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Summary: Mutual life insurance companies now must report on GAAP basis pursuant to FAS 120. The implementation of GAAP presented many issues for mutual companies.

Panelists discuss problematic aspects of applying GAAP to their products, challenges in producing GAAP financials, and various ways in which companies are integrating this new reporting basis into their management process.

Mr. Harold J. Darak: I'm from Deloitte & Touche. We have three speakers today, Al Reznicek, Ken LaSorella, and Lou Weisz, who will dazzle you with their knowledge and expertise in GAAP issues.

Al Reznicek is an audit partner in the Tampa office of Deloitte & Touche, specializing in GAAP and statutory accounting for life insurance companies. Prior to his assignment to Tampa he was assigned to the New York office for ten years, serving solely life insurance companies. Al serves as Deloitte's deputy national audit partner for life insurance. He has more than 36 years of professional experience, including 18 years serving stock and mutual life insurance companies. Currently Al is the audit partner for Metropolitan Life Insurance Company and is

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Note: The chart referred to in the text can be found at the end of the manuscript.

responsible for the audit of Met Life's GAAP financial statements. He was deeply involved in Met Life's implementation of mutual GAAP. Al has served as the audit partner for a number of stock life insurance companies. Al is a member of the NAIC and the AICPA working group. He has served on AICPA insurance company committees. Currently Al is working with the Demutualization Task Force of the AICPA's insurance companies committee. Al is a member of the AICPA and received his Bachelor of Business Administration degree from the University of Texas at Austin in 1962.

Mr. Albert J. Reznicek: What I'd like to do is give you an auditor's perspective on some of those current issues, as I have used them over the last 10 or 12 years, as companies have implemented GAAP. The areas to be covered today are:

- the infrastructure for GAAP and statutory reporting,
- which bases of accounting are being used by management for managing the enterprise,
- some of the system requirements,
- the resource needs to meet the expanded reporting requirements,
- the need for GAAP knowledge throughout the enterprise, and
- some of the challenges that companies have faced in implementing GAAP and some of the challenges that I see on a go-forward basis.

The infrastructure has to be established to support GAAP accounting. I believe that the policies and procedures have to be put in place to assure the development of reliable GAAP information. The policies have to focus on a number of things. One of the important areas that I see is policies to assure the consistent application of GAAP across the enterprise in making up the consolidated group. The volume of GAAP pronouncements that have been issued that were not implemented by mutual companies prior to adoption of mutual GAAP have been extensive; therefore, much attention must be given to these requirements to assure the consistent and appropriate application in the current environment and going forward. Further, I believe that processes have to be put into place to take into consideration new accounting pronouncements, to recognize what those requirements are going to be, and to communicate clearly throughout the organization the process for implementing those pronouncements. And also, most certainly as a company goes forward, what will be of interest will be the effects of new pronouncements or proposed pronouncements on the management of the enterprise. Structure needs to be put into place to address those issues to advise management well in advance of the impacts of new pronouncements.

Certainly from the standpoint of the infrastructure for statutory accounting, it must remain in place. The policies and procedures need to be monitored to assure that all regulatory requirements are being met and updated as necessary. Changes in

statutory accounting are continuing, and one of its changes that certainly is a clear example of the need to have an infrastructure within the reporting of an enterprise is codification. There's going to be a significant need to focus and communicate again throughout the organization what those changes are and their impacts on statutory and then, of course, the differences that result between statutory and GAAP reporting. Also, from the standpoint of infrastructure, it is very important that the individuals involved in financial reporting analyze each transaction now from three perspectives—one perspective being the impact that it will have on the GAAP financial statements, the second being the impact on statutory, and the third being the tax ramifications. Many times the results of these three models will produce results that will not be advantageous to the operating results.

Should the infrastructure of an organization be a combined statutory and GAAP accounting and reporting structure or should it be separate? The answer to this is probably dependent upon the size and complexity of the organization and the differences that exist between the GAAP and statutory amounts. I see it as a clear advantage to have these as a combined responsibility because the individuals who are responsible then for the accounting will be aware of all transactions and clearly understand the differences. But combining these responsibilities does add a significant workload to the individual. Another disadvantage is that you now must have individuals who have not only the required GAAP, but also the statutory expertise.

