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GAAP FOR MUTUALS

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The best way to learn is by example. This session will lead you through a case study that will outline the various considerations that arise in a project of this type. The case study will be followed by discussions in small groups.

MR. J. PETER DURAN: I'm an actuary with Ernst & Young in New York City. The format of this session is somewhat experimental. It's a case study, and I think it is best described as a combination of a panel discussion followed by fourteen, separate, simultaneous follow-up workshops. First, we'll have a regular panel discussion presentation. We'll take a few questions after that. Then the last portion will be devoted to the what I call the workshop portion. During that portion, we'd like each of the 14 tables to discuss the subject and talk about issues, challenges, and questions. Each table will appoint a spokesperson, and that spokesperson will give a report from the table on what that table has come up with. It can be questions for the panel, it can be comments about GAAP, or whatever you've discussed.

We have two presenters. The first is Ed Kline. Ed is not a Society member; he has an MBA. Ed is a vice president at Mass Mutual and is currently involved in Mass Mutual's GAAP implementation. Ed is going to be talking about GAAP for mutuals strictly from a project management point of view because, when all is said and done, this is a big project if you're actually going to do it. Ed's been with Mass Mutual for 22 years. I'm proud to say that I've known him for 19 of those years. During that time, he's had several assignments, including financial reporting in the ordinary life actuarial division, where we worked together, and he was also head of investment accounting and cash-flow management. He's been involved with projects like setting up an asset segmentation procedure at Mass Mutual, a bond-accounting system, and investment systems, and now he has been asked to head up the GAAP for mutuals project.

Tom Burke is an actuary with New York Life, who is responsible for the actuarial portions of the individual life GAAP implementation at New York Life. He's been with New York Life for about a year. Prior to that, he was with Connecticut Mutual for about eight years, where his responsibilities included reporting both statutory and internal management-basis GAAP in the corporate actuarial department.

Our recorder is Julie Curry. Julie is an actuary with Ernst & Young in Atlanta and has been with us for about two years. Ed is going to begin by discussing the subject from an implementation point of view. I hope that will set a framework for a more technical actuarial discussion.

*Mr. Kline, not a member of the sponsoring organizations, is Vice President of Mass Mutual Life Insurance Company in Springfield, MA.

MR. EDWARD M. KLINE: Some of you may be the project managers, and others may be the technical actuaries on a GAAP project. I'm sure a few of you are doubly blessed. I've structured this talk as if you were the project manager, and I'll try to give you some tips, but there are many ways to skin a cat, and some of my tips may not be applicable to you because you have a different management style. Your style should fit your personality. Hopefully you'll come away with a couple of ideas.

We've all been doing statutory and management accounting for many years, and our organizations know what to do, when to do it, and who does it. When somebody is sick or somebody's AWOL, we know who to replace and perhaps we have backups. In developing GAAP, what we're doing is creating a cultural change. We're carving out new concepts and implementing them, and in some ways, we're looking at wide-open spaces.

Up front in your project, you're going to have to establish or have established the basic parameters that are going to provide guidance and direction to your project, because, when push come to shove, when the discussions get hot, people are going to start going back to those basic parameters and directions. Very important: why are you GAAPing? Technically, most mutual insurance companies—I presume most people here are from mutual insurance companies—produce a policyholder report. I have the Mass Mutual report in front of me, and this is designed to look like a regular industrial company's stockholders' report. It has the usual sections: the good news and "rah rah" in the front with the messages from the chief executive officer (CEO), president, and chairman of the board; a small section on the finances of the company by the chief financial officer (CFO); the financials; and then the certification by the auditors that the financials are OK. The section with the bad news is contained in the footnotes of the financials. The management section for the mutual companies usually has the statement, "conformity with the National Association of Insurance Commissioners, which are considered generally accepted accounting practices of mutual life insurance companies." That allows your auditors to say that your report is in conformity with generally accepted accounting principles.

Why are we here today? Because this is a very important document that your company uses. And the Financial Accounting Standards Board (FASB) has said that if you're going to say that you are following generally accepted accounting principles (GAAP), you have to follow *all* aspects of GAAP. That started many things in motion, including development of a new statement of position (SOP) and a new accounting method for insurance products with dividends. Tom will be getting into that, but that's why we are beginning to do GAAP.

Given that you are doing it, you have to establish as a project manager, whether you are offensive or defensive. There are companies that say we want the GAAP because we think it's better; it's clearer; we think this is terrific, it will help our surplus; we'll look better compared to stock companies. And some other companies are saying, we don't want to do this; we are being dragged into it; it's terrible; it's horrible. As you begin to implement GAAP, that attitudinal difference will be picked up and will influence some of the decisions that are made. It is very important to establish your attitude.

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Who are the constituents? I know of one large-sized mutual insurance company that is very unhappy with statutory accounting and with the current management accounting and is going towards GAAP because management wants GAAP. It's the only way to run the company, and they think GAAP is terrific. I've heard of another company where people on the board are saying, "We don't understand statutory accounting principles (STAT)." They have had some very positive experiences in their lives with GAAP and are arguing that we should have been doing GAAP for years. That becomes a different force. The sales staff use this as a very important tool. If you go to your sales staff with an ordinary life, large corporate market area and say, "Do you want an annual report that doesn't have a clean opinion or even financials?," they will tell you, "No, we need that in order to compete." The same thing goes for group pension.

In managing a GAAP implementation, initially review other potential constituents and other uses so that you develop your list of concerns: how extensive, how deep is your implementation going to be? Consider rating agencies. Do you think that when rating agencies find out that your company now has a GAAP statement that they are not going to ask you for it? What are you prepared to show them? There are a lot of discussions about regulators and GAAP versus STAT, and we'll get into that later. The SEC requires you, as a sponsoring company that sells variable annuity (VA) or variable life (VL) products, to file financials with them. Do you think they may ask you for your GAAP statement? If you don't think so, you may do GAAP one way; if you do think so, you may do it a little differently. Is there demutualization in the future or any spin-offs of large product lines or subunits? If there are, you want to structure your GAAP project so that you can accomplish all the goals of your constituents and meet all your needs. Why? Because you don't want to go on your path from A to Z, hit T and realize you haven't done enough. You left out some important steps, and you have to go deeper. Then comes that very expensive redo, going back to M or L, or even G.

In getting organized, there are three parts to your team that you need to consider: steering committee, area project team, and consultants. As a project manager, you're going to be involved and perhaps responsible for defining their roles. I view the steering committee as this high-level committee commissioned by the GAAP executive sponsor at your organization. They have many concerns, and there are active discussions and debates among them. Besides following the project's progress, they're very concerned about implementing GAAP accounting practices and doing things that aren't done now. Doing actuarial calculations, accounting calculations and investment calculations, and getting things done that aren't required now requires clout. You need some powerful people on your steering committee, and then they're going to be active in deciding the GAAP accounting policies: how conservative or how liberal are you going to be within the implementation of the GAAP practices? You already have a whole slew of management reports, but how is GAAP going to fit in? To get this done, you're going to need resources, developers (people that are theoreticians), and the implementors (the people who are going to be doing those ongoing things that need to be done but are not being done right now). Your steering committee has to be able to make those resources available for you; no resources, no project.

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Under "who involved," I put down the corporate CFO. By that I really mean the executive sponsor. And by corporate finance, I mean the person who is in charge of making sure that all the financial reports are done on time. And I guess I should have slipped in the adjective "financial" when I list product-line actuaries, that is, the product-line financial actuaries (taxes and audit, people with clout). As project manager, you have to push for the strongest, most powerful steering committee that you can get.

I suggest that the steering committee meet regularly, monthly, perhaps biweekly. You have to get them very active very early in discussing high-level guidance and direction. You want them to actively debate the accounting policies, how conservative or how liberal you are going to be, and the extent of your GAAP. They will be reviewing progress reports, and they really set the tone for the project. There are always top priorities, super urgent projects, fighting for corporate resources. You need these people to fight for the GAAP project.

Below the steering committee, you will need area project teams, almost on a one-to-one basis. This is where the analysis and the number crunching are done. These teams are concerned with the details: identifying the GAAP/STAT differences and then, based on the guidance that they receive from the steering committee, evaluating and recommending GAAP policies, developing detailed schedules, meeting deadlines, and coordinating with other project teams.

