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GAAP FOR MUTUALS

Moderator: JEFFREY S. SCHLINSOG
Panelists: BRUCE E. LOVETT
DIONNE D. MCNAMEE*
BRADLEY M. SMITH
Recorder: JEFFREY S. SCHLINSOG

This session will cover FASB/AICPA pronouncements concerning application of GAAP to mutual life insurance companies. Panelists will discuss practical issues, including materiality and use of approximations. Issues of particular concern to smaller companies will be discussed.

MR. JEFFREY S. SCHLINSOG: At the time of the annual meeting in Chicago in the fall of 1994, the AICPA had issued a proposed statement of position (SOP) describing GAAP for mutuals in an exposure draft. The AICPA has since finalized that as SOP 95-1, "Accounting for Certain Insurance Activities of Mutual Life Insurance Enterprises." Then in January 1995, the FASB adopted *FAS 120* which prescribes GAAP for mutual life insurance companies. This is effective for fiscal years beginning after December 15, 1995.

Our agenda is an ambitious one. We want to introduce you to GAAP for mutuals, consider some practical implementation issues, review sample calculations, describe an alternative approach to developing opening balances that you might use, and discuss specific implementation issues for mutual companies. Of course, we want to leave some time for questions and comments.

Our first speaker is Dionne McNamee. Dionne is a director at Price Waterhouse LLP. She was formerly on the AICPA staff and, in fact, was on the task force that developed GAAP for mutual life insurance companies. Dionne will introduce us to the SOP and describe some of its history.

Bruce Lovett is second vice president and actuary at The Guardian. Among his interests he includes financial reporting, reinsurance, and agent compensation. Bruce will discuss some of the implementation issues for mutual companies.

Brad Smith is a principal at Milliman & Robertson, Inc. and heads up the Dallas office life and health consulting practice. He is also a council member of the Life Insurance Company Financial Reporting Section in the Society of Actuaries. Brad will introduce us to the calculation of estimated gross margins and deferred acquisition costs (DACs) under the SOP. He will also introduce an alternative method that may be useful for smaller companies or smaller lines of business.

MS. DIONNE D. MCNAMEE: GAAP for mutuals has been an issue since at least 1972. In 1972 the AICPA published an audit guide on accounting for life insurance companies.

*Ms. McNamee, not a member of the sponsoring organizations, is a Director at Price Waterhouse LLP in Washington, DC.

There was much controversy about whether that would apply to mutual life insurance companies, too. Ultimately, the powers-that-be were persuaded that mutual life insurance companies were different enough to be excluded from the guidance. This was taken as a blessing that statutory accounting practice (SAP) equals GAAP for a mutual life insurance company. That is, if this audit guide is applicable only to stock companies, then the presumption was that SAP was acceptable for mutuals.

In 1982, FASB issued *FAS 60*, which basically incorporated the conclusions from the 1972 audit guide. Discussions arose again about whether mutual life insurance companies should have to apply this accounting. Again FASB was persuaded that mutuals were different.

In 1987, *FAS 97* was issued. That deals with accounting for universal life (UL) and investment contracts. Again, mutual life insurance companies were exempt from that.

This leads us to 1993 when *FAS 40* was issued. Essentially, it applies to mutual and fraternal life insurance companies. The message in Interpretation No. 40 is that statutory financial statements can no longer be called GAAP.

Why did the FASB do this now after all the history, going back to 1972? I think when FASB realized how pervasive and significant the differences between statutory and GAAP were, it became very concerned about statutory financial statements being called GAAP.

However, it was not that easy. FASB could not just say, "Follow GAAP" because it had a tradition of exempting mutual life insurance companies from GAAP. So, FASB had to determine what is GAAP for mutuals. What did it do? FASB people commissioned an AICPA task force with representatives from the big six accounting firms, industry, and the American Academy of Actuaries. The objective of this group was to develop generally accepted accounting practices for the insurance products of mutual life insurance companies. Keep in mind that the task force members did not have a blank sheet of paper. They had to make it as consistent as possible with the accounting models that were already in place for the stock companies.