Another infrastructure need that I see from the standpoint of mutual GAAP is that of external reporting. Policyholders may be interested in continuing to receive statutory information, but clearly the GAAP information will be distributed to policyholders. From the standpoint of the rating agencies, my experience would indicate that they want as much financial information and data that they can obtain to do their ratings. Therefore, I see that they're going to continue to request or want both statutory and GAAP information. And, as the presentation information is developed for the rating agency, it will require an infrastructure to be able to develop and provide the pertinent information from both bases. Certainly an infrastructure needs to be in place from the perspective of reporting to investors, which in all likelihood will end up being on the GAAP basis. And certainly as some companies proceed with the demutualization, the structure of the company needs to be modified to incorporate all of the related SEC reporting requirements. From the standpoint of managing the company I believe that many, if not all, of the companies will attempt to manage the company from the perspective of GAAP results, indicating as they believe that it may be a fair indication of the performance of the company. The measures will vary all over the place. ROE could certainly be one of those measures; ROI, another. Also, measuring the performance might be dependent upon how the lines of business are structured. Clearly, from the

standpoint of GAAP reporting those lines may be different from the lines that would be appropriate for statutory reporting purposes. This is because of the unique characteristics of the products, the product types, the risk characteristics, and whatever the measure of success is that management puts upon the individuals within the organization.

Certainly from the standpoint of measuring performance, one of the dynamics that has to be considered is the dynamics of the amortization of deferred acquisition cost (DAC) and the establishment of loss recognition. You might ask, what are those dynamics? From the measuring performance standpoint, as unusual gains are realized from investments or unexpected events occur, some of those impacts will be offset by the need to revise the amortization of DAC. Alternatively, from the standpoint of having a product that was already in a loss recognition position, realizing investment gains would trigger the need to provide additional reserves and effectively result in no net income from that particular transaction. There would be, of course, a number of other measurement bases that would be used within the organization depending upon the level of management such as revenues, expense controls, and even some measures of productivity.

Certainly from the standpoint of managing the enterprise, statutory continues to be very important even though management may be using GAAP as a primary tool. The companies must continue to focus on risk-based capital (RBC) and RBC levels within the organization and how transactions may be impacting RBC. Whenever a company enters into a transaction it would also need to continue the focus on what are the asset valuation reserve requirements and the impacts that those have on statutory capital. Certainly one could focus and go forward and maximize GAAP earnings to the detriment of statutory levels of capital or RBC, so there needs to be a balancing act to make sure that all of these factors of performance versus maintaining statutory levels of capital and meeting those requirements are achieved. From the standpoint of systems I would say that from my perspective that most of the administrative systems have been in place and continue to be in place to produce the required statutory and policyholder information. But with the advancement to GAAP, the systems do not necessarily have all of the information in them that are necessary to produce the related adjustments to the financial statements or to produce the GAAP amounts individually and separately. So, therefore, system modification to effectively and efficiently gather that information is certainly a prime focus on a go-forward basis.

Certainly from the standpoint also of GAAP reporting one of the major processes and systems that I see that has to be put into place to effectively gather and report information is the consolidation process—the ability to produce complete GAAP financial statements through the consolidation of the various entities, balance sheet,

and income statements. One of the things that I think every company struggles with is an efficient and effective means to put together a cash-flow statement and all of the related footnotes taking into consideration the diversity and differences in each of the companies, consistency being a real key. From the standpoint again of requirements, can systems be developed or designed to produce statutory information and GAAP information separately or do they have to be interdependent? Much of this would depend I think upon the capabilities of the system, but ultimately upon a key important ingredient from the standpoint of being able to produce financial statements that are most important to management. One of the movements that I have seen within companies has been from managing on a statutory basis to managing on a GAAP basis. With that shift to GAAP basis, management's desire is to have GAAP information first and then secondarily to gather the statutory information to meet the regulatory reporting requirements.