Members of your steering committee are high-level executive managers. On the project teams, the manager/worker should be managing people who work for her or him within the project, but also getting her/his hands dirty. I think you need area project teams for your different product lines, of which the biggest and perhaps most important for GAAP implementation is going to be the individual product line. It could be about 50% of the total work that's going to be required. You need different teams for investment management, and there you may have a subteam for real estate and a subteam for securities; corporate finance, the large, corporate picture; postemployment, preretirement benefits, and postretirement benefits; postemployment health benefits; fixed assets; on and on. A team will be needed for all corporate financial matters that need to be looked at from a GAAP perspective. Taxes, systems, and perhaps strategic planning, each area needs to set up a schedule, and you, as project manager, have to review those schedules and make sure they all fit together.

Consultants may be used in two areas, accounting and actuarial, and these can be separated. I think you also have external auditors who firmly believe that they can provide the services in both of these areas, and you have to decide how you want to handle it. Several firms have hired separate actuarial consulting firms. There are benefits of doing it in both directions. Having a separate actuarial firm, consulting firm, gives you a separate point of view and a different perspective. Most companies that I've heard of have used their external auditors to be their accounting consultants. Using your external auditors can be tricky, and one of the things that I've tried to do is make sure that they realize which hat they have on. As I push for what we're looking for in GAAP, I'm always saying to the engagement partner of our auditing firm, "Well, Mr. Consultant, what suggestions do you have to help me push the auditors so they will agree with my perspective of what's best for Mass Mutual?"

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You pay a different price. Auditing is a commodity; consulting is a specialty. Don't let them wear their auditing hat, especially when you're paying them at consulting rates. While there are benefits to having a separate firm for actuarial consulting, there are a lot of scheduling problems introduced. For example, you may reach a point in the individual life area where you say, "This is the direction we want to go; let's have a meeting of our individual life area supported by our hired consulting firm." We'll meet with our auditors, who bring in their actuaries to discuss the direction in which we're going, because we don't want to go too far and then find out that the auditor actuaries have a different perspective than the consulting actuaries and we get into a fight. When you start bringing in a lot of consulting actuaries, you have timing problems, which is going to slow down your project, and you don't have much time.

There are benefits to going in both directions. I think you should clearly define and clarify how your consultants are going to help you. Are they just going to be involved in the theory? Are they going to advise you? Are they going to write the position papers or are you going to write the position papers? Are they going to develop the models or are you going to develop the models? Make sure up front you agree with both your accounting and your actuarial consultants on what's going to be expected, because as your project gets on and you begin to slip behind schedule and you look to your consulting firms to help fill in with the catch up, they may already be fully booked and they may not be available. Now you have some disagreement between you and your consultants, and that's not good. Of course, in hiring consultants, you're looking for knowledge, experience, and the proper chemistry. But as project manager, you want your area team project managers (who may be actuaries) to hire the actuarial consultants. You want to give them the responsibility, but as project manager you want to be involved; you have to be involved in all aspects. You can delegate, but you have to be involved because you're going to need that for the control of the project.

A major responsibility of the project manager is education. Education is very expensive. An hour's class can take 10-12 hours to prepare, and if you're paying consulting fees, that's a lot of money. Your targets are going to be not just the people who are developing, but the ongoing maintainers, the doers of the GAAP. We have been very successful. We had a one-day corporate overview session where everybody went off site and we discussed many levels of GAAP. We got people involved, and we let them know what was coming. This gets people not just on the same field, but gets them feeling that they're all playing on the same team. While the one-day training provides a lot of the background, it was not as extensive as the deep education that you're going to need.

You're going to have to make sure that within your area project teams, they provide education by product line. As an example, in individual life, you're going to need separate training for disability income products, annuities, traditional life, universal life, and variable life. You need to get the education up front so the people have the knowledge needed to implement GAAP. Much education comes from doing things. You have to make sure that you leave enough time in your meetings and in your work plans for long, lengthy educational sessions that take place as you're going. It's very easy as a project manager to think, OK, let's get it done, we're going to have a two-hour meeting. Then all of a sudden 25 minutes into it, you've gone off on a

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tangent for an hour clarifying a point. A lot of education comes from doing. If you don't have it in your time schedule, you will fall behind.

There are many other people who need to know what's going on in all the areas. As an example, taxes; they need to know where everybody's identifying the GAAP/STAT differences. Project-team minutes are a very effective way to communicate. Let me give you an example on consolidation. We had a class on consolidation just for the people who are putting together the consolidation, but everybody wants to know how we are building this one Mass Mutual GAAP report. So we have a class for a few people, very technical, on consolidation. They start working on consolidation, have their hands on learning, and get the process completed. Then they are required to come back and give a class to everybody else. One, we save the cost; we don't have to pay the outside consultants to do it; two, we force the people who are doing it to get the maximum learning because the fear of teaching, of course, really makes one learn; and three, it's appreciated. People are very empathetic with the other people because they're teaching, and then it's your turn. People who understand the whole picture of what's going on are much better off than if you just let them work in one tiny area with blinders. It's very easy to focus completely on the developers, the implementors. Don't forget about the operational staff, the people who will be doing this on and on again.

Establishing GAAP, thinking about the basics, driving down that guidance, drilling deeper on directions, making things clear. We have principles and we have accounting policy. You have to make sure that everybody involved understands the differences between principles and policies. In statutory accounting, we do not have any deferred acquisition costs; while as part of the principles of GAAP, acquisition costs directly related to new business are deferred. That's a principle. A policy is now that we have this asset established, how do we take it down, and what's the speed that it's coming down.

I look at these accounting policies as dials, a dial you can turn left or you can turn right. Maybe one side is called liberal, and the other side is called conservative. There are going to be lots of dials. Conservative or liberal, we mentioned this a couple of times. Meet with the steering committee. Overall, how do you want your company to be? Then you have to make sure that the different areas will line up their natural tendencies with the overall direction. Do you want to have large beginning surplus? Are you worried? Is capital king, the more surplus the stronger? Do you want to have the largest amount of deferred acquisition cost (DAC)? Do you want to have less surplus with larger future gains, or more surplus with smaller future gains? What is your company's policy? And are you aligning up in the insurance area?

I think you'll find that in the investment area they tend to have very liberal interpretations. Take real estate, you foreclosed on a mortgage. When it's valued for GAAP, the assumption is made that it is available for sale and it gets one type of valuation. But if they really like that property, they say it's held for the production of income, and it gets a more liberal type of valuation. I think your investment people have a natural, liberal bias on your overall statement. So, as project manager, you have to make sure that you're getting tests, the turnings of these dials, in the individual areas. How do all of them fit in? They're all going to give you what your company's going

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to be. *Where do you want to be, and how fast are you going to move to get there?* It's very complex and you're going to have lots of people in different areas having different biases in their assumptions. You may say, overall, we want a conservative approach. Then you analyze it and realize that there's a liberal bias. And, of course, management's going to want to wait until the last minute. What that means to you as project manager is that you have to avoid a lot of your hard coding. You have to go back into these areas; you have to identify where the policies exist, where the dial is set; and you have to make sure that there's variability on it that can be turned later. Because if you're coming in too short, a couple hundred feet short of the runway, and you can't find the dial because it's been hard coded, you're going to run into a problem. So I think it's a big challenge for a project manager to make sure that you have proper dials set up.

Other comprehensive bases of accounting. You already have STAT, tax, and management reports set up, and somewhere in between, there's a whole set of *incentive compensation measures that have already been established.* How will GAAP fit in at your company? When some companies begin doing GAAP, they plan to use it immediately. At other companies, they want to fully understand it before they begin to use it; in ten years, maybe they'll start using it. GAAP is very hard to understand. I think as project manager, you have to start planning the migration of GAAP into your management reports. Maybe you want to keep some of your management reports very detailed and you have a higher level GAAP, so you have to talk of a merging or an integration of your GAAP and your management reports. The area project teams may not be doing this. I think as project manager you have to make sure that the overall picture is developing as this is going on.

There is a difference between reporting and gathering data. By lines of business, I refer to different types of policies, term, ordinary life plans, etc. They may be gathering data right now for lines of business that fit into your general ledger. One suggestion is that perhaps you want to try to keep your GAAP micro lines of business aligned with your STAT lines of business as much as possible so that you can have reconciliation on the real basic, lowest elements of data.

How are you going to treat strategic business units? Some strategic companies develop or put together strategic business units in different ways. How are you going to handle it in GAAP so that it makes sense?

