiating changes in the internal formula. When we redid the formula on a C-1, C-2, C-3 risk basis in 1984 and 1985, we numbered that first formula T-1 and by the end of 1987 we were up to T-9 and were working on T-10. And Tom Sutton, who had just become our president and was about to become our CEO, and was one of the very good negotiators on that formula, decided that while he was CEO we weren't going to go through that process, so we adopted Moody's.

The third allocation that we changed was the allocation of investment results. That came about from the combination of our truing up assets by segment and the use of the internal debentures. Investment results from our individual and pension asset segments -- we have now moved group down into the subsidiaries -- go directly to those product lines; that is, the dividend; interest and rents and realized and unrealized capital gains from the pension asset segment go to the pension line or lines of business. We issue internal debentures to allocate investment income on benchmark surplus out of the corporate segment. That is, the corporate segment will issue to pensions, and to individual internal debentures equal to the benchmark surplus at the beginning of 1988, which is where we started this process. And then each year thereafter, as benchmark

surplus has changed we issue additional debentures out of the corporate segment to the product line to take care of the change from the unexpired debentures that are left to the new benchmark surplus total. We permit the product line officers to select the maturity period on the debentures they receive -- one, three, five, seven, or ten years -- and the yield or coupon that is paid on the debentures follows the Treasury curve for the maturity period selected. Then the corporate line of business receives all of the investment results from the real assets in the corporate segment, but the corporate line investment income is reduced by the debenture interest paid to the product lines.

For the fourth allocation of corporate expenses, we changed from a traditional expense allocation approach to transfer pricing. That is, our corporate cost centers that provide services to the product lines now bill for those services, mostly on an hourly basis, although there are different approaches used in the EDP area. But EDP, law, human resources, and even internal audit, bill the product lines for the services provided. Any corporate cost center expenses not billed out to the product lines stay in the corporate line of business.

And finally, there is equity tax. In 1987, our first year on the management basis financials, we allocated equity tax by product line, as we had previously for statutory purposes, in proportion to each product line's tax basis equity. Starting in 1988, however, we arbitrarily changed that and now allocate all equity tax to the corporate line of business.

Unrelated to our management basis reporting, but an interesting aside, I think, is that in 1988, when we had changed these allocation methods for management reporting purposes, we wrote to the California Insurance Department, described the change in our allocation of investment income as well as each of these other changes, and asked for approval to do two things. First, we wanted to set up a corporate line of business in the statutory statement using column 12 of page five of the statutory statement; and second, we wanted to reflect in our statutory allocations on page 5 the allocations here described as underlying our management reporting. California approved both those changes, so that is the way we allocate for page five of the annual statement as well as for our management basis reporting.

Our current financial reporting, then, is statutory for external reporting. Our statutory results are still audited by a CPA firm, and those audit results are still presented to the audit committee of our parent company board of directors. For internal purposes, we use our new GAAP basis almost exclusively. The financial officers in the corporate area and in our strategic business units still see statutory results, and we, of course, still pay attention to the relationship between our actual surplus and our benchmark surplus.

We use our version of GAAP for planning and control purposes. We concentrate on operating income, net income, and return on equity. The quarterly meetings between general management and strategic business unit (SBU) management are now focused, to the extent that they cover financial results, on variances between the planned GAAP results and the actual results. Reporting of financial results to our management group is entirely on a GAAP basis, focusing on GAAP net income and related return on equity

by a strategic business unit, and the total corporation. Of course, that reporting also includes marketing results, growth figures, and expense control.

The audit committee of the board sees the audited statutory financials. The full board sees only GAAP figures except for the capital adequacy ratio. We give the full board an abbreviated GAAP income statement on a consolidated basis and then highlight information such as GAAP net income, return on equity and so forth by strategic business unit.

In the incentive compensation plans, in which virtually all of our employees participate -- we use return on equity from our GAAP basis financials relative to planned return on equity as the primary financial measure.

Finally, I have just a few comments about our experiences in converting to GAAP and operating under it. At the time we started our conversion project, we had practically no one in the company who had any familiarity with stock life GAAP. So we leaned very heavily on our consultants. We moved up the learning curve slowly. We have supplemented the staff that learned our system of GAAP with a few people from outside the company who had stock life GAAP experience. The transition involved a lot of extra effort by our financial reporting people. I think from a general management perspective, however, the view would be that the transition went rather smoothly.

We chose to handle the transition presentations and the new basis results with our board ourselves rather than involving our consultants in that process. We have a retreat-type meeting for our board of directors each year, and at those meetings in 1985, 1986 and 1987, the new management basis financials were a major discussion item, which gave us more time to talk about what we were doing than we would have had at the normal monthly board meetings. We had no significant problems at either the management or board level with acceptance of the new basis of reporting.

It is much too early to determine if our management will be able to do any better job of managing the company with our GAAP basis financials as a tool, although that is clearly the objective. Certainly, using our version of GAAP, we now spend much less time giving the board technical explanations of financial results. For the most part those discussions now focus on performance reasons for variances from planned results and corrective actions being taken by management. And members of our management who report to the board view it as a positive sign that it has been almost two years now, since in a report to the board, we have used the terms "surplus strain" or "gain from surrenders."

MR. DICKE: You know, it's really an unusual situation that mutual companies find themselves in with the ability to try out their own version of reporting and actually use it with the board as a primary means of reporting the results of their operations. It's sort of a situation where, in many ways, a thousand flowers this phrase used to be, and there are many different approaches. Tim's approach was one of using more or less stopgap approaches and then modifying them for the situation that the company found itself. Sid LeBlanc is going to speak next about what was done at Pan-American, and its approach

was more of the other major category of approaches that are used which are often called value added.

MR. SIDNEY A. LEBLANC: As Arnold indicated, this meeting was on my way to the Giants/Braves game. It was nice of him to invite me out so I can come see my nephew play. One of the strange things about having a nephew who plays baseball is that these guys make some pretty hefty salaries. If you're not a baseball fan you may not know that Will signed a contract this spring for four years for $15 million. As actuaries, you will quickly realize that's $3.75 million per year, and as actuaries you will also realize that that's considerably more than our meager salaries, despite the fact that we have the No. 1 profession, we work harder than ballplayers, and we are smarter. Once the shock of this sinks in and the reality and equity of the free enterprise system takes over, you realize that it's really appropriate. After all, there's never been a documented instance where anybody ever paid to watch an actuary work.

Let's talk about value added. As Groucho Marx said, before I start my speech, I have something important to say. Is your chief marketing officer concerned with sales, or profit on sales? Which one should he be concerned with? I assume the answer to which one should he be is obvious, but I think in the industry, traditionally the answer is sales. That's what the chief marketing officer is measured on, that's what you report on, that's what he emphasizes. At Pan-American we've been on value added for four years, and our chief marketing officer came to the company last fall and recommended we cut the credited interest rate on universal life, which is our primary product. And the reason he recommended that is because he is measured on profit on sales and he wanted to increase the profit on sales. Now, I'm sure a lot of your companies have done things like cut dividends or cut credited interest rates in universal life, but how many of you have had the chief marketing officer recommend it? If the answer to this question in your company is he's concerned with sales and not profit on sales, then maybe the financial reporting system is part of the problem.