Resource Requirements

On a go-forward basis, there needs to be resource needs to meet both GAAP and statutory reporting. From a GAAP perspective, knowledge of the consolidation process is necessary. This is due to the significant additional information that has to be developed and the ability to go in, analyze that information, and be able to provide management with the appropriate indicators of what performance has been. Why has it resulted in the particular achievements that have been produced in the transaction? All of this indicates that there is a need for an expanded GAAP expertise within the organizations to meet those needs. And, of course, from the standpoint of statutory reporting, that reporting and that requirement continues to be there, and, as I see it, with no reduced requirements. In fact, with some of the future developments there is a need to be able to enhance the levels and skills to that group as well with such changes as codification coming. All of this, as I see, ends up increasing the workload within the actuarial as well as the accounting arena; therefore, the requirements do put stress on the organization.

How does an organization go about getting the GAAP knowledge? Certainly, one approach would be to go out and hire individuals to supplement the current staff. That's a challenge in being able to find individuals who have both the insurance expertise as well as the GAAP expertise. One of the suggestions or approaches would be to supplement the organization with key individuals with this expertise, expand into a training program that would be internal to make sure that everyone within the organization understands and has an appreciation of the requirements, and then supplement that with external training. There are a number of external training sources that are available.

Let me turn to some of the challenges that came to my mind when I was preparing my thoughts for this presentation. In the area of classification of products as being

one of the keys, one of the aspects that I saw was, of course, the determination as to whether or not the products had mortality risks. If they had mortality risks, what was the level of that risk? Was that risk significant enough to conclude that it should be viewed as an insurance product rather than an investment product? The application of the three pronouncements, *Financial Accounting Standard (FAS) 60*, *FAS 97* and *FAS 120*, which are the 3 accounting pronouncements that certainly give the basis of the accounting models to be used, is difficult in and of itself. There have been a number of products that have been developed or are being used in foreign countries that produce certain significant challenges. Looking at these, there's certainly a need to classify and clearly understand the impacts that the classification would have on the financial results. One of the challenges also that I saw from a product classification perspective was that the mutual company par policies were generally viewed as being policies that had dividends distributed on the basis of contribution principle and were actively managed. There was a question as to how actively this policy distribution was being managed by some companies, which raised the question as to whether or not *FAS 120* should be applied or some of the other pronouncements. Of course, reserves was another area that was unique from the standpoint of being able to focus on what appropriate assumptions should be used if reserves were to be established with factors or projections versus those reserves that were being developed for GAAP basis just using the account balance.

Again, loss recognition was an item that stirred a number of discussions from the perspective as to at what point in time in the product life do you look to see whether you had loss recognition? A few years ago products may have been issued in a very high interest-rate environment, and, as the interest rates came down, it ended up producing a scenario in which the product had a loss in it. Did you go all the way back to the peak? Did you pick some point in time between that peak and the current date or had there been movements up and down? How best to determine the point in time for the loss recognition tests and reserves was certainly one that created challenges for individuals implementing GAAP.

Another area that I viewed as important was the policy selection. Policy selection was important because it did select between acceptable alternatives, which could produce some significantly different results. It was important to make the selection and to continue to apply that selection on a go-forward basis. Of course, there is the option of being able to change, but generally that option would be only to change to a preferable method of accounting, which is a preferable approach. So, the selection was important because the restrictions been changed. The development of data out of the administrative systems or the accounting systems to be able to appropriately report investment-type products or account-balance-driven products when all of the statutory information had been developed on a statutory

basis previously was and continues to be a challenge. Historical DAC amounts, of course. How far back do you go into some of the traditional life-type products? If historical information isn't available, the challenge is to come up with some good proxy or good information to be used instead of the actual historical amounts.