Reports are best when they measure how management runs the company. There are reports that management wants and that they use. Identify what's happening. You want to try to align your GAAP project so you're getting them the reports that they use. You also have internal versus external concerns. Externally your company may say, *we're just going to show the total company in the policyholder report.* That's it, we won't show anything else to anybody else. What are you going to do if a rating agency wants to see it by major project line? Internally you're concerned about getting the information that management's going to use, and what are those different levels? There are product lines, there are lines of business, corporate accounts. Suppose you have a separate surplus account, what are you going to do with it on a GAAP basis? Is it now merged within your product lines? Do you want to keep it with the product lines or extract it so the product lines can be handled or viewed by themselves? How do you handle affiliates? How do you handle subs?

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Some companies try to look at their investment operations as a separate business, and they have their own internal profit and loss statement (P&L). Can you do something for GAAP on that? How are consolidations used? Can you provide management with GAAP reports that will help them get the answers that they need to run the business?

Regular industrial companies file a quarterly report publicly. Mutual companies are going to have one annual report. I've heard that some mutual companies are planning on doing quarterly GAAP. It gives them better control, allows them to understand the numbers, becomes routine, and provides easier transition as they merge towards GAAP. On the other side, it's very expensive. We know what it is to do quarterlies for statutory; it's a big problem and lots of money doing it quarterly for GAAP also. Perhaps there's some fallback, perhaps you can do it semiannually. Time it so you do your loss recognition tests somewhere during midyear based upon a six-month or semiannual GAAP. The reporting frequency needs to be addressed. Project managers should make sure up front that their steering committee is talking about subjects like that. How far back do you go?

When you do your first policyholder report, most mutual companies just show two years: 1993 balance sheet, 1994 income statement, 1994 balance sheet, 1995 income statement, and year-end 1995 balance sheet. Two years doesn't give you much of a trend, especially if you're not going to have 1994 to somewhere relate in 1995. Some companies have decided to do a 1992 balance sheet and generate a 1993 income statement. It's not needed for the policyholder report, but it will give them an extra year of trend. This is very expensive and a lot more work.

As a possible fallback, look for the areas that you're most concerned about where you need trend analysis. It may not be everything on your balance sheet; it may be 5, 6 or 10 items; then just work back on those 10 items, developing them for one year prior. It could save a lot of work. If you're doing a spin-off or you have one line of business that needs a spin-off, it may need five years. This may be the time to handle them. GAAP is GAAP, but the Securities Exchange Commission (SEC) looks at GAAP differently than the FASB. The SEC has a lot more stringent tests. How many years do you use to evaluate real estate that's available for sale? Five years to the SEC; for FASB, you could probably get away with seven years. Are you going to produce any GAAP that could pass an SEC inspection? Are you going to produce any GAAP that could pass your regular auditors' inspection? You need to know that up front.

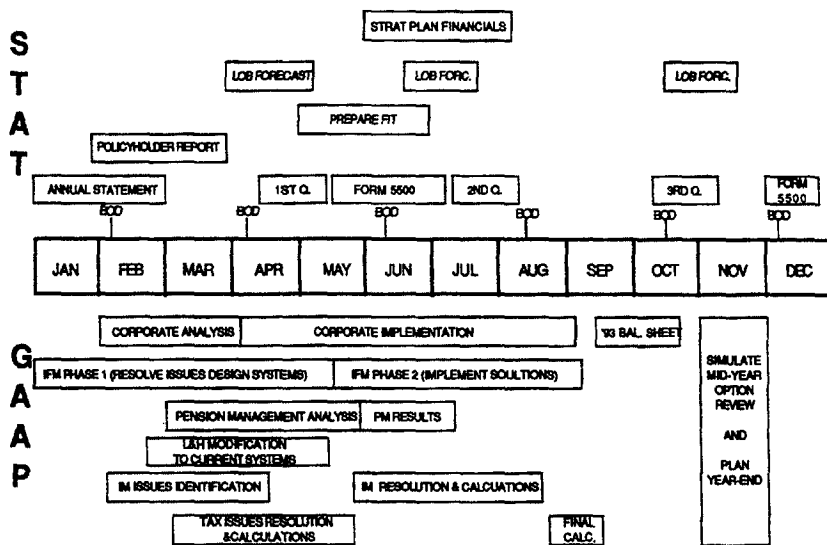
As I said earlier, there are lots of ways to skin a cat. Here are skinning techniques that I've used. Establish target dates and schedules; this is very important, including initial balance, processing deadline, simulated deadline, year-ends. Here's the way I've looked at it as a schedule.

The important thing, from my perspective, is the recognition that the people in my company who are working on the GAAP are the same people who are working on the STAT. So what I've done is put what's required on top, STAT. These people will not be available to work on the GAAP project during these times unless management decides to hire some more people, a zero probability. So now I can start working on my GAAP plans for development knowing when the resources are

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available. This is also used to help get commitments from the different area project team managers on when their people will be working. (See Chart 1.)

CHART 1
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On the more mundane and plebeian subject of budgets and costs, this is big ticket, not cheap, not chicken feed, especially if you're going to use consultants. So I think you need to start thinking about collecting the facts and making sure that you have the centralized information, because as a project manager you will be asked about it. That individual life area project team may be hiring the actuarial consulting firm but paying them out of your cost center. Try to get all the costs (the accounting system, the EDP costs) running through your cost center because, as project manager, you should have that information, and it's also going to help you on control.

Some other tips. Just as I believe that performance reviews are very helpful and absolutely required for people on your staff, I think you should give performance reviews to the actuarial and the accounting consultants that you hire. We've been doing it every six months. As project manager, you have to be very concerned about prompting the accounting policy process—getting the decisions made, getting that process going—because there are going to be a lot of natural delays. The steering committee is very powerful, with lots going on and a lot of discussions. Ms. Big or Mr. Big, the executive sponsor, should be very active in those discussions. I think in running a meeting, there are two roles. There's a person who controls the meeting, and there's a person who's involved in the ongoing discussions, and sometimes people confuse the roles. I facilitate the meetings, which allows everybody a fair opportunity to speak, and it allows the executive sponsors to get involved in the discussions. Again, a lot of these tips are going to depend upon your management style, which will reflect your personality.

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Frequent news bulletins provide the overview so people know what's going on. It helps to keep them informed on all aspects of your project. Keep everybody informed and keep the focus. It's also a good weapon against other, urgent projects. Let me show you what I do. I have a monthly newsletter.

I call it the "GAAP Rap," put out once a month. This is the subscription list. Subscriptions are free, and on top I have my logo. I can shrink it so when I put out any little memo, I shrink it in the "Re" section. I label everything with this GAAP logo, so if somebody sees it, they say, "ah, GAAP," and toss it. Or they put it into a stack of GAAP things that they'll get to on the weekend, but at least I'm getting the word GAAP in front of them. This project is out there; it's not going to go away. We're going to continue to nag you until you get it done.

Establish inter-team data passing. The technical actuaries who are involved in the estimated gross margins need to know what your financial results are going to be from stocks, bonds, mortgages; and they need to know it when they want to do their loss recognition tests. But the investment area may not have that information at the time it is needed. Now we're hearing from our real estate people that in late September 1994, they can provide the best estimate of what's going to foreclose this year, what's going to foreclose next year, and how much write-downs are going to be. So you have to find out who needs what information from whom and when, and then negotiate settlements between the different area project managers.

Also watch internal consistency. Our auditors always bug us that they want to be consistent from one area to another. This is account code review. After the principles are established and after your policies are set, you're going to need to make sure that all your account codes are implemented correctly. Let me give you an example. For universal life under the statutory accounting, the premiums are revenue. Under GAAP accounting, the premiums are not revenue; the margins that are charged are revenues. So you have to go through and identify the account codes for universal life. Here's how those amounts are calculated, and here's where they go into the statement. For GAAP, is the accounting policy the same, yes or no? If it is, I'm OK; if not, I have to establish a new one. Is the code OK, but the numbers are calculated differently? Who calculates that number? Who double-checks that number? Who does the manual review? Who trains the trainer? How do we get that number into the GAAP annual statement? How are the system feeds done?

This area is not very exciting, but if not completely and properly done, it will greatly embarrass you. There is a lot of work to be done over here. It reminds me of the story of a person viewing a great, beautifully sculpted elephant and he said to the sculptor, "How did you carve that elephant out of this big block of marble?" The sculptor said, "Well, I just chipped away everything that didn't look like an elephant."

You have a corporate communications section whose pride and joy is its annual report. They really believe that readers save these reports, they read the report this year, and then they go back and compare it to prior years. You have to give them plenty of time to plan and start thinking about the 1995 report. The 1995 report is going to be completely different, and we'll get into some of the differences in a minute. Do you want to say something in the 1994 report to prepare the readers for 1995, or will they read it in 1995 and say, "Gee, this is far different than anything I

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ever saw before, what a shock." Give them time to think about it, give management time to think about it. There's new information that's going in there; there may be new coordination within higher levels of management of what they want to say; and there's going to be more volatility in the GAAP. When do you start preparing information about volatility? There may be different contacts that need to be made to get the information that goes into the policyholders' report.