When we made the decision to go to value added, it was 1985, so I have some comparisons of where we were in 1985 and where we are today. In terms of premium assets and surplus, in 1985 we viewed ourselves as an individual life company and a high surplus company. We viewed both of those as inappropriate. Individual was in a profit squeeze, and it wasn't going to get much better. Now all of our lines are in a profit squeeze. Clearly, if you look at the ratio of surplus to assets, we were a very high surplus company in 1985. We were interested in either hiding that surplus or investing it, primarily in investing it. We hid it partly through about a $5 million a year depreciation on buildings, and we invested it through growth, primarily; in this period the assets and the revenue doubled. The individual life line, was growing fast enough that we showed statutory losses in that line for most of that period. We have been organized on a profit center basis since 1972.

In 1985, the need, as we saw it in terms of the financial area, was an increased profit focus on individual insurance. Our marketing man would have said he's concerned with sales at that point. The entire individual business unit would not have related to profits. We needed to preserve the long-term surplus as we invested it. And we needed to measure profits in the individual and in the rest of the company. As Tim mentioned,

statutory was not appropriate, it clearly didn't do the job. We looked at GAAP, considered it, and decided we wanted to go with value added. Again, in 1985, level return on equity GAAP wasn't available and FAS 97 didn't exist. The primary motivation for us using value added is that we felt that it measured the performance of management. And we still feel that way, that's still the No. 1 reason why we agree that this is the best approach for our company. By 1990, we are primarily a group and pension company and our surplus ratio is only a bit above average.

What is value added? The economic value of the company is the price which a purchaser would pay if he bought the company; that's the appraisal value, since we're actuaries here. This equals the statutory surplus plus the present value of future profits on existing and new business. The value added profit is the increase in economic value during the year. Those are fairly straightforward concepts. And I think that's one thing that helps value added; the management of the company understands these straightforward concepts. If at the end of one year the statutory surplus is $44 million, and the present value and future profits on existing business were $70 million, new business zero, the total value of the company at the end of that year is $114 million. That $114 million would be what you could sell the company for at that point. We do the same calculation at the end of the following year. And the end of the following year the statutory surplus has increased to $56 million, assuming we don't have any spies from the stock side here, and since ignoring any capital paid in or dividends. The present value future profits at the end of the year or the year for existing business is $78 million, so the total value of the company, at the end of the year is the $78 million plus the $66 million for $134 million. So that's the value at the end of the year. The value added profit for the year is the increase in value during the year, or $134 million minus $114 million equals $20 million. The return on equity is the $20 million profit divided by the $114 million at the beginning of the year, or 17%. That looks more hypothetical than it did in 1986.

Let me describe some of the attributes of value added profit. It shows profit when results are good, for instance profitable sales are up. It shows losses when the results are bad. For instance, if lapses are up. These echo the comments that Tim made that you don't have to explain statutory losses or surrendered gains. In general, when good things happen it's going to show good results; if bad things happen, this is going to show bad results. Value added shows all the long term impacts of the current year management action on the value of the company. Since we view the objective of the management to increase the value of the company, this profit measurement system measures management performance. It's also adaptable to the change in circumstances, unlike stock company GAAP, and it yields a realistic return on equity.

So what have we learned since 1985? Well, here are the major successes: (1) Value added helps focus on the long-term profits of the company. (2) It helps focus on the right topics to impact on those profits. (3) It's well-received by management. And again, we come back to the same reason why we chose this -- the purpose of management is to increase the value of the company, and therefore value added measures management performance. And it also has the impact of coordinating pricing and reporting.

There are certain by-products which come from the value-added system. If you have a financial projection system, the value-added system is fairly easy to implement; it would

be cheaper than GAAP, most likely. If you don't have a financial projection system, this is obviously a desirable by-product. The second by-product is the assumptions-setting process -- in order to do projections, you have to set assumptions. In our case the strategic business unit set the assumptions, and they were approved by the corporate area. There is a natural process which happens when you set assumptions: you ask if you can achieve them; you turn the assumptions into goals; you talk about strategies to obtain those goals; and ultimately you set incentive compensation to pay if you achieve those goals. And that's exactly what happened at our company.

Value added allows a validation of the pricing assumption, and I'll touch on that again later. It does give a profit and dividend review on each product and in total. Periodic regular review of the profit on each major product and each major segment of your operation gives an opportunity to react to it and to do something about it. If you're seeing that you're losing money, and you're measured on it, you obviously are motivated to react to it.

To go back to successes, in 1985 our individual profit center view of the top three goals were first, sales, second, sales, and third, sales. The president of the company viewed the goals for the individual profit centers as profits. What's wrong with this picture? It's obviously out of sync, and the major accomplishment that this system has had since its inception is that we have unity between the goals of the people who are running the profit center and who can impact on those results and the goals of the president. Sales are only a means to an end. If you get more sales and they're profitable, you make profits; if you get more sales, you can reduce your unit expense rate. If the sales don't do that for you, you don't sell.

Value added helps focus on the right topics. A key purpose of financial reporting is to surface issues to management on a timely basis. If your financial reporting system isn't doing that, it isn't functioning well. We already talked about profitable sales. A second example that came up recently deals with suspensions. Most of our universal life sales have a big excess premium, maybe three times the amount of target premium. We found out a couple of years after the fact that our insureds were treating this as a three-pay life or a five-pay life. They'd pay a couple of premiums and then quit. If that happens on GAAP or statutory, it doesn't have a whole lot of impact. If it happens on value added, we change the assumptions, and there's a substantial drop in the value of the business. When that happens, the people who are involved try to do something about it. For instance, we've written letters to all of our policyowners, who bought the policies before the Technical and Miscellaneous Revenue Act of 1988 (TAMRA) and told them they have a tax advantaged product. That is, they are grandfathered in; they can put more money in to it; they've got a wonderful deal. Again, the people who are involved in the business unit are aware of this and are trying to do something to improve the long-term profitability of the company.

If there is an interest subsidy on your block of business, it has a major impact in the value of the business, because you're going to project some continuation of that interest subsidy on an ongoing basis; it's not going to go away right away. The same is true for excess expenses. In areas like this we have tended to be more concerned with the practical considerations than the theoretical; what we're after is a measurement system

which will motivate our management to do the right things. When we finished developing value added in 1986, Larry Warnock and I wrote a 20-page article of technical theory in *Best's*. There's probably five or six people in the country who read it all the way to the end. I hope none of them are here because I've forgotten much of the theory.