The first step in this process was to look at the type of products for which the task force members were trying to produce guidance. Typically these policies have level fixed premiums, no specific expense charges, risk charges, or investment credits, and no explicit account balance. On the surface, the form of these contracts seemed very much like the conventional life contracts that a stock company might account for under *FAS 60*. But as the task force members reviewed these products further, they saw that the contracts have many similarities to UL contracts. The task force members considered how dividends, especially actively managed dividends, work. A big factor in why the group members reached the conclusions they did was the fact that most of the people on the task force believed these products were most like UL contracts, especially in how the earnings emerge on the products.

The next step was to account for these products in a manner similar to UL-type contracts for a stock company. Therefore, we looked at *FAS 97*. One of the differences between the accounting under this SOP and the accounting under *FAS 97* for UL contracts is premiums. Premiums are reported as revenue in the income statement of a mutual life company. It is interesting that this was very important to many of the industry people on

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the task force. They argued that the income statement does not really matter at a mutual life insurance company. However, they thought, if you are going to have an income statement, it may as well have premiums as revenue. This was somewhat controversial, but ultimately the task force prevailed.

Dividends under the SOP are reported as an expense. It is on an accrual basis based on the anniversary date. It does not include future dividends beyond the policy anniversary date. There is some special guidance in the SOP on dividend options. This relates more to estimated gross margins. Another item that differs from the stock companies is that terminal dividends are accrued over the life of the book of the business.

Since a UL product has an account balance, you can assess charges on that. However, for participating policies the task force had to determine a proxy for the account balance. The members considered several alternatives including the dividend fund and several net level premium reserves at different interest rates. Most of the industry people liked the dividend fund the best. However, the accounting people were not convinced that it was consistent for all companies or that all companies even had a dividend fund. So, the net level premium reserve was settled on as the most objectively determinable amount.

No GAAP model would be complete without deferring acquisition costs. There is no change from current GAAP as to what constitutes acquisition costs. The SOP requires the amortization of acquisition costs based on the present value of estimated gross margins. You use best estimates of all the elements that determine what your gross margin is. There is a subtle difference in the use of best estimates in the SOP versus *FAS 97*. *FAS 97* requires that you explicitly determine a best estimate for each element that goes into your gross margin. In the SOP, and the actuaries thought this was important, your gross margin result just has to be a best estimate. Some people think that makes it a bit easier to work with.

Another item that was touched upon in the SOP is capital gains and losses. Although the task force did not plan on dealing with capital gains and losses on investments, many inquiries were made in comment letters. Can you defer capital gains? There are all sorts of good reasons for deferring capital gains. Why should you recognize them when they are realized? The SOP does not deal with that in the body, but in the background it does discuss capital gains. It merely quotes from *FAS 97* and states that capital gains should not be directly or indirectly deferred. If you have a policyholder liability, you can report it. Whether or not you have a policyholder liability is just a matter of judgment.

When mutuals begin applying GAAP in 1996, there will really be three sources of GAAP for them. For participating policies for which the contribution principal is met, you would follow this SOP. The task force was thinking of participating policies with actively managed dividends. That is what distinguishes the policies of a mutual company from a stock life company. If a stock company has participating policies which it believes meet the contribution principal, the company could also apply this SOP. That is allowed but not required. The members of the task force thought the only companies that might be in that situation are companies that have demutualized. To the extent that a mutual has investment contracts or UL-type contracts, the company follows *FAS 97* just like a stock life company would. For accident and health-type business you would follow *FAS 60*, just like a stock life company. And, of course, *FAS 113* is the standard for reinsurance.

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The task force received many comments on the exposure draft. One of the big things that was changed in the initial exposure draft was a 1995 effective date. That was changed to 1996. I think the standard setters were persuaded that this is not that easy to do. We need a little time. Even if we could do it by 1995, we would like to have some time to get comfortable with the information. So, 1996 is the effective date.