From the standpoint of investments, the fluctuation in the market values of investments was certainly a challenge to decide whether or not securities were going to be held to maturity or whether they were available for trading or just for sale. The results of those decisions would have ramifications on income or on shareholders equity. I mentioned the consolidation previously, which was certainly a challenge in being able to adopt and present complete, consistent financial information.

Quickly from the standpoint of future challenges, one of the future challenges that I see is the ability of companies to continue to be able to reconcile from the GAAP financial information to the statutory information. It should be a simple process, but because of the volume differences in presentations, it is a challenge. One of the movements I also see is the movement to attempt to minimize the differences between GAAP and statutory each time you create a difference. There is the additional need to maintain records to gather and report those differences. And lastly I guess I'll say that one of the challenges that I really see that management of an enterprise has on a go-forward basis is maintaining the quality of both GAAP and statutory. The reason I say that is if GAAP becomes the primary basis, the attention is given to that basis of accounting and the emphasis on the statutory starts to trail off. It's very important from my perspective that the emphasis continues to be in place to meet both the statutory and GAAP reporting on an appropriate high-quality basis. I'll take questions after the other presenters have made their presentations.

Mr. Darak: Ken LaSorella joined Sun Life of Canada as a management trainee in the Chicago branch in 1967. He worked 19 years in various administrative and actuarial capacities, including starting the financial actuarial department in the U.S. Ken left Sun and worked for seven years as a consulting actuary with KPMG Peat Marwick. At Peat he was exposed to GAAP in mergers and acquisitions and GAAP conversions and audits. He returned to Sun in 1993 to start the individual actuarial department. Last year, Ken was appointed vice president of U.S. GAAP and assumed the role of worldwide actuarial project leader to help Sun through a GAAP conversion and provide technical actuarial leadership to Sun's U.S., Canada, U.K., Asia Pacific, and reinsurance operations. Ken chairs the worldwide actuarial technical team, comprised of territorial actuarial leaders and consultants.

Mr. Kenneth A. LaSorella: How many people are currently working for mutual companies? And how many have converted to U.S. GAAP or are about to convert?

Quite a few, so I guess what I'll do then is focus on the essence of the GAAP conversion and some of the problems we've had at Sun Life.

I want to address seven areas. The first one, project management structure, I think is critical when we talk about senior management support. It's really the fact that we get senior management involved in the process that makes the difference. What we did was set up a steering committee comprised of vice presidents or higher, which was basically a ruling body that made decisions. It was a working steering committee, and I think this is imperative. Otherwise, it seems like you move at a snail's pace.

We also had a core project team. There's a project management office out of the corporate office. It was corporate-run and it was comprised of one project manager worldwide along with an actuarial lead, an accounting lead, an investment lead, and a systems lead. And if you think of that as a macrocosm, we had a microcosm in every territory—the U.S., Great Britain, Canada, Asia Pacific, reinsurance group, and the corporate office. We also had dedicated company resources, and I think that's critical because unless you designate individuals who are responsible for U.S. GAAP there are always conflicting objectives and priorities when you're trying to go through a conversion.

We also heavily relied on external consultants. We spent quite a bit there, but it was certainly worth it because we did the conversion in about a year and normally it takes about two years. The worldwide accounting technical team and the worldwide actuarial technical team were critical as well because it's amazing how you think you understand GAAP initially and every week something comes up. There's always some issue that needs to be resolved so by having a subcommittee, a technical team that's a working, decision-making committee comprised of both company people and external consultants, you can address the issues very quickly and put them to bed and move on.

Second, the education process; monumental maybe is an understatement. To give you an example, the FASBs. Everybody's familiar with those. If we look at around 1977, we had under 20 and now we have 134, so you can imagine how awful it is to have accountants read through the literature and try to figure out what makes sense. The Emerging Issues Task Force is way ahead of the FASB, so there are issues surfacing all the time that need to be addressed.