We at the Mass Mutual show the same exhibits, the same boring exhibits, year after year, five years of data. And when we do our GAAP, we're only going to have two years. We may not, in fact, want to use those same exhibits; we may want to have different exhibits. A lot of thought will have to go in to the format of the annual report. Do you want to have a reconciliation to statutory? Do you want to mention statutory? If you do want to mention statutory, how are you going to put it into your GAAP reports? You must start planning with the corporate communications department. Do you want to show segmentation information or not? Raising the questions leads to decisions about this data. Now this data is different. You and I are used to financial data. Corporate communications is talking about marketing financial data. That extra adjective adds a little twist to things. You have to work with them.

You have to consider the board; this is no small matter. They must be considered, and unfortunately, the path to the board involves the CEO. For years I've heard mentioned from executive management in their speeches that they've been training the board to understand statutory accounting. How are we going to train them to do GAAP? Do they want to see comparisons with other companies? What are you doing right now with comparisons of other companies and the board? We forecast to tell the board, here's what we're going to do next year. We tell them a little bit in December, and we tell them a lot in February of what we're going to do in that year. Are you prepared to forecast 1995 GAAP? A lot of us don't even know what 1994 is going to look like. How are you going to answer? Yes or no, do you want a forecast? How are you going to make the transition?

Different committees are going to be involved. The audit committee at the annual meeting makes representations that they've looked at the financials that are appearing in the annual report. How comfortable will they be with the GAAP numbers? The investment committee sees regular reports right now. But we're going to have different investment numbers on what's been impaired on real estate on a GAAP basis. We have to get them involved. What about the compensation committee? One of the things I would suggest here is to plan future board meetings along with the executive sponsor. I've laid out all the board meetings between now and 1997 and asked the executive sponsor, what do you want me to do or have done in front of the board, with the board, for the board at every one of these meetings until this date, because we have a lot of problems up here and a lot of things to consider. As project manager, you have to be concerned about the board.

How are we going to get those numbers from where they are right now to where they need to be? A little problem we had involved variable life and a great deal of differences in the accounting. If I go to the systems area, what I hear is, "The systems area is working and is way behind in implementation of the new, important, we-must-have, can't-live-without variable life product, and don't bother them for three years because they can't answer any of your questions or do anything for you." But

we need some information. "Perhaps maybe at the end of the year, tell them what you want and they will program something to just give you a few numbers. Then you have to enter it into your systems to get the data, but come armed with plenty of man-months." Up front, where are you going to need the information and where's the flow integrity of your numbers on your system? How's the data going to flow? You have to avoid the dreaded overlay of data.

Do you have a project where you're doing just enough to pass the audit? Management has agreed not to ask you lots of questions to explain what's going on. And if they do ask you a question, it's perfectly acceptable to say, "I don't know why it's happening, but it's in compliance with GAAP accounting." Or are they going to want to know how implied GAAP results compare with what's implied by your cash-flow testing under Regulation 126, why your answers are different than current management reports, and what this trend means. It's not simply can you forecast, but can you explain what the forecast means? As project managers, you may not have to answer these questions, but you have to assign people up front who will answer those questions. If you're the technical actuary, this is an area you have to start worrying about. And then there is the dreaded explaining unanticipated results. Is the data bad? No, the data's okay. Is the theory flawed? The data's OK, the theory's OK. Has it been programmed wrong? Or we just hit a very unique point in the curve that we hadn't considered where the curve falls off precipitously. I've worked on other systems, on other projects, and you have to go through this whole evaluation process because everybody is pointing at everybody else. You have to be aware of the changes that are going on.

I think that as project managers you have to follow what's happening in the NAIC. Let me give you an example. On statutory accounting, they're very concerned with the solvency of the company. They want to identify very early whether a company is solvent. If it's starting to get weak, they want to keep things quiet and then work with the company to get it back on track. On GAAP accounting, the auditors are interested in providing all the information that's known, so that if the company goes south, an investor won't sue the auditing firm because the investor made a decision based on the financials that were incorrect and the auditing firm had sanctioned those financials. So if anything is bad, they want complete publicity. You have two different opinions that are worlds apart. There's a lot that is going to happen between NAIC versus the auditing firms.

I think it's beneficial to meet with other company project managers, and I'd be willing to meet with any one of you here later on or your project managers. I could share ideas with you, and learn tips from you. Please don't forget about the documentation. It always comes last and is always forgotten. As project manager, I think the most important thing you can think about is that you're there to facilitate; you're there to help; you're there to prompt; and you're there to assist those project teams to get things done.

MR. DURAN: Our next speaker is Tom Burke from New York Life. Tom, in contrast to Ed, is going to talk about some of the more technical actuarial aspects of the project.

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MR. THOMAS PATRICK BURKE: I'm going to talk about GAAP for mutuals from the actuarial point of view. My talk is going to have a fairly heavy emphasis on life insurance business, not only because that's the part of the project I'm working on, but also because, for any company with a substantial block of life business, the bulk of the effort to convert to GAAP is going to be on the life products. But I will try to point out any special considerations for other products, such as disability income (DI) or annuities. I'll be talking about four main areas. The first section is going to be a general overview of why mutual companies have to produce GAAP statements; the second section will be a comparison of current-stock company GAAP with mutual company GAAP, and a brief review of stock company GAAP; the third section will be a fairly detailed review of the new GAAP for mutuals SOP; and the fourth and longest section will be a detailed review of all kinds of issues that come up with implementing GAAP at a mutual company.

I'll start with the first section, that is, why GAAP is required for mutual companies. The short answer to that question is because the Financial Accounting Standards Board (FASB) said so. The FASB is the rulemaking body for the accounting profession. Last year it issued something called Interpretation 40, which basically formalized the board's intentions to have mutual companies report on a GAAP basis. It says that auditors can only give audit opinions on GAAP statements. Now in the past, mutual companies have been excluded from GAAP reporting. However, this exemption wasn't due to a decision that GAAP concepts didn't apply to mutuals. The issue had come up numerous times in developing the GAAP literature for stock companies, but it had been deferred for a couple of reasons. One of them is that it's fairly difficult to apply GAAP to mutual company business primarily because of the dividend mechanism on participating contracts. There was also a disagreement over the real purpose of mutual companies' financial statements, and because mutual companies weren't publicly traded, there was no pressure from financial markets or securities analysts for GAAP statements. So not much happened on GAAP for mutuals until about 1992, when the FASB instructed the AICPA to, in their words, "expeditiously complete" its GAAP for mutuals project.

And that leads us to the next issue, which is the evolution of the GAAP for mutuals draft SOP. Since there was no GAAP guidance for mutual companies, something had to be put together. The first step was to review the existing GAAP guidance, *FAS 60* and *FAS 97*. It was concluded that neither *FAS 60* nor *FAS 97* was suitable for participating life contracts. That's mainly because participating contracts have features of both *FAS 60* and *FAS 97* products. Like *FAS 60* products, premiums are fixed and are typically level, and the policy charges are not unbundled. However, the emergence of earnings on participating contracts is more like that of an *FAS 97* product because of the dividend mechanism.

The AICPA concluded that special treatment was required for participating life business and that all other business issued by mutual companies would fall under the current accounting as it applies to stock companies. So a task force was put together to develop the GAAP guidance for mutuals, and it was instructed to work from the existing GAAP guidance, *FAS 60* and *FAS 97*. Two tentative position papers were developed. One of them used *FAS 60* as a starting point and featured concepts of having reserves calculated by using experience assumptions and DAC amortization in proportion to premium income. The other one, which used *FAS 97* as

a starting point, featured DAC amortization in proportion to basically the profit stream. There was a preference for the *FAS 97* approach. Part of the reason was that the *FAS 60* approach featured prospective unlocking, while the *FAS 97* was a full retrospective unlocking. And the *FAS 97*-based approach was accepted by the AICPA.

That leads us to the next issue, which is the status of SOP. Earlier this year, the FASB voted, and it was accepted as an exposure draft. It's currently out now as an exposure draft, and the comment period runs through June 30, 1994. The effective dates for this SOP would be for the 1995 financial statements. Two prior-year statements would be required at that time.