The treatment of dividend options is another area where changes were made to the exposure draft. The exposure draft more or less said that, regardless of the dividend option that your policyholder elects, you should assume that dividends are paid in cash. A lot of people wrote to the task force to disagree with that treatment. Now, the SOP says you should use your best estimate of the dividend options chosen when doing an estimated gross margin calculation.

On each reporting date, you have a retrospective unlocking of the DAC asset on your books. Besides the effective date, that probably was the issue that people liked the least about this SOP. Almost everyone who wrote—say, 75% of the people writing comments—disagreed with this. They would have preferred a prospective unlocking of the DAC. The task force could have agreed with that. However, most of the arguments for not using a retrospective adjustment to DAC are the same as for *FAS 97*. Understand, *FAS 97* requires the retrospective adjustment to DAC, which is what this SOP did. Stock companies do not like to retrospectively adjust the DAC either. So to the extent that this was going to be changed, it would have to be changed for everyone. To change it for everyone, the mutuals and the stocks would have to get together and make a case to FASB as to why this does not make sense.

MR. BRUCE E. LOVETT: At The Guardian Life we began our mutual company GAAP project in the fall of 1993 when we first received the initial AICPA exposure draft. I guess it was no secret in the industry that something was going on. When a group of people who were involved in the life insurance operation and I read it, we all had the same reaction. We thought this was actually a doable thing. We wanted to identify the problem areas, and in a short time we began to plan our process to meet what seemed, at that time, to be a very close-on date. As Ms. McNamee said, the original SOP document spoke of financial reporting periods beginning after December 15, 1994.

At The Guardian we have a profit center organization. If we are going to report on a GAAP basis for the whole company, each profit center needs to be involved. The individual who spearheaded the effort at The Guardian is our chief financial officer who also happens to be an actuary. I think that is a big plus, by the way. I think it really brought something special to the table that is not present in every sort of operation.

The other thing we did fairly early on was engage our audit firm. We engaged our auditors to provide us with advice and support along the way. We thought this made a whole lot of sense to us because this was the firm that was going to have to audit the financial results. It seemed logical to us to work with the same group of people throughout the entire process.

Fundamentally, we had no real concerns about our ability to meet the technical needs that the exposure draft indicated. We felt we had a group of strong technicians, and we really thought we could do this job. The concern that I had, and other people shared the concern, was the early date. I viewed December 15, 1994 as kind of early. To me it

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meant that by the end of 1995, at the very latest, but more than likely mid-1995, you would need to be finished. But you would have a lot of actual deliverables along the way. You would have to deliver December 31, 1994 balance sheets. And you would have to deliver balance sheets for 1992 and 1993 as well.

All this work would need to be audited. We probably also have to begin thinking about how we would do quarterly work. We would have to have all systems going, all the assumptions set, all the assumption monitoring procedures set. To reiterate, it just seemed like a lot to me, and I personally was glad when the final pronouncement came out that the inception date was going to be pushed back one year. My personal feeling is it makes for a better product.

There is something that we had at The Guardian that I think added a little plus to this whole process. We have had a ten-year history of reporting what we originally called adjusted gains. Later this evolved into a more sophisticated form of financial reporting called management financial statements. The need for this was driven by rapid growth early in the 1980s, a net level premium valuation standard, and some other conservative statutory financial reporting elements. This combination produced a steady stream of statutory losses—not every year, but often enough. That created a challenge to justify a rich dividend scale. The main theme here is that for ten years we had been working to educate senior management and the board of directors on the merits of something other than statutory accounting. They had seen financial results over a full decade on a basis other than statutory accounting. They were accustomed to it. I think that it was a good thing to have done along the way.

There are three major themes I want to discuss. The first issue is investment yield. You are required to use interest in your DAC amortization work, but what interest rates should be used? At The Guardian, we had some fairly unusual situations triggered primarily by our investment strategy. They presented some challenges for us along the way. The second point I will mention is dividends. There are many dividend options. Some of them are more profitable than others to the company. If you are going to amortize DAC in proportion to estimated gross margins, you really need to decide your philosophy on this. And there is a tremendous amount of variation between major policy series on the use of dividends. How exact do you have to be? The third thing deals with how large a model you need in order to get credible results.