I'll give you one example on a closed block. If you're contemplating closed blocks a question that has come up recently is, could you have a deferred dividend liability? So, for example, the fund, the closed block, is doing well. Let's suppose your experience is very good; you ended up with less death claims than you

thought. You have extra money, and it's an *FAS 120* product. What do you do with the extra money? Ultimately, it's going to be paid out in the way of a dividend, so should you set up a deferred dividend liability? There's a lot of controversy around that because with *FAS 60* it's very clear you can do that—there's a paragraph 42 that addresses that specifically. But *FAS 120* is silent on that issue. If you go through normal *FAS 120* mechanics, a large chunk of that extra, say, earnings for that year would actually go to amortize DAC or establish a terminal dividend liability, but there still would be something dropping to the bottom line. So you would have phony income for the shareholders. Just to give you one technical example since you are getting continuing education credits today.

Now with *FAS 60*, without going into detail here, you're trying to educate and tell management that we look at the difference between gross and net premiums, so that's not too bad. Then there's some provision for adverse deviation (PADs)—and the subsequent releases of provisions for adverse deviation. Then most likely there would be some surplus investment income on supporting assets, GAAP equity may be more accurate, because at the segment level if you're managing on some basis other than U.S. GAAP you'll probably have surplus assets. So that's understandable and premiums are revenue. When you move to *FAS 97* all of a sudden the whole picture changes. We no longer recognize premiums as revenue. We're looking at primarily the portion of the gross profits, which are primarily the gain from interest what you earn versus what you credit to account values. The cost of insurance (COI) charges less the real cost of the death claims and surrender charges and gains or losses on expenses as well. When you look at those gross profits, a large portion goes to amortize DAC and some of it goes into unearned revenue, but what's left over spills to the bottom line to be tax-affected eventually.

There's also some amortization of unearned revenue, which will spill into income and finally the investment income after taxes on the surplus assets. Those are two drastically different patterns. Chart 1 is not meant to represent any particular product, but in general the profit pattern will follow the premiums on *FAS 60*. Premiums come down over time. Usually you have high first-year lapse rates followed by improving lapse rates for a while, whereas because the *FAS 97*-type products are fund-driven, you'll find that the funds go up before they come down and you'll have a totally different pattern. That's very confusing to people who haven't operated with GAAP.

How many accountants do we have in the room? Are you aware of *FAS 97* where we discount the gross profits at the credited rate of interest? OK. Now if you think of the net assets that we're holding, you might think of it as being, to keep it simple, the account value less the DAC. So if the net assets go up to 10% shouldn't that mean that the account value will go up to 10%? We earn 10% investment income

on the account value, but we also should have the DAC go up to 10% because the net assets are going up to 10%. The actuaries would have definitely said that everything goes up at the earn rate. DAC should be amortized with the earn rate, therefore present value gross profits would be at the earn rate. That's done in *FAS 120*, but not in *FAS 97*, so the question is how could that possibly take place? And the answer is that the actuaries couldn't get their act together; the accountants eventually just gave up and decided we'll just go with this and declare it.

International Operations

You have to fit foreign products into U.S. GAAP. Just to give you an idea in Canada, we have level COI charge products. What do you do? Do you look at the difference between a standard increasing yearly-renewable-term-type pattern and take the difference and put it into unearned revenue? That's certainly one option. Another strange phenomenon takes place if you follow the letter of the law in *FAS 120*. You might find that they don't follow the contribution principle. This is very unfortunate because the combination of terminal bonuses, which are huge terminal dividends, and the reversionary bonuses are annual dividends. That combination very accurately follows the contribution principle. So in the aggregate, if you look at long term they follow it based on asset shares. They probably follow the contribution principle much better than typical U.S. companies. But technically the annual dividend doesn't follow the contribution principle. It does say in the literature that the annual dividend must follow the contribution principle, whereas they might freeze annual dividends for ten years at a time. Because of that you can't use *FAS 120*.