This system was well received by management. It's conceptually easier to understand. This is the value of the company; this is how much you could sell it for last year; this is how much you could sell it for this year; this is how much it changed. These are things that you can relate to. It's also easy to understand what you must do to improve results. We tell management in our business units, if you increase the profits on your sales, here's the impact on your value-added profit. Here's what happens if you improve the persistency. Here's what happens if you sell more business. So management knows what to do to ring the bells. In addition, in individual insurance, the profit is a large positive instead of negative since we were growing fairly rapidly, and we had statutory losses during this era, the people in the profit center didn't relate the profits at all. It's understandable, I can imagine the head of the unit calling in his staff and saying, "We had a fantastic year this year, we lost a million dollars." He didn't want to talk about it, he didn't want anybody else talking about it. Under value added, we show him as making an $8 million profit -- then he's got a warm and fuzzy feeling, he can bring in his staff and say, "We're doing great, guys. We're making money." So profit became not a dirty word, but something the staff is interested in, something they have to do something about.

Value added includes all impacts from current actions in this year's results. If your management feels like it is doing a good job, it doesn't want to have some other joker five years down the line get credit for it. So anything that we do this year that has an impact on future profits comes into this year's profit results.

Value added helps coordinate pricing and reporting. A start point for the projections is the pricing assumptions. If there are any differences between current experience and the pricing assumptions, that is projected and monitored separately each quarter. At points we've had the interest subsidy, and we've reported on where that stood each quarter. We've had expense overruns -- to my knowledge, since 1955 and probably before then -- and we're reporting on that quarterly. These have a major impact on the profitability -- as reported in the value-added system. If experience is different from pricing; it's an easily identified profit or loss issue. For instance, in death claims, the process yields projection of profits for next year that includes the death claims. If your death claims are higher than projected, you know that you're experiencing worse mortality than your pricing assumptions. If they're 8.3% higher, you're not going to say the mortality is 8.3% higher -- it's a little higher, but you can't refine it that well. But you have a general impression where you are on death claims, on lapses, and on other assumptions.

I keep coming back to this, because this is one of the things that attracted us to the system in the first place. The purpose of management is to increase the value of the company, so value added measures management performance. That's true whether it's a stock or mutual company. In a mutual company you have to pull out changes in dividends. What we were about in this era was trying to invest surplus wisely and measure the return that we've earned on that.

Well, that's enough about the successes. Let me talk about the problems we've had with value added. No. 1 is that we're a different company than we were in 1985. We've had considerable growth in the nonindividual lines. We don't allocate accumulated surplus, so the profits shown on a statutory basis for the group line are really, "What have you done for us lately?" Under a value added system, we do assign value to the group or pension line of business, and so, on value added, the group profit center can make its required profits by growing. We're now tight on surplus; it's a scarce resource, so we don't want group and pensions to achieve their goals solely through growing. So in the group and pension profit center we report both value added and statutory, but that center's incentive is paid on the statutory results. That's a result of a change in our company in terms of the level of surplus and the additional growth in the nonindividual lines.

Confidence in the numbers by management is a problem. Before value added, the management didn't understand statutory profits. That's probably a sign of intelligence, but it really wasn't important, because management wasn't judged on statutory profit. Now, since management is judged on value added profits, it becomes important for those people to have a better understanding of the profits. While the basic concepts were easy to understand, the management looks on the numbers as something of a black box. Even the actuaries had a bit of a problem in understanding and analyzing of the results at first. Reporting a profit is just the beginning. We want to know why profit is different from expected and what issues does that surface, and so that analysis takes a little getting used to. Modeling universal life is another problem we had early on. Anybody who's done any modeling or projecting universal life realizes that that's not an easy thing to accomplish.

Changes in value due to changes in assumption and technique cause concerns. When you report the value-added profits, you want to report a profit on the same assumptions at the beginning and end of the year, so you're reporting a profit between January 1 and December 31 on the same basis. However, if you change assumptions, then there's in effect a change between December 31 and January 1. This is part of the change in value. It must be analyzed to determine if it is related to management's action or is beyond their control. All value-added changes in assumption are, at first blush, included in the incentive compensation, but we do have a facility to take that out if that's considered inappropriate.

Value added is not widely recognized and accepted -- this is more of a problem with the board than with the management. Members on our board, like the members on your board, are businessmen -- they're used to audited statements that are audited according to generally accepted accounting principles and an external auditor puts his signature on them. I'm not sure what type of problem Tim had in this regard, but when we were telling our board that this was something different from generally accepted accounting principles, we were almost saying, "Trust us," and that's obviously something undesirable to say to your board. At this point we don't have external review of what we do. We probably will have to get into that eventually. That did cause us some problems with the board members in terms of their initial reaction to it. Value added also can't compare to other companies. That would be the same with statutory. If mutual GAAP is similar

enough to stock GAAP, you can make comparisons, but that's a bit of a problem with anything you do.

In terms of effort and expense, value added obviously is an additional effort versus statutory. Compared to GAAP, if you have a projection modeling system, value added is going to be easier; if you don't, it's probably comparable. And then you have to do quarterly reporting because obviously if you're going to measure people's results on this, you want to look at them quarterly and see what issues come up. So that was an additional complication.

In summary, we still prefer the value added to alternative reporting systems. We don't like it as well as we did in 1985, but we still feel it's a preferable system since it measures management performance better than the alternatives. And it's caused a lot of changes in attitudes in the company that have been good.

MR. DICKE: That's a very good explanation of the value-added approach. One of the things that you start asking when you think about the fact that companies have used all these different techniques is: What are the numbers of companies on each of these approaches? Of course, each of these approaches has subcategories, too -- lots of different things that are treated differently. Even the companies that use something like a stopgap model have differences in the way they treat details, and the same is true for companies that may be using the value added model. So it occurred to us that a way to get at that was to try a survey of mutual companies to see what they're actually doing. And that survey has been tabulated by Pete Duran.

DR. J. PETER DURAN: I'm going to speak about what companies are actually doing in the field of management basis financials (MBFs) -- what accounting and reporting methodologies companies use, how they use this information to manage their business, and what the results have been, at least what has been reported to us in terms of numerical results. Then I will offer some perspectives on why I think different companies have chosen the methods that they have. I'm not going to get into any value judgments, at least, during my presentation, on value added versus GAAP. But that certainly is an interesting topic. One of the reasons I've found this topic so interesting is because I think it does reflect the way that individual companies look at their own businesses and how they view the philosophy of their businesses, how they think about their operations and their relationship with policyholders. One of the examples of that might be in the capital gains area, where it would seem that companies that credit capital gains to their policyholders, and for the interest credits, they try to find a way to be consistent with that practice in their financial reporting systems. Or, another example might be companies that price for a particular spread over a period of time might construct their financial reporting systems in such a way so that the expected profit would be equal to that spread each year. Although those aren't really the fundamental questions with management reporting, I think it goes to the issues that both Tim and Sid alluded to, i.e., does the system help management to manage its business, to take the right actions, etc.?