What is the appropriate expected investment yield to use in the amortization of DAC? And how, if at all, does this relate to dividend scale management? Here is our situation. We are a portfolio mutual life insurance company, probably in the truest sense of the word. We have no dedicated assets, except for policy loans, backing life cash values. The portfolio is not segmented at all for any purpose whatsoever. We also have a fairly significant amount of tax-exempt bonds—of course, this varies from time to time depending on marketplace conditions. And we have a fairly significant amount of common stock. I would say common stocks might be about 10% of our investment portfolio, and tax exempts might be 15%, but that varies quite a lot over time. We also have a lot of convertible bonds.

Since we have quite a lot of common stock, which is nominally a low-yielding asset, we earn investment income on it through capital gains. We have the view that policyholders should benefit in these capital gains through their dividends. Sometimes these capital

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gains are capital losses, but over long periods of time they have been capital gains. Also, because of the nominally low-yielding asset called tax-exempt securities, we end up with what you might call a nominal earned rate that is less than our dividend interest rate. The difference, of course, is made up out of capital gains and out of the tax benefit on the tax-exempt securities.

The GAAP issue that was triggered by this situation is as follows. You look at your pattern of estimated gross margins where you need to take into consideration dividends, and let's say dividends are at 9%. But your nominal earned rate, if you include tax exemptions at their nominal rate, and if you include stocks at their dividend rate, would produce ultimately negative margins. Now, negative margins are not the end of the world because this does not mean the products are unprofitable. It just means that you cannot use negative margins if you are amortizing DAC. You would need to switch to some other alternative basis.

There are some alternative methods for amortization of DAC that are mentioned other than gross margins. One of them is gross margins before dividends. Another one is gross premiums. A third is face amount in force. We looked at these. The gross margin before dividend is an extremely slow amortization pattern. I believe that the DAC balance at the end of the 20th year is fundamentally the same as it was when the policy was issued. I am not sure if that is acceptable or not. I think that the pattern of DAC amortization using gross premiums or face amount is not overwhelmingly different than the pattern of DAC amortization if you use estimated gross margins, if they are positive. But it is a deviation. It is a deviation from what seems to be the main path of the SOP, and to us that would be an undesirable thing to do.

So, we had a problem. To use the simple numbers I quoted before, suppose we had a nominal earned rate of 8%, but we had a 9% dividend scale. If we were not willing to switch amortization bases after 20 years or whenever the margin turned negative, we needed to solve this problem. So, we were looking for an avenue by which we could support the interest spread that we have in our dividend scale as a best estimate assumption for the estimated gross margin. We went back to our asset base, which comfortably exceeds our cash values. We segmented out assets that were greater than our cash values in total. We demonstrated that there was a positive yield spread between the yield on those assets, which would be bonds, mortgages, and collateralized mortgage obligations (CMOs). We demonstrated there was a positive margin of spread between the yield on those assets and the dividend interest rate that we were paying. We satisfied ourselves and our auditors with our view that had we chosen to manage the portfolio in a segmented manner, we would have had a positive spread. That is the first issue and its resolution.

The second issue is, how do companies consider use of their dividends in their estimated gross margin development assuming lifetime amortization of DAC? Originally, lifetime amortization was the assumption that we made. You have paid-up additions. You have cash. Those are extremes. You have a vanish that I probably could call premium offset. All of these options have tremendously different profit streams, and the options elected vary tremendously block-by-block. And we would expect they would vary over time as people go through their life cycle.

What about assuming all paid-up additions? 90% of new business is sold with paid-up additions, maybe more. About 70% of our total dividends paid are recycled into the

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company through paid-up additions. But we do not know if those things are going to continue. The 90% number has been pretty stable for a little while. The 70% has been, I think, ratcheting up slowly over time. But we do not realistically expect that an individual buying a policy today on a paid-up additions dividend option is going to continue with it through the lifetime of this policy. It just does not seem reasonable to me, and I think most people would agree. So, it is undesirable from that point of view. Another reason why it is undesirable is it produces a very slow pattern of DAC amortization. Paid-up additions are very profitable. The more of them you have, the more back-loaded your margin is. And the more back-loaded your margin is, the slower the DAC amortization is. So, you could end up, after 20 or 30 years of a policy in force, with what you might think is just too much DAC.