Now I'm going to move on to section two, which is a stock company GAAP versus mutual company GAAP. I'm sure most of you are aware that there are two main GAAP models for stock companies, *FAS 60* and *FAS 97*. Under *FAS 60*, income emerges as a level percentage of premium. The change in reserves is reported in the income statement as an expense item. Another feature of *FAS 60* is the "lock-in" concept, which basically says that your reserve and DAC assumptions are set at issue and are not changed, except in unusual circumstances.

Now for *FAS 97*, the key features are that income emerges in proportion to the margins in the product, the margins being the excess of the cost of insurance (COI) charges over mortality, the excess of the interest earned over the interest credited, any expense margin, and surrender charges. Other features of *FAS 97* are that the income statement itself is based on the policy charges, reserves are equal to the policyholder account balances, and the use of retrospective unlocking. Now the area that is different between current stock company GAAP and mutual GAAP is the treatment of participating business, which leads to the third section: the mutual company GAAP definition.

This is the new SOP for mutuals, which is out right now as an exposure draft. The first section is the scope of the SOP: it applies to all mutual and fraternal life companies; it applies only to participating business; it applies only to life insurance business, so no annuities or DI are covered by this, even if they are participating. To meet the definition of participating, two criteria have to be met. First, the contracts have to be of long duration and expected to pay dividends based on actual experience, and second, dividends have to be based on the contribution principle. In earlier versions of this draft this was referred to as "actively managed," a line that has since been taken out, but basically reflects the same concept. So all other contracts that don't meet those criteria in a mutual company would be classified under either *FAS 60* or *FAS 97*. One interesting item is that this SOP is optionally applicable to stock companies that have participating business. The AICPA recommended that it be required for stock companies, but the FASB backed off and switched it to optional.

The next issue is definition, and this is basically how it's going to work, or how it's going to look. The first thing is the income statement presentation. Now the GAAP for mutuals SOP, even though it uses *FAS 97* as the starting point, will have an income statement that looks more like *FAS 60*. In the income statement under the GAAP for mutuals SOP, premiums will be recorded as revenue. The only difference from *FAS 60* is that there will be some special treatment for limited pay contracts

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similar to that in *FAS 97*. An *FAS 97*-type, margin-based statement was considered, but that was rejected for a couple of reasons. The main reason is there are practical problems with breaking a participating policy into the separate components. Also, there are differences in the nature of premiums between UL and traditional products. One reason for having the margin-based statement for UL contracts was the flexible premium nature of UL, and that really isn't the case with traditional products, so the premium recognition will be similar to that in *FAS 60*. Other items on the income statement will also be similar to *FAS 60*. The change in the benefit reserve will be reported in the income statement; surrender benefits and the gross amount of death benefits will be included in the income statement, etc.

The next item is the reserve basis for the mutual GAAP business, and this is one of the more *FAS 97*-like concepts. Unlike *FAS 60*, where the reserves are calculated using estimates of actual experience, the mutual GAAP SOP will have reserves that are more analogous to the account balance on the UL contract. Because there is no explicit account balance for traditional policies, some sort of proxy had to be developed and several alternatives were considered. It was decided to use as a proxy for the account balance a net-level premium statutory reserve calculated on the following assumptions: the interest rate used would be the same as what they call the "dividend fund" interest rate (the dividend fund is basically the item that experience is measured against in calculating your dividends; it's the basis of your dividend scale); the mortality basis used in the reserve would be that used in the guaranteed cash value. In most cases, it's going to work out that the interest and mortality are the same as those used in the statutory reserves, so your GAAP benefit reserves will often be net-level premium reserves calculated on the same basis as your statutory reserves.

The next item is the DAC amortization. This is really the key to the whole method, and it's where the *FAS 97* nature becomes quite clear. Deferred acquisition costs are going to be amortized in proportion to something called the gross margin, and the gross margin is somewhat similar to statutory net income with a couple adjustments. The revenue items that go into the gross margin would be premium income and investment income, calculated on just the policy liability balances. In that investment income, realized capital gains would be reflected, consistent with *FAS 97*. The expense items that would go into the gross margin calculation would be things like maintenance expenses, death benefits, surrender benefits, any endowment on maturity benefits, the change in the benefit reserve, and policyholder dividends. There might be some other items that I'll get to later, depending on the approach you've taken to actually calculating this. One difference in the policyholder dividends is that the dividend liability used on a GAAP basis would probably be different from your statutory dividend liability. Under statutory, the dividend liability is basically the next-year's expected dividend payout. On a GAAP basis, it would be more like a half-year's dividend payout.

Another feature taken from *FAS 97* is retrospective unlocking. The SOP requires that the estimates of expected gross margins be evaluated regularly and that the total amortization recorded to date be adjusted by a charge or credit to current earnings. So the assumptions used have to be reviewed and periodically changed to reflect your new, best estimate, and your past experience to reflect what actually happened. Any change in DAC would run through the current year's earnings. In practice, this

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probably means that you'll be revising assumptions consistent with changes in your dividend scale.

Another feature of the mutual GAAP SOP is adverse deviation. The SOP specifically says that no adverse deviation will be used in calculating the gross margin, and once again, that's consistent with *FAS 97* and consistent with the goal of having profits emerge in constant proportion to the gross margin. Of course, that's different from *FAS 60*, which requires an explicit provision for adverse deviation. Another way to look at the adverse deviation issue is that the ability to adjust the dividends implicitly takes into account any provision needed for adverse deviation.

The next item is dividends paid in cash. This is one item that's been a little controversial in the exposure draft. In calculating the gross margin, you are required in most cases to assume that dividends are paid in cash. There is an exception. If a policy is built around a specific dividend option, such as paid-up additions (PUA), then that can be taken into account. But in most cases, it's required to assume that dividends will be paid in cash. What that means is that any profits arising from dividend options, such as PUA or one-year term, can't be taken into account in calculating your basis of DAC amortization. Some people have expressed some concern that that leaves out a fairly significant piece of profit.

Another item on the GAAP for mutuals SOP is the treatment of terminal dividends. The SOP requires special treatment for terminal dividends. A separate liability is to be calculated, and it's basically a reserve equal to the present value of expected dividend payouts spread out in proportion to the gross margin amount. Some people have also expressed concern about this issue because the magnitude of terminal dividends tends to be quite small, and it's a fair amount of work to actually calculate this relatively small liability. It was suggested that perhaps it would be easier to include terminal dividends with the regular policyholder dividends and include those in the gross margin calculation, even though they are theoretically different.

The next point I'm going to cover is comparison with *FAS 60* and *FAS 97*, and this is just a brief review of what I've gone over so far. The mutual GAAP SOP has features of both *FAS 97* and *FAS 60*, though the key elements are taken from *FAS 97*. The *FAS 97* features are that the DAC amortization is based on the margin pattern, retrospective unlocking is required, the reserves are set equal to the "account balance," and best estimate assumptions are to be used. Some of the *FAS 60* features in the mutual GAAP SOP are that premiums are booked as revenue and that the change in reserve is booked as an expense.

The next topic I have is a comparison with statutory. One thing that's somewhat interesting about this is that since the gross margin pattern is so similar to the statutory net income, you're going to get an emergence of profit on a GAAP basis, which is similar to the statutory income, the statutory after the first couple of years when the distortion due to acquisition expenses wears off. Another thing that's interesting when you compare it to statutory is that the reserves on a GAAP basis will be higher than those on a statutory basis.

The last section is implementation issues. The first thing is the overall approach, detailed versus simplified. I am overlapping with what Ed has talked about before,

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and that's the overall philosophy of the project. And that really depends on the next item, which is what GAAP financials will be used for, and the questions there would be whether the company intends to manage on a GAAP basis or whether the company is putting together GAAP statements simply for compliance reasons in order to get a clean audit opinion. Based on that, the answer of detailed versus simplified can be answered a little more clearly. Some of the things that would fall into the detailed-versus-simplified category includes, does the company intend to produce financial statements just for the entity, or by line of business, or by separate product? Do you want to put together fully automated systems to calculate the values that go into the GAAP statements, or are more manual approximations acceptable? Does the company want a full source-of-earnings capability? Do you want to calculate the reserves on a seriatim basis, or would a model-type approach be acceptable? If you're using a model, what level of detail would you want in that? Would you want GAAP earnings projection capability? And there are many, many more issues that I won't get into.