The first result isn't terribly surprising (Table 1). We surveyed the 55 largest mutual companies. We got a pretty good -- 80%, in fact -- response rate in that 44 of them

responded. I've arbitrarily divided the companies into what I call large and small. Large is defined as greater than $5 billion of statutory assets, and small is defined as less than $5 billion of statutory assets. Probably a more accurate description would have been very large and not very large, so I apologize to those small companies in the room with $4 billion of assets.

TABLE 1

Companies Preparing MBFs

	Yes	No	Total
Small (< $5B)	12	15	27
Large (> $5B)	15	2	17
All	27	17	44
Total Surveyed			55

The large companies do MBFs a lot more often than the small ones (Table 2). We've got less than half of the small companies that actually have a management basis reporting system, whereas almost all of the large companies that responded do have such a system. I don't think that's terribly surprising.

TABLE 2

Accounting Models -- Traditional Participating Business

	Percent	
	Small Companies	Large Companies
Level Percent Premium	42	20
Pricing/Dividend Margins	17	47
Level ROE	8	7
Value Added	17	7
Statutory	8	0
Other	25	27
Number Responding	12	15

In any event, we've got 12 small companies and 15 large companies, for a total of 27 companies that our results are going to be based on. So that's our sample size, basically 27 of the top 55 companies. Most of the results will be presented in terms of percentages, but that's the universe we're talking about. And again, most of the results I've divided as between large and small. There are, I think, some interesting differences between the way small companies and the way large companies have tended to approach MBFs. The smaller companies tend to be more on a GAAP model than the larger companies, I guess is the way I would phrase it. More small companies use the level

percentage of premium approach on traditional participating business, as compared to larger companies where the pricing and dividend margins approach is more common. I alluded to this earlier, for example, the dividend formula is looking for, let's say 50 points of spread on reserves; the corresponding reporting approach might report the 50 points each year as a profit, if everything comes out the way it's expected to. Another interesting aspect here, I think is that value added is more common among the smaller companies than the larger companies. Of course, you have to keep in mind the sample size; in fact, we've only got two companies here on value added in the small category and one in the large category, so all the remarks are tempered by that.

In the other lines of business, i.e., other than traditional participating, it would appear that GAAP and modifications of GAAP, (what companies characterize as modified GAAP), are the most predominant methods when in fact something other than statutory is used. So, for example, on universal life, GAAP and modified GAAP are the methods most commonly used (Tables 3 & 4).

TABLE 3

Accounting Models -- Other Lines

	Percent		
	UL	Deferred Annuities	Payout Annuities
GAAP	46	46	24
Mod GAAP	25	25	14
Level ROE	8	8	10
Value Added	8	4	5
Statutory	0	4	38
Other	13	13	10
Number Responding	24	24	21

TABLE 4

Accounting Models -- Other Lines

	Percent		
	Individual Health	Group Annuities	Group L&H
GAAP	40	29	36
Mod GAAP	15	24	9
Level ROE	5	10	9
Value Added	5	5	0
Statutory	25	24	46
Other	10	10	0
Number Responding	20	21	22

We had one company, I guess, on value added for universal life; similarly, for deferred annuities, GAAP-type approaches seem to be the most prevalent. We have a large category of companies that report annuities and payout on a statutory basis. I suspect

the reason for that is not theoretical but just the fact that for those companies, annuities and payout are not a particularly important line of business, so that statutory is good enough. The results are similar in the other lines. In group life and health, where GAAP and statutory really aren't very different, we have a lot of companies that said they report on a statutory basis.

Table 5 talks about the criteria that companies use to defer acquisition expenses. Again, this reinforces the point I made earlier, that the smaller companies tend to follow GAAP to a greater extent than the larger companies, with 60% of them reporting that their criteria for deferrability are the GAAP criteria. Of course, you know that the GAAP criteria are that the expense should be directly related to, and vary with, the acquisition of new business.

TABLE 5

Deferrable Expenses

	Percent	
	Small Companies	Large Companies
Per GAAP	60	27
Per Pricing	20	60
Other	20	13
Number Responding	10	15

The larger companies, I think, tend to defer expenses based on their pricing assumptions, at least that's what Table 6 is showing, and that's consistent with my experience as well. It's not clear what these other categories really mean.

TABLE 6

Reserve/DAC Assumptions

	Percent	
	Small Companies	Large Companies
Best Estimate	8	27
Original Pricing	33	33
Most Recent Repricing	17	40
Statutory	17	7
Other	42	20
Number Responding	12	15

In a lot of cases we got a response of "other" on the survey with no explanation, so some of the other categories are fairly mysterious. As far as reserve and DAC assumptions, our concern was we had much larger companies reporting that they use either the most recent repricing or the original pricing, so they are tying with the pricing assumptions;

and in the small companies the largest single category is "other." I didn't really understand that result, so I looked at the actual submissions. I didn't change what companies reported, but my impression from looking at the forms that people filled out is that the "other" category could have been spread back to the other four categories in about the same proportion as those categories are there now. For example, one company only uses statutory cash. It uses cash values as the reserves, and then simply spreads the acquisition expenses over 15 years. I'd probably categorize that in the statutory category.

Loss recognition and recoverability -- is it done? Most of the large companies do it (Table 7). Most of the small companies don't do it for various reasons. Many of them don't do it, but they believe that the DAC is recoverable. Two of the larger companies reported that they don't do it because they feel it's inappropriate. They feel it's not consistent with their basic financial reporting model. And we have one company in each category that said it didn't do this because of resource constraints. You might notice -- I think this is the first table in which this occurs -- that the percentages add up to more than 100%. That occurs in a number of the tables. People check more than one category, so it might be that a company both believes it's DAC is recoverable and doesn't do recoverability testing because of resource constraints. I won't comment on that again, but if you notice numbers adding up to more than 100%, it's, to the best of my knowledge, not a mistake in the tables.

TABLE 7

Recoverability/Loss Recognition Testing Performed

	Percent	
	Small Companies	Large Companies
Yes	37	60
No - Believe DAC Recoverable	18	20
No - Believe Inappropriate	0	13
No - Resource Constraints	9	7
No - Other	36	13
Number Responding	11	15

Allocation of investment income is covered in Table 8. Of course, the name of the game to a large extent in management reporting is reporting on a line of business basis, and the allocation of investment income is crucial to that. The most prevalent and most popular method for allocating investment income is based on required assets. In that model, of course, each line of business is assigned assets equal to its statutory liabilities plus required surplus and the investment income on those assets is allocated to the line in a number of variations on that. Tim described one that is used at Pacific Mutual.

Historical asset allocations, i.e., basing the investment income allocated to a line on the assets that have built up historically in a line, are the second most popular approach, and statutory liabilities are the third most popular approach, which could be considered a subset of the required asset approach, if you will, where your target surplus is zero. That

process probably predates, I would suspect, some of the more recent work on required surplus.