Well, you could assume all dividends are applied as vanish or premium offset. That is probably an increasingly popular use of dividends. Realistically speaking, people do not always want to pay insurance premiums. They have other things to do with their money. In the early durations the pattern of DAC amortization looks a lot like the pattern you get if you assume paid-up additions. Later on, it seems a lot like the pattern you get if you assume paid-in-cash. But our view is that it is unrealistic for another reason. The other reason is that we are not really capable of predicting the future direction of interest rates. It is certainly possible for dividends to decrease in the future, and it is certainly possible for premiums to reemerge after a policy has nominally vanished. Well, I am not sure what the impact of that would be, but it seems to me that you might want to avoid this when you do your DAC amortization work.

Or you could assume all cash. Cash is nice. It has the most rapid amortization, but it is not a realistic assumption. There may be other reasons why assuming all paid-in-cash works, which we will get to in a moment.

So, we did some work analyzing a weighted average of dividend options. We looked at major blocks of business, and the term *major block* here means primarily valuation block. We looked at the cash values actually in force by major block versus the potential cash values that would have been in force had paid-up additions been produced since the issue date. The results were quite striking. In the very old policy series valuation blocks, it was almost as if paid-up additions had never been heard of. The very new valuation blocks had quite a lot of activity. In between the picture was quite mixed. We were ready to implement something like this. We were actually prepared to weight dividend options, make variations at the valuation basis level, and monitor everything on a going-forward basis. Then it was pointed out to us that the pattern of DAC amortization depended to a very great degree on assumptions that were made very far into the future. Now, that is not a completely unreasonable thing, but it was an assumption about human behavior very far into the future. Next there was a retreat away from the lifetime amortization assumption, and we reviewed other lengths of amortization periods. We concluded that 30 years, which is still a long time, would produce results that were not heavily dependent on the dividend option assumption. Putting it another way, the dividend option under a 30-year amortization rule had no material financial impact. So, we ended up choosing the option that all dividends are taken in cash.

How large should a GAAP model be? Well, GAAP requires a model. For general information, we have about 525,000 policies in force. We have a model now that has 5,000 cells. So, something in the area of a 1-to-100 ratio has been satisfactory to us. The

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way I define *satisfactory* is that, if you take the model net level premium GAAP benefit valuation and compare the result with the actual net level premium GAAP benefit reserve, the model is about 2.5–3% understated. About half of that is due to unmodeled plans. The other half of the model error is the result of making some central age assumptions. The result is a model that is manageable and one that does not introduce a tremendous amount of distortion into the result.

MR. BRADLEY M. SMITH: When you create a new accounting model, you have to answer three basic questions. The first question is, how are reserves calculated? The second question is, how is DAC amortized? And the third question is, how are financial results presented? We have now gone through this exercise in the insurance industry essentially three times, and we have come up with three different answers.

For *FAS 60*-type products, traditional, nonparticipating products, we have premiums as revenue and profits emerging as a level percentage of premium, plus a release from risk component. UL and annuity-type products have *FAS 97* dictates. Premiums are not revenue. Loads and interest earnings are revenue. Profits emerge as a level percentage of the gross profits, and there is no release from adverse deviation component. For participating products with actively managed dividends issued by mutual companies, we now have SOP 95-1 requirements. In that model we have premiums as revenue, and there is no margin for adverse deviation in the assumptions. Profits emerge as a level percentage of gross margins.