Once there's an overall philosophy, I think one of the first steps in implementing GAAP is product classification. You have to decide which of the three GAAP accounting models each product would fall under (participating SOP, *FAS 97*, or *FAS 60*). Much of this is straightforward, but there are a couple of vague issues. The first thing would be mutual-company GAAP products, and that's basically going to be all the company's participating life business, where the definition of participating products is those that expect to pay dividends based on actual experience and dividends that are calculated based on a contribution principle. One item it does include would be limited-pay participating contracts. *FAS 97* has some special treatment for limited-pay contracts, but the order of classification is such that if a product meets the mutual definition, then it goes into that bucket first and then after that would be a test whether it would be an *FAS 60* or *FAS 97* product. So limited-pay participating contracts would first be tested for whether they meet the participating definition.

The next group of products would be *FAS 97* products, and the big ones would be universal life contracts, and those would also include any excess-interest-type contracts. Other *FAS 97* contracts would be investment contracts, and those are defined as long-duration contracts without mortality or morbidity risks. Some examples of those would be things like deferred annuities or GICs. Other *FAS 97* products would be limited-pay contracts, and those are defined simply as long-duration contracts for which the premiums are payable over a shorter period than the benefit period. As I said before, those would be only nonparticipating contracts in a mutual company. The last product classification would be *FAS 60* products, and that's basically everything else. For a mutual company, it would include the nonparticipating life business, and that might turn out to be fairly small. In our case, it was really just the term business that fell into the nonparticipating life bucket. Also, immediate annuities and disability income would fall into *FAS 60*.

There are a couple of gray areas in product classification. One of them, which actually isn't that gray, would be nominally participating contracts. Nominally participating are contracts that are filed as participating, but the company does not intend to pay dividends on those. Those would be classified as *FAS 60* because they fail to meet part of the definition for participating that requires that the company

expects to pay dividends. Another case that is less clear is that of participating contracts that do pay dividends, but whose scales are revised very infrequently. If the scales are set at issue and almost never changed (there are certain term contracts that are like that), then it's probably clear that they'd be *FAS 60* because they wouldn't meet the contribution principle definition. However, as the scale revisions become more frequent, it becomes less clear exactly what bucket they'd go into.

Another gray area would be the treatment of nonparticipating term riders that are attached to participating contracts. It's a fairly common feature to have a term rider on a participating contract. However, the SOP is silent about the treatment of term riders. You can make a fairly good case that the term riders should be viewed as part of the base contract. In that case, any profits arising from the term business would be included with that of the base contract in calculating the gross margin used to amortize the DAC. You could also make a case, though, that they should be viewed as separate policies and treated as *FAS 60* business. That's the case that we plan to make, and that was more for administrative reasons. It was easier to separate them out that way, so we plan on doing that. Another vague area is that of immediate annuities or structured settlements that have small amounts of mortality risk. If there's no risk, then it would be clear that's an *FAS 97* contract. But if there's a small amount, should they be classified as an *FAS 97* investment contract, or should they fall under *FAS 60*?

The next thing we go to is the *FAS 60* approach. *FAS 60* is probably the most straightforward of the three methods to implement. Things to consider when implementing *FAS 60* would be what plans to model and, conversely, which plans to exclude due to immateriality. Other things would be whether statutory reserves are an acceptable approximation for GAAP reserves. There might be some products for which that would work. There's some old term business we have that is small enough that we felt that was going to be acceptable. Another issue to consider is the amortization period used for the DAC. Theoretically, your DAC should be amortized over the life of the contract. However, in practice, it's a much shorter period that would be acceptable. And it's up to you and your auditors to decide what's acceptable. As a rule of thumb, a period where only 10-15% of the business is left would probably give you an acceptable amortization period and not distort the results. Some other issues with *FAS 60* are, should the evaluation be done on a seriatim basis or is a modeled approach acceptable? If you choose a modeled approach, then you have to decide on the cells to use, and you have to strike a balance between having a very detailed, but hard-to-maintain model with a lot of cells and a more simplified, but less-precise model with a few cells. Other issues would be the systems approach to use. Should the reserves be calculated from first principles or from factors? Should a new system be developed? Should an existing system be modified? Should a system be purchased from an outside vendor? There are many cases where no system at all might be acceptable.

Another *FAS 60* issue: what assumptions to use. *FAS 60* requires best-estimate assumptions at the time of issue with a provision for adverse deviation. So for implementing GAAP, it's necessary to go back and get those original assumptions, and that can be quite a chore, because everything is not always kept. That's been one of the things we found difficult, going back and getting the original assumptions that were used.

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Some issues that apply just to DI would be things about claim reserve. Should that be locked in at time of incurral, or should it be locked in at time of issue? The assumptions: should they be locked in, or should they be periodically trued up? Another thing is loss recognition, probably more significant on DI than on other products, mainly because of the deterioration the industry has had in morbidity. It could turn out that no DAC at all is recoverable. That isn't particularly good news. It does simplify the implementation, because no DAC has to be developed.

A couple of special issues for term insurance or extended term insurance: this *probably isn't too big a deal for most stock companies, but there are many mutual companies that have an awful lot of extended term business on their books. Because on a statutory basis those reserves are calculated using the CET tables, which have very high mortality, the difference between the GAAP reserve and the STAT reserve is going to be quite high. You may have to do special GAAP treatment for extended term, and that leads to other issues about what assumptions to use, because extended term often isn't explicitly priced.*

Another issue for term insurance is the treatment of conversions. The extra mortality at the time of conversion will more likely than not have to be included in the benefit reserves. Many companies set up a reserve on a statutory basis for term conversions, and that may or may not be usable in a GAAP assumption. You would have to base a GAAP reserve on a more realistic mortality, a more realistic interest, and also include things like lapses once the policy converts.

There are some complicating issues for *FAS 60* implementation; one is prospective unlocking. Even though *FAS 60* specifies lock in, it's fairly common practice, at least as I understand, to unlock reserve assumptions on repricing nonguaranteed premium products, at the time of replacing. That will only be a prospective unlocking, so it's something to consider if you have nonguaranteed premium term insurance. Another problem that I've alluded to is data problems, and that's just finding the old historical data that you need in order to calculate the reserves. And if you're going back 15 or 20 years to dig up the old pricing assumptions, you might find that they aren't always there. Another issue is systems modifications. That's hardly a surprise, but, as always, systems modifications take a little longer than expected.

The *FAS 97* amortization is based on profits; consequently there has to be some way to calculate those profits on both a historical basis and a projected basis, and many of the difficulties that come up on *FAS 97* are due to that. Also there are the same issues as with *FAS 60* on which plans to model and which ones to exclude. There may be some that are so immaterial that there's no need to even capture the DAC on those, or there are some plans where the pattern of amortization can be approximated by using the amortization pattern from a different product. Like *FAS 60*, an amortization period has to be selected. Because *FAS 97* is based on profits rather than premium, it makes more sense to test your amortization period based on the percentage of profits left after a certain period than the percentage of business in force.

Another issue to consider is whether to use the worksheet-versus-factor approach for calculating the DAC. There seems to be a fairly strong consensus that it's best to stay away from the factor approach for *FAS 97* products. That's due to the problems of retrospective unlocking. Once again, there are the systems issues, such as

whether to develop a fully automated system or use a combination of systems and manual worksheet adjustments (such as using the PTS system or the TAS system for projecting the gross profits). The next item is the selection of assumptions. *FAS 97* specifies that assumptions are on a best-estimate basis.

The next item is retrospective unlocking, and this leads to the problem of creating the historical gross profits. In order to implement GAAP, you have to go back to inception or back by the length of your amortization period, and calculate the gross profits, the margins in the product, in order to bring the DAC up to your opening balance date. There are several ways to do that. One way is to take the model you're going to use for projections, start that at the inception year, and run it forward. One problem with that is it's difficult to validate. It's going to be very hard to match what actually happened by running your model forward. There's an awful lot of points to hit, and it's unlikely that you can hit many of them.

Another way is to work from statutory-type numbers and convert those into GAAP numbers. That's the approach we chose to use, but the problem with this approach is that much of the information, especially for *FAS 97*, isn't available in your statutory accounting. You can get at it, though, by putting together an account roll-forward and backing into things that you're missing, things like the COI charges. This approach has the advantage that, because you're working from your statutory financials, you're automatically validating. The next thing I have here is the development of the projected gross margins. There are options of using an existing model or developing a new one. One of the advantages of using the existing one is that it's probably going to validate fairly well if it was created for uses like cash-flow testing and other company modeling.

Some complications that arise in the *FAS 97* implementation: first, the lack of data. That's been our biggest problem, going back and getting the historical data. All the computer tapes aren't always available; sometimes they aren't in the right format. Another complication is the treatment of riders. Once again, the accounting literature is silent on what to do with riders, but it probably makes sense that they should be included in your gross profit stream. A second complication is reinsurance. If there's a significant amount of reinsurance on the business, that also should be brought into your gross profit stream to calculate the proper amortization.