TABLE 8

Allocation of Investment Income

	Percent	
	Small Companies	Large Companies
Required Assets	42	47
Historical Assets	25	40
Management Liabilities	8	0
Statutory Liabilities	16	0
Other	8	13
Number Responding	12	15

Does the company report a separate corporate account in its management basis financials? Most of the large companies do; the small companies, on the other hand, are pretty evenly divided (Table 9). There is a large group of companies, nonetheless, that don't report internally on a corporate line of business. My own personal suspicion is that the reason for that has to do, at least in part, with the strength of the line organizations in the companies that view interest on their historical surplus as something that shouldn't be taken away from them and the strength of those organizations.

TABLE 9

Separate Corporate Account Reported

	Percent	
	Small Companies	Large Companies
Yes - Holds "Non-Required" Surplus	33	53
Yes - Other Basis	33	7
No	33	40
Number Responding	12	15

Deferred taxes -- most companies use the deferred approach, the rest use some form of a liability approach (Table 10). Very few have actually gone through the effort, expense, etc. of FAS 96. That, I think, is one of the easier decisions that companies have to make in terms of deviations from GAAP. The simplified liability approach is the second most common approach, and one of the larger companies does use a discounted liability approach. I'm sure there are more larger companies that use that approach that simply didn't answer our survey, because I have seen that in a number of cases, at least indirectly.

TABLE 10

Deferred Tax Treatment

	Percent	
	Small Companies	Large Companies
Deferred	36	50
Simplified Liability	18	36
Liability Per FAS 96	9	7
Discounted Liability	0	7
Other	36	0
Number Responding	11	14

The next series of tables has to do with asset related issues. The asset issues, I think, can have as much or more of an impact on the reported financial results than the approach to the liabilities side. Real estate valuation, for the majority of companies, is done on the same basis as statutory, i.e., depreciated cost (Table 11). However, there is a significant minority of companies that have chosen to use a market value for their real estate based on either an internal or an external appraisal, for the most part internal.

TABLE 11

Real Estate Valuation

	Number	
	Small Companies	Large Companies
Depreciated Cost	58	60
Internal Appraisal	17	33
External Appraisal	8	13
Other	17	7
Number Responding	12	15

Then we get into the treatment of realized capital gains (Table 12). We asked a number of questions in this regard and broke it up into the type of asset, first with respect to fixed income investments. Most companies put realized capital gains directly through the income statement or in an amortized fashion through the income statement. Amortization through the income statement might be justified on a number of grounds, for example, consistency with the way interest credits are done to policyholders, or in terms of matching -- trying to get at the underlying economics of what goes on when, let's say, a loss is incurred and the increase in future investment income is received in exchange for the loss. There still are companies that reflect the realized capital gains directly in the surplus account, which is interesting. That's not done either in GAAP or in statutory anymore. I suspect that's a holdover from the old, before-1988 version of the statutory blank.

TABLE 12

Realized Capital Gains Fixed Income Investments

	Percent	
	Small Companies	Large Companies
Direct to Income	25	33
Amortized to Income	42	47
Direct Surplus	25	13
Other	8	7
Number Responding	12	15

Realized capital gains on equities is a similar story, although the number of companies that amortize the gains on equities is smaller than the number of companies that amortize gains and losses on fixed income investments (Table 13). On a gain, for example, what they give up in future income is not so obviously matched against the current gain.

TABLE 13

Realized Capital Gains Equities

	Percent	
	Small Companies	Large Companies
Direct to Income	33	40
Amortized to Income	25	33
Direct Surplus	33	20
Other	8	7
Number Responding	12	15

Asset write-downs were a surprise to me (Table 14). The number of small companies that actually amortize asset write-downs in to income contrasted with the larger companies, where the entire asset write-down tends to be recognized in the year it happens, either through surplus or through the income statement.

TABLE 14

Asset Write-Downs

	Percent	
	Small Companies	Large Companies
Direct to Income	25	47
Amortized to Income	42	20
Direct Surplus	25	13
Other	8	20
Number Responding	12	15

The small companies are clearly a more conservative approach, if you really believe that the asset is permanently impaired. I'm not clear what the justification would be for amortizing that loss over a number of years, other than, perhaps, general consistency with what you're doing for gains and losses due to changes in interest rates.

For unrealized capital gains on equities, the most common treatment is statutory; they go directly to surplus the same as statutory or GAAP, for that matter (Table 15). Although interestingly, 27% of both the larger and the smaller companies do amortize unrealized capital gains on equities, presumably in some fashion akin to the Canadian method, or a variation thereon. And here again, I think the tie between the pricing and the reporting is very evident.

TABLE 15

Unrealized Capital Gains Equities

	Percent	
	Small Companies	Large Companies
Direct to Income	18	27
Amortized to Income	27	27
Direct Surplus	63	40
Other	0	7
Number Responding	11	15

Then comes perhaps the most interesting and also, I think, hard to interpret part of the survey. We asked about ROE results. We're defining the ROE to be the total company income divided by the management basis equity. We received only 10 responses for 1987 and 1988 and nine in 1989, and I guess, in my opinion, these results are hard to analyze (Table 16).

TABLE 16

Total Company ROE

	Percent		
	1987	1988	1989
< 0%	0	0	11
0% - 5%	40	40	22
5% - 7.5%	10	20	11
7.5% - 10%	20	0	22
10% - 15%	20	30	11
> 15%	10	10	22
Number Responding	10	10	9

There are more companies than I would have expected in the over 10% category; that sort of goes against the general wisdom. We got 30% over 10% -- 30, 40, 33. I did look at the responses. One company said, in that high category and I don't remember whether it was 10-15 or over 15, did say, "Note that we treat policyholder dividends not as an expense, but as a distribution of earnings," which I take to mean that their income number is prepolicyholder dividends. Well, obviously, that's going to help out in a big way. I suspect that company is unique, but I don't know. If other companies are doing that, that would go a long way toward explaining the high ROEs. Another observation is that there doesn't appear to be much of a trend either up or down. The results are widely dispersed, and if you look at the year-to-year, it's a pretty level trend. I didn't really take the time to analyze whether or not individual companies were going up and down and averaging out to a sort of level trend in total.

We did ask questions about profitability by line of business, but I'm not presenting the results here because we didn't get enough responses for that to be meaningful. We asked about uses of the management basis reports, and operational planning was one of the primary uses (Table 17).