I would like to review the details of the SOP. Reserves are calculated using a net level premium method where the dividend interest rate and cash-value mortality is used. And we determine a liability for terminal dividends. In the DAC amortization we use what essentially is a retrospective deposit approach, notwithstanding the fact that there is a proxy for a deposit. Similar to the method that you use in *FAS 97* for UL products, estimated gross margins are used as the basis for amortization. The assumed net investment rate equals the discount rate. Best estimate assumptions are used. There is no margin for adverse deviation. And we are subject to unlocking both retrospectively and prospectively consistent with the methodology in *FAS 97*. As far as income statement presentation goes, we have premium income as revenue. This obviously differs from the UL presentation where you have loads, surrender charges, and investment income as revenue.

So, the key is, how do you calculate estimated gross margins? Gross profits are essentially very similar to a book-profit-type calculation where revenues are equal to premium income plus investment income. Investment income is earned on the net level premium reserve determined for GAAP, plus cash flow during the year. There is no target surplus or cost of target surplus to be used in these numbers. You subtract off the dividends that are earned excluding terminal dividends. Terminal dividends are accounted for separately. Costs include level maintenance expense, the ultimate level of commission paid, and the increase in reserve (using the GAAP reserve as the basis for your reserve) is subtracted off. The commissions represent that level of commissions that are not capitalized.

Consider the example in Table 1. It was projected for 50 years, although I agree that 20–30 years is probably a reasonable period for the amortization. Column 1 is statutory book profit where we have used the valuation basis of 1980 CSO, 4% commissioners' reserve valuation method (CRVM). In the first few years you have, as expected, a drain

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on surplus. Again, there is no investment income on target surplus in this calculation. You eventually turn positive such that the present value of your profit at issue is \$445. The second column shows that same profit stream but substituting the GAAP net level premium reserve for the statutory reserves. The valuation basis is net level 1980 CSO, 4%, in this calculation. The third column represents capitalized expenses. In this example the ultimate level of commissions paid occurs in year 11 so that you have incremental capitalized expenses in years one through ten. The present value at the assumed investment earnings rate is \$1,437. Gross profits are in the final column. The first-year gross profit of \$319 is equal to the capitalized expense of \$1,199 times one plus your interest rate added to "unadjusted" GAAP profit of (\$966). The capitalized expense is assumed to occur at the beginning of the year.

Let's continue in Table 2. The first column is the capitalized expense. The gross profit column is the same as in Table 1. The last two columns are DAC and GAAP profit. The first thing you do is calculate your amortization percentage. The amortization percentage is the present value of the capitalized expenses divided by the present value of the gross profits. In this case it is \$1,437 divided by \$1,882, so that your amortization percentage is 76%. Then calculate DAC. See footnote 1. DAC in the first year would be equal to the capitalized expense of \$1,199 times one plus the investment earnings rate minus the amortization percentage of 76% times your profit of \$319. That gives you \$1,041. In the second year, you take DAC at the end of the prior year, the \$1,041, plus the incremental capitalized expense of \$62 assumed to occur at the beginning of the year. Multiply the sum of those two numbers by one plus your investment earnings rate. Then subtract the amortization percentage of 76% times the gross profit in that year of \$261. You end up with a DAC balance of \$984. It is a self-checking process. If you go through this and your DAC is not zero at the end of the amortization period, you know you have made a mistake.

TABLE 1

Year	Statutory Book Profit ¹	GAAP Profit Before DAC Adjustment ²	Capitalized Expenses	Gross Profit/Margin
1	(67.38)	(966.20)	1,199.00	319.73 ³
2	(5.42)	195.03	62.36	261.91
3	(22.13)	103.29	53.59	160.77
4	(27.24)	80.24	49.26	133.07
5	(26.74)	65.96	45.77	115.05
6	10.48	96.77	21.49	119.82
7	22.11	102.38	20.17	124.01
PV @ 7.25%	445.71	445.63	1,437.28	1,882.91