Unit links are like a variable-type product. In the U.S. if a policyholder gives us \$1,000, we put \$1,000 in a fund. It doesn't matter what the surrender charges are, we have the whole \$1,000 there, so if the fund doubles in size we're protected. You might say that there's seed capital or some surplus invested in this separate account. In the U.K. they'll put in a smaller amount, so when \$1,000 comes in, \$600 would be put in the fund, so if the \$600 doubles the liability would be \$1,200 right? No problem, except that for U.S. GAAP purposes because of how the products are illustrated, the liability becomes the full account value; that is, \$1,000. If that fund doubles it goes from \$1,000 to \$2,000, which causes a loss. So, we'll be projecting losses simply because the product doesn't quite fit U.S. GAAP. So, just to give you a warning—if you're multinational you're going to run into all kinds of problems where products don't exactly fit U.S. GAAP. How many companies here are international in scope? One, I think some will be in the future.

On historical data I'm not going to go through any details here, but your experience studies might not go all the way back when you do a conversion. That causes some problems. It's not just needed for, say, *FAS 60* where you think, "Well, we have to

go back and set assumptions at year of issue and then add PADs. It's also *FAS 97* because you have to get historical gross margins. Luckily, a lot of the account value products weren't introduced till the 1980s, but you still have to go back pretty far.

Actuarial Models

Without slamming actuaries here, from my experience as an auditor the vast majority of companies had home-grown actuarial models that were pretty good. But a lot of times they're written by very sharp students and there's no time to really check everything in detail. So there's liable to be some embedded errors and a lack of controls. What I mean by that is they generally don't produce everything automatically like roll forwards. They don't start with opening account values and add all the pieces for reconciliation like interest credited, surrender charges, and so on. They usually don't build from beginning to end, whereas the commercial software usually takes DAC and will start with opening DAC and unlocking of assumptions, add interest and new capitalization of acquisition expenses and amortization, and finally end up with a new balance. So, normally there are all kinds of internal controls as well as you'll know that John Doe happened to change the assumptions on June 13 last. That's usually stored somewhere in commercial software because I know it's important, whereas on the independent home-grown software rarely do you have that kind of control. You're trying to find out what's the latest assumption set and you're not sure who made the changes. So, that's pretty tricky. When you go live, you have to be fully automated.

I just want to say a couple words about the true-up process. If you run an actuarial model based on an in-force file, the trouble with that is that you have to go back now and say, "OK the model would have produced death claims of 100, but we got death claims of 110." So, for historical gross margin purposes you have to go back and allocate or put the extra death claims somewhere. If you had a model that ran both active and cancelled policies, you wouldn't have to true-up. You wouldn't have to go back and play games with the models or tweak them because the cancelled policies would be automatically allocated to the year of issue and to the right product line. Some of the commercial software works for both active and cancelled policies. I'm not necessarily pushing that, but I'm saying there is a difference in the amount of work for true up.

If you use models based on in-force files you have to do a lot of truing-up. And to give you one more example, you're trying to true-up the surrenders and you tweak them and say, "OK the surrender should have been 10% higher than what we have," so you increase the lapse rates. All of a sudden you find now that you don't match the renewal premiums or the in-force face. It's like bumps on a mattress—you push one down and the other one pops up somewhere else, whereas if you have active and cancelled policies you can at least get past things like death claims,

surrenders, premiums received, and a whole lot of other things. You still have to allocate investment income and expenses, but at least the things that are actually policy-driven—COI charges, interest, credited, things like that—will be accurate.

I think it's worth mentioning a few strategic issues. Expense allocation may be one of the most important ones. GAAP works with variable expenses, so let's start off with total expenses given to product line A. We'll take the direct only, and we have variable and fixed. We're going to focus on variable. Finally, we get to the split between acquisition and maintenance. If you want to look at deferrable expenses they're only the variable acquisition expenses. That's all that we're after. Now, with that in mind, when you have to split between fixed and variable you can argue there's no such thing as a variable expense or you can argue there's no such thing as a fixed expense. I choose the latter argument that no expenses are really fixed because even the chair of the company, the chair's salary, would be a lot lower if the company were half the size. Or, likewise, if it tripled in size or became ten times more there would probably be a bigger paycheck. So all expenses are variable at some point, but it's a matter of how responsive they are to movement in new business. And there it's very subjective.