TABLE 17

MBF Statements Uses

	Primary	Secondary	Not Used
Operational Planning	67	22	20
Setting Dividends	4	52	52
Expense Management	17	39	57
Investment Management	17	48	62
Tax Planning	8	35	67
Capital Allocation	13	39	33
Strategic Decisions	50	44	14
Other	33	13	0
Number Responding	24	23	21

We had lots of secondary uses as well, setting dividends was a big one, although nobody or only one company, I guess, identified dividend setting as a primary use. Some of the other uses would be strategic decisions -- I was surprised that only 13% of the companies identified capital allocation as a primary use of the management basis statements, although we did have 39% identifying it as a secondary use. And then we had a fairly sizable "other" category. When I looked at that, most of the responses there had to do with incentive compensation; we didn't have incentive compensation as one of the uses in this particular question, but we did ask a separate question on incentive compensation (Table 18). This was interesting, I think. Performance results are widely used among the large companies for incentive compensation. We had 11 companies responding. The large companies said that they used incentive compensation. Whereas we only had four small companies saying that they used the results for incentive compensation More

commonly, annual performance is the key rather than long-term performance, although we had a lot of companies that based incentive compensation on long-term performance.

TABLE 18

Use for Incentive Compensation

	Percent	
	Small Companies	Large Companies
Incentives for Senior Management Only	50	36
Incentives Based on Annual Performance	50	82
Incentives Based on Long Term Performance	50	46
Number Responding	4	11

How are financial goals expressed (Table 19)? We had ROE, dollar amount percent of premium, and other. Twenty-five percent of the smaller companies use percent of premium to express their goal, consistent, of course, with the results we've been seeing all along, that the classical GAAP model, the FAS 60 model, I think, is what a number of companies use on their traditional participating business. None of the larger companies have percent of premium as a method for expressing their goals. We had 46% using ROE, 85% of the larger companies using dollar amounts. A little arithmetic shows that 54% use dollar amounts only, 15% use ROE amounts only, 31% use both -- I'm speaking about the larger companies, just by doing some subtractions and such there.

TABLE 19

How Goals Are Expressed

	Percent	
	Small Companies	Large Companies
ROE	63	46
Dollar Amount	50	85
Percent of Premium	25	0
Other	13	0
Number Responding	8	13

Who's the audience for these statements (Table 20)? No one said that policyholders and the public were the audience, either primary or secondary, despite the fact that particular use has gotten a lot of discussion. The board is certainly a major audience. Most companies identified it as a secondary audience, whereas senior management was identified as the primary audience. So this is pretty much what you'd expect. The field

and home office employees may or may not be an audience; more often than not, they're not.

TABLE 20

Audience

	Primary	Secondary	No
Policyholders/Public	0	0	100
Board	36	65	4
Senior Management	76	26	4
Middle Management	12	73	8
Field	0	13	83
H.O. Employees	0	39	54
Number Responding	25	23	24

What's the importance, in the companies' views, of the management basis financials as compared to statutory (Table 21)? It's markedly different between large and small companies. Some 57% of large companies report that the management basis results are of primary importance, while 74% of the smaller companies report statutory is primary -- I'm combining some categories there. I'm not sure what the reason is for that, it could reflect the different methodologies that have been adopted or the level of management understanding or acceptance. Also, I think perhaps this result reflects the relative surplus positions of the companies involved. A company with a low surplus level must, I think, clearly have statutory as a primary focus, particularly if statutory earnings are weak as well. And perhaps that is what is reflected here, I really don't know the answer, I'm just sort of speculating.

TABLE 21

Importance Versus Statutory

	Percent	
	Small Companies	Large Companies
Primary Performance Measure	33	57
Statutory Primary -- MBF is Backup	66	21
Statutory Primary -- MBF not Used	8	21
Number Responding	12	14

The final question in the survey asked the companies to evaluate management's reaction (Table 22). For the most part, management is either highly satisfied, satisfied, or neutral. There is more satisfaction on the part of the larger companies than the smaller companies. No one was out-and-out negative, but we did have a third of the smaller companies reportedly in doubt and 14% of the larger companies in doubt. Again, the reasons for that, I'm sure, vary from company to company, and I think one of the

interesting questions is, why are the companies in doubt? If anybody has any experiences that they would like to share with us in the question and answer period, that would be most welcome.

TABLE 22

Management's Reaction

	Percent	
	Small Companies	Large Companies
Highly Satisfied	8	21
Satisfied	50	43
Neutral	8	21
In Doubt	33	14
Negative	0	0
Number Responding	12	14

I hope I've put some perspective on this for you. I appreciate the opportunity to share these results.

MR. RICHARD E. OSTUW: Mr. LeBlanc, I thought I understood your presentation and I enjoyed it greatly. I'm sure there's a connection between those two thoughts. I was very interested in the various specifics of using pricing assumptions and then separately projecting the expected values in the future as opposed to the pricing assumptions. Then you speak of the connections between the whole system and this is the value of the company. And I'm wondering if there is a specific component in the value for volatility, particularly if the expected future experience is deteriorating from the pricing basis, I would think volatility would get in there somewhere and people would worry and the appraisal value of the company would go down. Is this part of your thinking for the future?

MR. LEBLANC: We don't have something built in specifically for volatility. I would think if you did want to put something in for that, that would normally be in the form of a higher discount rate, in terms of buying blocks of business. We basically use pricing assumptions although there are areas where we do show differences -- a primary one being expense overruns -- and when you include that, we're almost at experience assumptions. Does that answer your questions?

MR. DICKE: I want to ask Sid and Tim, particularly, have these management basis financials been used for any particularly difficult or strategic decisions in your companies? Have they led to any changes in the way, apart from the way ordinary operations are being done, in the direction of the company at all, do you believe? Or have they aided those changes?

MR. PENROSE: I don't think so, Arnold, up to this point in our company. We did make a decision recently to sell off our individual health operation, but it was not based on anything directly related to our new management reporting basis.

MR. DICKE: With specifics on the return on the business?

MR. PENROSE: No, no. In fact, I think our individual division in terms of its short-term outlook, or near-term outlook for ROE, would have preferred to keep that block of business.

MR. DICKE: Your company, nevertheless, over a period of time, underwent a rather major transition during the time you were there, wouldn't you say? From when you first joined the company until what it is now?

MR. PENROSE: Oh, no question about that.

MR. DICKE: To follow on that, would you say that the kind of thinking that was involved in the change in direction of the company was the same sort of thinking that helped you select the types of approaches you used for management basis financials and the fact that, for example, you report mainly those and don't focus on statutory and that sort of thing? Was that all part of the same mode of thinking?

MR. PENROSE: I think so. We have been undergoing a change in corporate culture for ten years at least, and stressing accountability, among other things. And I think that's all part of the same picture.

MR. DICKE: Let's move on to Sid. What about at Pan-American?

MR. LEBLANC: I think most of the decisions that have come out of value added have been operational rather than strategic. We haven't sold any blocks or bought any blocks. We have restrained the growth in some areas of the company, partly because of the concern over our surplus ratios, and the decision as to which area we've looked at has been partly based on the type of returns we're getting in those areas.

MR. JAMES F. REISKYTL: Your question prompts a thought that's on my mind. I wonder what it costs, to Sid and Tim, to put in a value-added system or a mutual GAAP system. Do you have any idea which is more expensive or less expensive; and probably the tougher question, was it a good use of your policyowners' money?