¹ Valuation Basis: CRVM 1980 CSO 4.0%

² Valuation Basis: Net level 1980 CSO 4.0%

³ 319.73 = 1,199.00 * 1.0725 - 966.20

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TABLE 2

Year	Capitalized Expenses	Gross Profit/Margin	DAC (EOY)	GAAP Profit
1	1,199.00	319.73	1,041.87 ^a	75.67 ^c
2	62.36	261.91	984.36 ^b	137.52 ^d
3	53.59	160.77	990.49	109.42
4	49.26	133.07	1,013.55	103.30
5	45.77	115.05	1,048.30	100.71
PV @ 7.25%	1,437.28	1,882.91		
Amort. %: 1,437.28/1,882.91 = 76.33%				

^a $1,041.87 = 1,199.00 * 1.0725 - 0.7633 * 319.73$

^b $984.36 = (1,041.87 + 62.36) * 1.0725 - 0.7633 * 261.91$

^c $75.67 = 319.73 - 1,199.00 * 1.0725 + 1,041.87$

^d $137.52 = 261.91 - 62.36 * 1.0725 + 984.36 - 1,041.87$

Following through with footnote 3, you can see how the GAAP profit is calculated. First take the gross profit in year one of \$319, and subtract the capitalized expenses of \$1,199 brought forward to the end of the year. (These are profits shown at the end of the year.) Then add in the DAC as of the end of the year of \$1,041. That gives you \$75 of GAAP profit. In the second year, it is a similar calculation. Take the gross profit in the second year, subtract off the capitalized expenses accumulated to the end of the year, and add back the change in DAC during the year. See footnote 4.

The last thing I want to speak about is a methodology that Walter S. Rugland and I developed for a mutual company to use in the conversion to GAAP. We coauthored an article that was published in the December 1994 *Financial Reporter* of the Life Insurance Company Financial Reporting Section, which describes this method. This method does not alter the SOP. It offers an easier methodology for the conversion process. Basically, it attempts to use a purchase-GAAP methodology. Purchase-GAAP is the method that stock companies use when they acquire a company or a block of business.

Literally, according to the SOP, for all policies issued in prior years, I have to go back and capture all of the capitalized expenses and all of the experience and so forth to develop an opening GAAP balance sheet as of December 31, 1992. Then I can restate my financial statements from 1993 going forward. Obviously, that is a very onerous and, at best, a very inaccurate process. Many companies do not have that information.

When you complete that entire process, there are a few tests that are going to be applied to your beginning DAC result. We know that DAC is going to be tested for loss recognition. Loss recognition means that, under GAAP, you cannot defer a loss. You cannot have a DAC balance if its release would create a future loss. So we know that the

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DAC cannot exceed the present value of the gross margins using a discount rate equal to the investment earnings rate. So, we have an upper limit on the DAC. Likewise, we postulate in the article that your auditors are not going to allow your DAC balance to be inordinately low. If you set your initial DAC at an extremely low level, you would essentially overstate earnings going prospectively. Remember, DAC is an asset. As you amortize that asset, it is a drain on earnings. So, if you set it inappropriately low, you are going to overstate future earnings. My sense, and this is something that we postulate, is that your auditors are not going to allow that DAC balance to be less than the present value of the gross margins discounted at a rate of anywhere from 15% to 17%. Obviously, if you set up an initial DAC such that it was equivalent to the present value of profits discounted at a rate equal to 25% or 30%, they would have a problem with it. The exact level is debatable, but it is in there somewhere.

In the article we compare what happens if you set your initial DAC balance equal to the present value of gross margins using a discount rate equal to a risk-adjusted rate of 13%. This should be consistent with your profit objective on new business. We compare that initial balance to the balance you would calculate if, in fact, you were able to accurately capture all of the expense data from all your historical issues, and bring it forward under the SOP. What we found is that the balances are extremely close.

So, the question is, why would you go back and capture all these data, inaccurate as they are, create all of that work, when in fact there is going to be a test applied to that calculation? There is going to be an upper limit absolutely set to the DAC level, and practically, there is going to be a lower level set. We do not know exactly what that lower level is, but we can postulate as to what that level is. Then we are going to use a purchase-GAAP method and set DAC at a level in between those two extremes consistent with our pricing return on investment.