Now when you get to something like rents for example, you can argue that ultimately you might sublet, but most likely if your sales are down, you're not going to really change the rent. You're still going to be incurring the same rent. The allocation may be different, so within the company one line of business might get a bigger or smaller allocation, and you can say rent is variable. Well, that's not quite true because at the incurred level, the expense is primarily fixed. Let's suppose you choose to be ultraconservative. Every time you have an opportunity to go with fixed versus variable, you lean toward fixed. What will happen is you'll end up with a very low starting DAC because it's only the variable that you can defer. This is a two-edged sword, so it's great for a fresh start. You have this small amount of DAC that has to be repaid out of future earnings, but you can't change your philosophy midstream. So when you get new business coming in the door, if you're going to say rents are fixed, you can't defer any of those rents. You're going to hurt yourself on new business, but you're going to look good regarding the in-force. You either have to go along the lines of taking a different kind of management action or writing business that's more variable through a brokerage system instead of a career agent system.

Another strategic issue is investment income allocation. For U.S. GAAP, if there's a realized gain, 100% of the gain enters income and consequently the gross margin or the gross profits for DAC amortization. Nothing of unrealized. Now on Canadian GAAP to contrast, Sun Life's a Canadian company so I'll use this as an example. Only 15% of the realized gains go into income. Of the remaining 85% that didn't

go into income, 15% of that would go into income for next year and so on. So it's all with 15% of the declining balance. Almost the same thing takes place with the unrealized gains and losses. The difference between market and book, technically called the adjusted book, is computed and 15% of that is taken. This is regarding stocks. While this is sort of a Canadian methodology, something very similar might take place in the U.S. If you decide to smooth your realized gains or losses or smooth your unrealized gains, say on stocks or on real estate, you could end up with the same phenomenon and that gets kind of tricky. These are available for sale by the way, which almost all companies are using for standard products. No one I know of is using the held-to-maturity category, so either something is variable in nature where it's trading or something is in the fixed account and generally available for sale.

You can group the contracts any reasonable way depending on how you manage the business. But an interesting strategic issue is that if you thought you had a pretty bad year, say 1994, you're better off taking loss recognition in 1994 than establishing a higher reserve then. Now, if conditions have improved, you can't take it down; it's like a ratchet effect. That reserve will have some embedded value as well as you won't allow the distortion to take place where you're going to take away profits from future business like, say, 1995, 1996, 1997, and 1998 issues. That business might be profitable, whereas if you did the loss recognition all at once in 1998 you would end up with a smaller amount of deficiency, but it also means you wouldn't make any profit off that business if those are truly your best estimates. You're better off going to the high-water mark, finding when was the worst year and the worst case and set up the reserve. At least then you'll have some profits coming in from future business from that point.

Management Philosophy

When we have segmented assets or segmentation in companies, we have to decide how we're going to allocate those assets to the segment. Is it statutory like U.S. statutory? Will it be Canadian Annual Statement? You can allocate on some GAAP basis, but then you won't have any GAAP equity and, depending on what you choose, you can actually add a percentage of Minimum Continuing Capital and Surplus Requirements in Canada or RBC in the U.S. You can take percentages of that and add that as well, but once you've defined how you want to allocate assets to a segment, that automatically defines the GAAP equity and then you can look at ROEs or some other measurement. So, the management philosophy is very important there.

Dividend philosophy is the same thing, especially the smoothing of capital gains both realized and unrealized. How you're actually going to allocate dividends. Investments. Intersegment trading. Now I don't know how many companies do

this necessarily, but let's suppose you have an asset. It's U.S. GAAP value is 80 and its market value is 100. This could be a bond where maybe it was 10% at one time; it was purchased as a 10% coupon and maybe the rates are down to 6% or something. Let's say segment A sells it to segment B. Segment A receives 100 for this asset, which is the market value. Segment A would like to report 20 of capital gains, i.e., realized gains. Well, U.S. GAAP says you haven't really sold the asset externally, so you don't really have a gain at that point. The other segment that purchased the asset pays 100 market value, but gets something that's only worth 80 on the books. If the second segment, segment B, sells it 1 day later they could realize a gain of 20. Now that doesn't make a whole lot of sense, so you can see where you could have some earnings manipulation. You have to look at what's real GAAP and what's an external sale versus what's an internal sale. You might have to have consolidating adjustments. Without bogging you down in detail and complexity you can see that's a major issue. If you're going to do intersegment trades you have to work out a system.