The final area of implementation, and it's the biggest one, is the mutual company GAAP implementation. Because mutual company GAAP is also based on the profit-type pattern for DAC amortization, it's necessary to go back and calculate the gross margin amount on a historical, as well as a projected, basis. One of the items you'll need is the reserves. Those are the net-level premium reserves calculated at the time, on a basis similar to your statutory reserves. And there are the different options to do that. It can be done on a seriatim basis, it can be done on a model basis, or perhaps you could adjust your statutory reserves. You can develop durational factors to adjust your commissioners reserve valuation method (CRVM) reserves to a net-level premium basis.

DAC has similar issues to the *FAS 97*. The worksheets or factors approach is a question once again. It probably makes sense to avoid the factor-type approach because of the unlocking nature of the method. Selection of assumptions is also

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consistent with *FAS 97*. They are to be done on a best-estimate basis, with no provision for adverse deviation. One thing that's important to keep in mind is that it's necessary to have consistency between the dividend scales and the assumptions. If the decline in portfolio rate is projected, it makes sense that the dividend scale should also be projected to come down consistent with that. The next item is the historical gross margins. They're similar to the *FAS 97* margins, and there are a couple ways to calculate historical margins. They can also be calculated by using the model you're going to use for projections, and running that starting at an earlier date. That will have the same problem with validation, or you can work from the statutory financials and convert those into what you need for the gross margin amount. Once again that offers the automatic validation capability, but it can be difficult to get all the data you need.

Like *FAS 97*, the biggest implementation complication was the lack of data problem, and this is a bigger problem on the mutual business primarily because the mutual business tends to be quite a bit older than the *FAS 97* business. You have to go back even further and there's more of it. One problem that we've run into is that we have to go back past the retention limit of some of the computer tapes; the data has been deleted, so it's not available anymore. Another problem is that the old tapes exist, but the format of the systems has changed, so they can't be read any more. Also, hard copy output often exists, but it's not of sufficient detail to calculate the gross margin amount. Another complication comes from the treatment of riders. As I said before, the SOP is silent on the treatment of riders; however, it seems reasonable to assume that they should be included in the gross margin calculation. Therefore, there are additional items to collect in order to do that: the benefits, premiums, reserves, etc. Then they have to be allocated consistent with the way you're calculating the gross margins, by a year of issue at least. And there is also the possible option of treating term riders as *FAS 60* products.

The next thing I'm going to cover is the treatment of nonforfeiture options. When a policy lapses to a nonforfeiture option, such as extended term or reduced paid up, there's a question about whether the nonforfeiture option that it goes to should be considered a continuation of the original policy or a lapse. If you treat it as a continuation, then the DAC has to be transferred to that reduced paid up or extended term policy, and there has to be some way of tracking that transaction. If it's treated as a lapse, then the amount lapsing to a nonforfeiture option has to be tracked.

This is more complicated than it seems, because this is one item that doesn't have any analog in statutory accounting. You don't have recorded in your statutory books the amount of business that goes to reduced paid up or extended term, and the number can be fairly large. We found that it's definitely within the materiality range, and we spent a disproportionate amount of time trying to take care of that issue. The next thing I'm going to talk about is the treatment of reinsurance, and I won't get into that too much, other than to say that if there is a significant amount of reinsurance, that also has to be brought into the gross-margin calculation. Dividend additions are to be excluded from the gross-margin calculation because of the assumption that dividends are paid in cash.

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I just want to highlight approximations. No matter how precise you want to be, it's necessary to make some fairly large approximations as you go back in and re-create the historical information.

The next two points, "how good is good enough" and "materiality standards" are really the same thing. That refers to how precise you want the information to be and how precise the auditors expect you to be.

There is not much to say about loss recognition and recoverability, except that loss recognition may or may not be a big issue. I expect it wouldn't be a big issue for participating business. Loss recognition testing on participating business would be done similar to *FAS 97*, where you compare the DAC to the future, gross-profit amount.

I'm going to finish up with just a couple things about changes to ongoing procedures. In order to report GAAP going forward, you probably want to make some permanent systems changes for *FAS 97* reporting in order to get the COI charges, the interest credited, etc. You'll have to modify the systems to produce those. There probably won't be as many changes on the mutual GAAP side, but there may be. The nonforfeiture issue was kind of difficult, and systems may have to be modified for that.

The final item, "understanding mutual company GAAP," is a subject for a whole meeting in itself. One problem with understanding it is there is going to be an inconsistency with stock companies. Because there are many stock companies that have some participating business, the treatment of mutual company business is going to be different from stock business, though stock companies do have the option of adopting the mutual GAAP SOP. It's unclear how many would actually go to the trouble of doing that.

MR. DURAN: Each table consists of its own breakout group, so appoint a recorder/spokesperson and try to identify what you see as the big issues, the big questions, the big challenges in implementing mutual GAAP. I think it would be particularly helpful if people came up with areas that have not been touched on by the panelists, or areas where they might have a different view or want to add a different perspective. I think each company is going to look at this thing a little differently from every other company, and everybody has a valid perspective to bring to this. We'll do working groups and then report back. We have 14 tables here, so we're not going to be able to get very extensive or lengthy reports.

MR. BRUCE R. DARLING: I'm with Booke Seminars and we teach GAAP seminars among other things, and there are many issues that have come up in our seminars as well as around the table. I have one question about implementation. There are probably going to be some companies that don't implement in 1995. The FASB statement or the proposed new standard seems to indicate that you have to restate all the way back to 1993 whenever you implement, because it talks about fiscal years after December 15, 1992. So I just wanted to raise that as an observation, but it also raises a question: what happens with the SEC in filing variable life and variable annuities after 1995? Have you heard anything about how the SEC is now looking at this whole thing?

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MR. KLINE: I haven't heard anything very recently, no.

MR. BURKE: Back when Interpretation 40 came out, the SEC said that they hadn't really thought about it and that statutory would continue to be OK for mutuals.

MR. DURAN: They said that a number of times after that on a very informal basis, so there's nothing official from the SEC that I have heard of. Many people believe that once these standards have been finalized, the SEC may well take the position that companies need GAAP statements in their filings, but it's really an unknown.

MR. DARLING: Right. So that one's still hanging out there. I have a question about capital gains in the margins for participating products, that wasn't really addressed in the SOP. Practice Bulletin 8 says that you should do it for UL-type contracts, and this is kind of modeled after that. Would you include capital gains for participating products as well?

MR. BURKE: We were taking the interpretation that you would include realized capital gains in the gross margins, consistent with the *FAS 97* approach.

MR. DARLING: That raises a related issue. The SEC and the FASB have both said that for available-for-sale assets under *FAS 115*, you should take the shadow DAC against the unrealized holding gains and losses in equity. Just to recap what that's all about, available-for-sale assets are marked to market, but the changes in market value go through equity below the line and not through income, so they wouldn't affect UL-type amortization. However, the SEC feels that if you just show the whole unrealized gain, you're overstating your equity because, first, tax effects, they say to take tax effects off, and second, if you were to take that into your amortization as if it were in your income, then it would affect that and would reduce your capital gains also. So the question is whether that also means you have to calculate your DAC twice, with and without these unrealized gains, for participating products as well as UL.

MR. BURKE: We were taking the interpretation that you would on the participating products as well as the UL.

MR. DARLING: That's a big implementation issue people need to be aware of because that might be difficult to do. It might be easy if you have a worksheet method; you can just add them in.

MR. BURKE: I agree that it's definitely a big implementation issue.

MR. DURAN: That is an SEC requirement only. It's not a *FASB* GAAP requirement.

MR. DARLING: Well, the *FASB* Emerging Issues Task Force (EITF) blessed it at their January 20, 1994 meeting.

MR. DURAN: I've been assuming that based on the spirit of the SOP, which is consistency with *FAS 97* income emergence, that companies would make those so-called, pro forma adjustments. Is there any company in the room that is planning on adopting GAAP, but not doing that on the participating business?

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MR. DARLING: We hadn't thought about it yet. I have a question about limited-pay products, limited-pay participating products. The SOP accounting is different than the limited-pay treatment for nonparticipating products under *FAS 60* and *FAS 97*. It says that you're supposed to spread the premiums on those and defer them as unearned revenue, and include the unearned revenue spreading in the gross margins that are used as the basis of amortization. I was a little confused by that. Does that mean that you're supposed to literally treat that as unearned revenue and change your premium revenue line in your income statement to reflect that, or is it simply in the margin for amortization?