As you go through this process, I would recommend that you consider this. There is no question that you should go through the exercise of the SOP for the recently issued business. But when you get to minor lines of business and business that was issued a long time ago, I would urge you to consider a simplified method such as the one that we have recommended.

MR. DANIEL F. CASE: These are my views. They are not the views of my employer. An interesting feature of mutual company GAAP is that it will not show the company's surplus. It will show something else. Policy dividends are treated as expenses. Termination dividends that are expected to be paid are accrued as a liability. The rest of the policy liability contains an accrual of future annual dividends. What is left over as the bottom line in the balance sheet is only the portion of surplus that is not expected to be paid out to the existing participating policyholders.

Mutual companies' policies refer to dividends as divisible surplus. Dividends are distributions of surplus. Consequently, a balance sheet item that does not include any money that is expected to be returned to existing policyholders, according to the accounting rules that are followed, is not the surplus. It is just the portion of surplus that is not dedicated to the existing policyholders.

Similarly, the income that is reported will exclude any portion of the earnings that are accruing for the benefit of existing policyholders. The income that is reported over the

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lifetime of a block of business will be what is left over when the block has run off and all dividends and benefits have been paid to the participating policyholders.

My concern is that the bottom line of the balance sheet and the bottom line of the income statement not be mislabeled. I would also consider calling the balance sheet item *surplus* to be mislabeling it. If it were called some kind of equity, I would consider policyholders' equity to be a mislabeling. I believe that stockholders regard stockholders' equity to be what they hope to receive either this year or in the future out of some stockholder dividends. Nobody wants to call it future policyholders' equity, and I doubt that we will see that, but I suggest that would be a more accurate label for simply policyholders' equity and would not be misleading.

MS. MCNAMEE: I think that was the issue that always delayed conclusions on GAAP for mutuals from 1972 onward. The task force that had to provide the accounting guidance avoided the issue in order to get this done. Who owns the company? Whose surplus is this? These are intergenerational issues. The objective in the accounting was limited to the relationship between a policyholder and an insurance company—not recognizing that there is also an ownership relationship, too. That probably does not satisfy you, but that is the only way we could get it done.

MR. EDWARD J. FREEMAN: I have a question for Ms. McNamee. Earlier in your presentation you mentioned that we should not have a deferral of capital gains and losses, but can we record these as policyholder liabilities?

MS. MCNAMEE: *FAS 97* says you cannot directly or indirectly defer capital gains or losses. However, the background section of that statement states that, if there is a commitment on the part of the insurance company to give those capital gains to the policyholders, in those circumstances you could record a policyholder liability. The effect of this would be similar to deferring the capital gains.

MR. FREEMAN: Can I extend this a little further? I am thinking of an investment fund where you would keep a piece of your investment income out of dividends, out of the income statement, to pay for future investment losses. If everything turns out grand, you are going to pay that back to the policyholder. If it does not, you do not. But the intention is that you will pay it back. Does that mean I can set up an investment valuation reserve under GAAP?

MS. MCNAMEE: I would say not necessarily. A quick answer is no.

MR. PETER L. HUTCHINGS: I have a question in the nature of conjecture. We now have three profoundly different answers to three relatively similar questions. Do any of the panel members have a guess as to whether the accounting profession is going to hammer some kind of consistency out of this, or do you think the accounting profession has had quite enough life insurance accounting for this century? What are your thoughts on that?

MS. MCNAMEE: I guess I speak for the accounting profession on this panel. It has probably had enough life insurance accounting for this century. The AICPA's mutual life insurance task force that developed this guidance is still in place to deal with any implementation issues.

GAAP FOR MUTUALS

MR. SMITH: You may think at the time of the conversion that your management is not going to be very interested in the GAAP result. But, as a test for reasonableness and for future considerations, I recommend that you should project your future GAAP income. It is my sense that the rating agencies are going to be interested in it. As more outside entities become interested in your result, your senior management is going to become more interested in your result. Therefore, it is beneficial from your standpoint to project the results before you have to explain the result so that you understand the dynamics of the process. It will also help you to identify errors as you go through the conversion process.