MR. PENROSE: I can't respond from the standpoint of which is more expensive. The value added or the approach that we took in terms of a very round number would be maybe a million dollars. That would be the general level of cost of our implementation.

MR. LEBLANC: I would say ours would have been a lot less than that, but then we're about half your size, too. I think, when we looked at it in 1985, we looked at cost of both systems to an extent, and I guess it was our impression that if you didn't have a projection system in house, they might be comparable. And that's fairly crude, but that's the impression. As far as whether it was a good investment of our policyowners' money, we did feel like we've gotten a lot more profit focus from it. And that inures to the benefit of the participating policyowners.

MR. REISKYTL: Our objective is obviously to provide maximum value to the policyowner, but that doesn't necessarily mean maximizing profit. I presume you say, once you've made this profit, you then in turn pay it out to your policyowners?

MR. LEBLANC: Well, it would depend on the company. When we look at profit, we're looking at profit before changes in policyowner dividends, so we don't count any change in dividends against or toward the individual line of business. So I feel like the emphasis on profits has helped the profits of the company, and therefore our ability to pay dividends to the policyowners.

MR. BENITO JOEL G. CUEVO, JR.: I had three questions for Mr. Penrose. The first question is, do you change your evaluation assumptions; if yes, how often? So basically how do you address the lock-in principle? The second question is, what were management's reasons for not using margins for adverse deviation, if changing the dividend scale could be of a political nature? And the third question, how do you take care of any discrepancy in the variable expenses between actual and assumed results, with regard to the DAC amortization amount and DAC balance to be reported? So, basically, how do you account for any discrepancy between -- valuation assumptions, and actual experience when it comes to financial reporting?

MR. DICKE: Let's make sure we have these questions clearly voiced as we answer each of them. The first one, related to the lock-in principle, and what is the procedure; when are some things changed and how often.

MR. PENROSE: I probably ought to defer to Gary Falde in the audience who, from the standpoint of our individual operation, would be more familiar with these details.

MR. DICKE: You've not changed any assumptions? You haven't unlocked anything?

MR. GARY FALDE: As Tim mentioned, we started out on a FAS 60 basis, but we are currently in the process of moving to FAS 97 for our interest sensitive products. We are just now getting into the process of determining how we're going to unlock assumptions. We have seen some experience that has differed from the pricing assumptions that we put into the 97 model. Last year we were starting to see some good persistency in the UL products that we were doing 97 on, but because of the way 97 works, we didn't get enough surrender charges, which gets back to your statutory problem of trying to explain gain and loss on surrender. So we're starting to look at some way of unlocking, as the stock companies would be needing to do on a regular basis, at least as far as the persistency, and then we'll also be looking at other sources as well. As far as locking in and unlocking, I think that is where we are.

MR. DICKE: Have you changed your dividend scale, since you introduced this system? In other words, are you still on the assumptions that corresponded to a prior dividend scale?

MR. FALDE: Well, it's on the current scale. We're currently on a review process that Tim is quite involved in looking at a dividend scale, but there haven't been any changes in the dividend scale since we adopted GAAP, and I have to say that most of our recent

individual new business is not of the traditional participating type. We've really been selling, since 1983, primarily interest sensitive whole life and universal life products.

MR. PENROSE: Those products are technically or legally participating, but it's been made clear to the buyer at the time in illustrations and in the policy form that it's not anticipated that there will be any dividends paid. The credits go to interest credits and mortality expense credits. So our traditional individual life block is really pretty much a closed block of business issued prior to mid-1983.

MR. DICKE: Perhaps we should hear what Sid has to say about this question.

MR. LEBLANC: Value added really doesn't have a lock-in. You can change assumptions on any of the in-force block any time you felt it was appropriate.

MR. DICKE: In fact, one of the major differences in value added is probably the fact that it doesn't have a lock-in type principle, and so consequently it basically does loss recognition on a kind of con-free basis.

MR. FALDE: I was going to ask a similar question of Sid, as far as what kind of approval process do you go through with management in order to change assumptions, since it could have a similarly dramatic effect on results as FAS 97 does on lock-in, I would think, and it might have a dramatic effect on incentive compensation, and that type of thing.

MR. LEBLANC: Well, while there isn't a lock-in, we haven't had a large number of changes in assumptions; we really haven't had a big dispute about them generally. The corporate area, the financial area and the business unit have generally agreed that they were appropriate changes. If there were ever disputes, the president would play Solomon.

MR. DICKE: I could throw in a little bit from my experience on that for some of my clients that have used value added, particularly certain lines of business, it's proven to be a good idea to have more or less a procedure for selecting in this case basically a health line of business in which the assumptions are changed regularly by a procedure that's set in place. It is sort of a rolling average type thing, so that there's a way to make that change every year. Then the size of the change isn't that abrupt, and you get a relatively smooth pattern.

DR. DURAN: I think most companies do unlock; most of the new business, or a large portion of the new business, is FAS 97 business where you're supposed to unlock. In the traditional business, I would say, my impression is that the majority of companies unlock when they change their dividend scales. If the dividend assumptions and the GAAP assumptions are not identical, then it gets a little fuzzier as to when you should unlock on traditional business.

MR. CUEVO: You mentioned that you're not using margins for adverse deviation, right? At Connecticut Mutual, we use a margin for adverse deviation for mortality and

we also have one for interest, and the reason is that you cannot just simply change your dividend scale because it's very political.

MR. DICKE: You're saying that the change of a dividend can't be done as easily as a change in assumption in your financial reporting.

MR. CUEVO: Yes. Normally, what other actuaries are saying is that, that might be enough, just changing your dividend scale to cover fluctuations in mortality expenses and interest.

MR. DICKE: So, you're expecting that adverse deviation relative to the dividend will have to get fairly significant before you'll get a chance to change the dividend scale.

MR. PENROSE: We did not include any specific margin for adverse deviation in our approach to GAAP; that was a decision we made when we adopted the method. Our understanding, from our consultants, was that wasn't so unusual, to take that approach where we were basing it on pricing margins. As far as we know, it hasn't been a problem yet.

MR. DICKE: Sid, maybe you'd like to say a little bit more about the way you said dividends are treated, I think that might be appropriate.

MR. LEBLANC: We don't have anything for adverse deviation. When we used to price, we used to have hidden actuarial profits, but that has all been ferreted out and doesn't exist any more. The way we treat dividends, for value added, is they are a benefit like any other, but any change in the dividend scale would not be profit or loss to the line of business involved.

MR. DICKE: I'd like to ask Sid an assumption question. How do you set the discount rate, and have you changed it at all over the years?

MR. LEBLANC: We haven't changed it. We had a lot of discussion going in as to where to set it, and there was a certain amount of practical consideration. We'd like to set it to where it would motivate people to do the right things, and that was as much of a consideration as the theoretical, "What is the proper hurdle rate and what should it be?"