MR. DURAN: My understanding of it is that there will be a change to your income statement. You still record premiums as revenue as you do for *FAS 60* limited-pay products, but there will be an unearned premium reserve, if you will, and the gross margins will also be modified so that premiums will be spread. That's my understanding. For those who might not know, this issue came up after the task force had sent what they believed to be the final version off to the FASB for review, and the FASB insisted that some language like that be put in. I think there will be a number of comments that oppose the change.

MR. DARLING: If the premiums are then spread over the lifetime of the contract, does that mean the net-level reserve also should be done with a whole-life premium payment or whole-term premium payment, instead of limited? That would seem to be consistent.

MR. DURAN: I don't know. That's a good question.

MR. DARLING: I found it to be complicated and not very clear.

MR. DURAN: It certainly doesn't say one way or another. There are a lot of areas where the SOP is simply silent.

MR. DARLING: I also have a question about terminal dividends. The guidance there says to accrue them as a percentage of the gross profits. This was patterned, I guess, after persistency bonuses on UL. Were those things ever approved as a percentage of gross profits, estimated gross profits?

MR. DURAN: I'm sorry. I don't understand the question.

MR. DARLING: I was wondering if the guidance in this SOP that terminal dividends should be accrued for as a percentage of the gross margins would end up being applied to universal-life type contracts where you have something like persistency bonuses, where you can accrue for them any way you want to right now. Would you try to make people accrue for them as a percentage of gross profits?

MR. DURAN: I agree with you that the intent under the SOP is that the terminal dividends be spread in proportion to gross margins. Because the SOP comes after *FAS 97*, that would lend some weight to doing persistency bonuses under *FAS 97* the same way. But because there is no written rule, I don't know why the accounting for universal life business for stock companies, for example, would suddenly have

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gotten more restrictive. That is a method that some people use. I don't know if you can interpret the SOP to be speaking about that; I suppose you could.

MR. DARLING: There is also a concern at our table about some of their products really being classed as universal life-type contracts because they were participating deferred annuities or because they were adjustable life contracts with premium dump-ins allowed. Have you had to deal with those types of contracts and with the order of defining something as UL or participating?

MR. BURKE: We haven't had any vague issues on the universal life. The closest to vague would be excess-interest whole life, but nothing that seemed very unclear to us.

MR. DURAN: You mentioned deferred annuities. That one, in my opinion, is not the least bit vague. The SOP says it applies to participating life insurance contracts and in the basis for conclusions, it says that it was decided that other contracts, and they list about six or seven (DI, GICs, deferred annuities specifically), would continue to follow the current guidance. Now your other question, I'm not sure what it relates to unless it's participating policies with dump-in provisions as, for example, to purchase paid-up adds.

MR. DARLING: Or increase the cash value where the cash value's defined as an account balance-type accrual.

MR. DURAN: I think if it's a mutual company and it's life insurance and it's long duration and expected to pay dividends and in accordance with the contribution principle, in my mind that says it's an SOP product.

MR. DARLING: Well, the SOP also says that products that are essentially like others in a stock company would be treated by 60 or 97. So to me there's still a question about the order of applying those principles.

MR. DURAN: OK.

MR. DARLING: I have one last observation. Zero first-year dividends are common in the industry, and that amounts to something like a front-end load in calculating your margins. Under FAS 97, with the UL-type contract, that front-end load would be spread over the term of the contract. Under the participating contracts, it's just increasing the margin the first year, so it increases your DAC amortization, but the whole bit of that extra margin goes through that year. So essentially, if you have two otherwise identical participating and UL contracts, profits will come in earlier on a participating contract because that isn't being spread.

MR. DURAN: I agree with that. I would say there's a requirement against treating a zero first-year dividend as a load. There's no basis to do that in the SOP. So yes, I would agree with your conclusion. In general, the approach taken in the SOP makes the reported results highly dependent on the product structure and the slope of the dividend scale. Two products with the same present value of dividends can have vastly different reported income depending on how the dividends are sloped. What

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you mention is probably an example of that. I'd be curious if there is any company that would like to or thinks it has a basis for deferring a zero-first-year dividend.

MR. ROBERT LALONDE: Our table discussed what we might do with the numbers that we produce after we go through this conversion to GAAP. Although most of the people who were representing the mutual companies did not agree that statutory accounting methodology was the best way to manage your business, it seemed that all of them had their own internal way of being able to account for the profitability of the business and being able to manage the dividend scales. I think the consensus was that each company or each person had their own idea about the best way to do this, yet they were not ready to say that GAAP, although they're going to use it for marketing purposes or because it's necessary to help the company move along, is going to be the methodology that they might use to manage the business. They did recognize that the internal management method might move over time to GAAP, but they were not ready to kick start that at this moment.

MR. DURAN: Would anyone else like to make some observations?

MR. SCOTT D. HAGLUND: I can respond better to Bruce's comment about product classification. One of the issues we have is that we sell a lot of adjustable products. Some of our adjustable products seem to be clearly *FAS 97* and some fall under the SOP, and one of the difficulties is that we allow reissues between the products. You can switch from *FAS 97* accounting to the SOP accounting. Just from my consistency standpoint, our earnings streams have gone wild during some of these times, so we're attempting to justify treating them all as probably the SOP instead of *FAS 97*, although *FAS 97* treatment might be more clear. So it's just one of the internal classification struggles we've run into.

At our table, one of the issues we talked about was the dividend application and how you can inject it into the benefit stream in projecting certain things. I know application of dividend has a big impact on the policy. If you treat it as cash, you can definitely alter the future income stream, so I know we're dealing with the issue of possibly not treating them as cash, because it does have a dramatic impact on projections. I know that's one of the issues with the new SOP, when it talks about treating them as cash or paid-up additions, that it may not reflect accurately the product characteristics and has a real material impact on earnings streams.

MR. DURAN: It certainly does, and as I said, I know of a number of companies that intend to comment on that particular aspect of the SOP. I would not personally be tremendously surprised to see that change. For one thing, it's really not consistent with the whole spirit of basing your experience on best-estimate assumptions. You do everything on best estimate, but then you assume the dividends will be paid in cash, when in fact maybe 80% of them aren't. I think that on a theoretical basis the SOP is very weak on that particular point.

MR. HAGLUND: I agree. One last comment that we talked about is on the financial reporting appearance, where you have the difficulty of the *FAS 60, 97*, and the SOP having different items in the income statement, and just more of what people may be doing to present a more consistent report, instead of having three entirely different types of financial reports.

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MR. DURAN: I'd be curious if anybody has found a solution to that particular problem. I know it was a concern to many stock companies back in 1988, when *FAS 97* came out. Now we have three models rather than two. Does anybody have any comments on that?

MR. JOHN W. H. TAYLOR: London Pacific went through that problem of confusion caused by the two. Mutual companies are going to have three different methods of treating products. They made the decision that because they had more products that were *FAS 97* than were *FAS 60*, they decided to report everything to management as if it were *FAS 97* and then convert to whatever outside reporting required, so it could be at least understood internally.

MR. DURAN: I know that many mutual companies in their internal management-basis statements, even though they may have had an *FAS 97* approach to universal life, counted the premiums as revenue because of this problem. They can't do that, obviously, in statements that are supposed to be GAAP. Is there anybody else who would like to volunteer some thoughts?

MR. GILBERT SCOTT FEIN: We acknowledged that the majority of the new GAAP implications will have an impact in the individual area. We were curious at our table if you would comment on the impact it might have on the group or the pension area.

MR. DURAN: I think often the group area has no GAAP adjustments of an insurance nature, or minimal. The premiums paid in advance asset might be different for STAT than GAAP, and if you have a lot of long term disability (LTD) business valued at very low interest rates, you might adjust that, but, in general, it's pretty minimal. For group pension business, usually the major adjustment is to pay out annuities, to put them on a GAAP reserve basis rather than statutory. Many companies don't have a DAC on group business. It's a case-by-case situation. Often those products are so investment-oriented and the commissions are small relative to the other sources of income and expense, so that very often there is no DAC.

FROM THE FLOOR: You wouldn't think there would be any DAC on group life or group health?

MR. DURAN: Well of course, it depends on your distribution system and how you acquire the business. Most often companies will make the argument that business has to be reacquired every year, so that most of the expenses are really in the nature of an ongoing expense. There are some expenses associated with initial case setup and that type of thing, but those are minimal in the grand scheme of things.