MR. REISKYTL: I'm curious about the fellow from Connecticut Mutual, why you would include any deviations from the expected; my own view is, if you really want to have any value, measuring as a mutual company and you're interested in how well your pricing is doing, I think you're coming from a different concept. You seem to be coming from a mind-set that stopgap means something for a mutual company, which I personally, and my comments probably indicate, don't think there is. Therefore, I'd be very curious why you'd want to put margins in there, because I would think you would want these deviations to show up so that you would have some idea whether your dividend scale you're placing was in whack. And if you put something else in there, it seems you're going to start clouding the very thing you're trying to find out. If there's any value to doing this modified approach, surely it would be in having your pricing assumptions in there, so you could find out when your experience is deviating from them. What you're

asking about seems like you're following a cookbook, but does it have some value in management information?

MR. DICKE: The tables have been turned on you, you've been asked a question. Would you care to respond?

MR. LEBLANC: While he's thinking about it, I tend to agree with Jim, and to go back to your earlier question of whether we should do this, I think that there are a number of other ways to get good experience in your firm and thereby improve dividends; and I think value added in our firm has helped us get that experience. I think Northwestern Mutual has got some good experience without it, and it isn't the only way to get there. I may have given him enough time to come back with a retort.

MR. CUEVO: Well, what I could think of is, like just for a stock company, it is using margins for adverse deviation, and we have some sources of earnings analysis we do to look at how much of a margin for adverse deviation we'd use -- let's say it's 10%. Now we would look at actual, and for valuation assumption, we use margins for adverse deviation. But when it comes to variance analysis, we have the actual results and then we also have planned results. At least, as long as we know what the margin is, we can still explain, let's say, if actual turns out to be 15% over, we know that it's like 25% over best estimate assumptions. We are trying to protect ourselves from any substantial or adverse fluctuations in mortality. We know that there is 10%. Now if actual deviates less than 10%, over 10%, we still know that; but we're just protecting ourselves for any fluctuations.

MR. DICKE: Do we have another question, or do we want to go ahead with the third question? Would you state it again?

MR. CUEVO: The modified GAAP research system at Connecticut Mutual is that, we produce DAC reserves based on valuation assumptions. And now, we also produce assumed deferable expenses. We try to estimate what we're going to defer for next year. Now, let's say your actual deferable expense turned out to be ten million over assumed deferable expenses. How do you account for that discrepancy? How do you reflect that discrepancy in the actual internal adjusted earnings statement?

MR. DICKE: In other words, comparing to plan, is that it?

MR. CUEVO: Yes.

MR. DICKE: In the way up from plan. Does that cause problems for anyone?

MR. PENROSE: I believe I said that under our approach we would develop DAC consistent with pricing, meaning we defer those -- for expenses developed from our pricing assumptions. I think as a fact, our first year expenses have typically been higher than our pricing basis assumptions, to the extent that they are, those have been expensed in the year of issue of the policy. Gary, is there anything you want to add?

MR. FALDE: That is what we've been doing so far. Any overage of actual over our priced acquisition costs are just expensed in the current year, but we are in the process of looking at quantifying what would be real GAAP deferrable acquisition costs. It's a slow process that's just kind of getting started, but as Tim alluded to during the presentation, we have some people in house now from stock company backgrounds who have some experience at doing this, so we are going to be looking at our operating areas and trying to quantify the actual amounts that would be considered acquisition costs under GAAP. I think that the result probably won't change anything initially because I do believe that our actual and acquisition costs at this point are higher than pricing. But we are going to have a process in place so that, if that does change, we'll be able to catch that and we would defer the lesser of the two.

DR. DURAN: I have a comment on that. If you're using pricing assumptions to develop your deferable cost, then the answer to the question is simply that it's all volume related, and any explanation is, you had more sales than you had put into your plan. If you're using a strict GAAP approach, then you have to be more sophisticated in the analysis. There's a nonvolume-related component, perhaps.

MR. REISKYTL: Have you taken any significant management action? Earlier Arnold asked you if you took a strategic action. I now ask, have you taken any significant management action as a result of having these quarterly financials?

MR. DICKE: Well, while we ask the two companies that, let me also ask Pete to follow up afterward and ask if he knows of situations, beyond the two companies that are speaking here. What would you say, Tim?

MR. PENROSE: I'm sure there must be some, Jim, but I can't think of them, off the top of my head.

MR. LEBLANC: We have had situations where we've taken management action as a result of the value added reporting system. Reducing the interest rate was one example. The actuaries were concerned that we were developing a bit of an interest subsidy and weren't getting anywhere. But when this was implemented and became part of the incentive compensation goals, then everybody said, "We've got to cut the interest rate, and now there's no subsidy anymore. We don't play that game." And we have made some other changes; it really has had an impact.

MR. DICKE: Pete, what general experience have you seen?

DR. DURAN: I think there have been specific actions; I think more generally, though, I'd characterize it as a change in culture to be more conscious of interest crediting, strategies, expense control strategies, etc. I think, too, that in certain lines of business you have a heavy surplus strain. You know that on a statutory basis you're in a continual dispute over whether the loss is due to surplus strain or the fact that the business is unprofitable. I don't know that any specific action comes out of that, but at least you will eliminate half the discussion.

MR. DAVID C. ZIMMERLI: I wanted to follow up quickly on the first gentleman's question about value added and the volatility embodied in that. When you have a certain amount of sales, I assume you show a value added number in your statement as a result of the future profits you expect from those sales, or at least to the extent they're greater than anticipated in the goodwill number. You say that if profits are more uncertain, you could just discount at a higher rate. Have you thought at all about developing some kind of variance measure of those profits, or of some measure of how far in the future those profits are expected to come in? Has management shown any interest in that?

MR. LEBLANC: We don't have anything in right now for the value of future sales.

MR. ZIMMERLI: No, I meant sales that occurred during the past year, or during the past year that's being measured.

MR. LEBLANC: We don't have anything built in directly to the value-added system for volatility. Now, we do independent studies that are sometimes based off the projection system, the value-added system, to look at volatility. For instance, if you want to look at the C-3 risk, you need to look at volatility. That would be a key area where we've looked at it and in that regard we have purchased a swap option in order to partially protect the company against fluctuations in interest due to universal life, and the cost of that swap option is built in to the results from the individual life lines, so there is some impact of volatility built in, for certain things like that.

MR. ZIMMERLI: OK, but I guess you're saying, among various sources of value added, you don't feel the difference in volatility is high enough, when you take into account these hedges, to warrant an additional measure, showing that some pieces of value added are more certain and others are less certain.

MR. LEBLANC: Like between different business units?

MR. ZIMMERLI: Yes, or different types of policies, or whatever.

MR. LEBLANC: We haven't done that. I see your point, there would be some merit to doing that.

MR. DICKE: I don't know if it's on the line yet, but there is one company that I know of that's beginning to use stochastic methods with annuity lines of business, and it probably takes account of some of what you're talking about, maybe not exactly what you're talking about.