Pooled funds—same thing, stock and real estate. For pooled funds you might decide that it's easier to just put all the stocks in one fund and then basically everybody owns units. Each segment owns units or shares. That causes some other problems too because it's the fund that sells almost like a mutual fund generates gains, and then you have to allocate those gains back to the segments. You don't have earmarked actual assets if you're going to use pooled funds. They create their own problems and you're back to real versus internal GAAP.

Mr. Darak: For those of you who thought you only had two speakers today because you looked in your book, we do have a third speaker. Lou Weisz joined New England Financial, then known as New England Mutual Life, immediately upon graduating from college and has worked there his entire 30-plus-year career. Since completing his Fellowship, he has worked on financial reporting and tax matters for New England. Early in his career, he was instrumental in helping design a cash-flow reporting system and implement the reporting of profits for the pension line of business. More recently, he actively worked on actuarial tax issues, including the company's policy update program. He has served twice as an SOA seminar leader on federal income taxes and has served on several tax panels. He has also served on several SOA committees and is a past Chair of the Professional Actuarial Specialty Guides Committee and the Life Insurance Specialty Guides Committee. Over the past several years he has been heavily involved in the implementation and reporting of GAAP for mutuals.

Mr. Louis M. Weisz: My talk this morning will be on the practical problems in implementing GAAP. We'll talk about the background and initial work and then practical considerations in the financial management at New England.

For the background, it has consisted of two companies and their products, which are issued. The companies are the old New England Mutual Life Insurance Company, where I started to work, and the successor company where I still work. Right now it's a closed block in the business form. Metropolitan Life and New England Mutual were merged into Metropolitan in August 1996. New England set up a subsidiary company also known as New England Variable Life Insurance Company, or NEVLICO, in the early 1980s to sell variable life insurance. At the time of the merger, the name of that was changed to New England Life Insurance Company, or NELICO. The "V" was dropped, and the company was redomesticated from Delaware to Massachusetts.

Having finished converting to GAAP, we have a whole range of products at New England. The major products are par traditional life, variable life, and individual annuities. Par traditional was New England's mainstay product. But in recent years the sales of par traditional have waned a bit. Variable life was introduced first in the early 1980s and the sales of that were slow to get going, but that now accounts for about 80% of the permanent business being sold. We still sell par life as well as all the other products through the subsidiary NELICO. Third, we sell individual annuities. Most of those are deferred annuities and most of the preferred annuities are variable annuities. We also sell a whole range of other products such as universal life, disability income, group life, and health and group pension.

I break down the initial work into three different sections: the consultants and auditors, the minor work, and finally the bulk of the work. We've had two sets of consultants and auditors on this GAAP effort. At first, when we started this, the merger had not taken place. It took us about two years to convert to GAAP and we hired our auditors at Coopers and Lybrand, who are now PricewaterhouseCoopers. We worked with their accountants and actuaries and they were very, very instrumental in helping us learn GAAP. Since the merger, Deloitte & Touche, our friends up here Harold and Al, are Metropolitan Life's auditors, and, as a result, are New England's auditors. We've worked with them, their accountants and their actuaries, and both sets of auditors and accountants have been exceptionally helpful.

The minor work that was done, which I'll cover first before getting into the real detail, was revaluing the reserves. As an actuary, I think revaluing the reserves is pretty simple. For par traditional life, what you have to do is just revalue that to a net-level premium basis. Most of our recent issues were reserved using the commissioner's reserve valuation method (CRVM) business. In *FAS 120* and *Standard of Practice (SOP) 95-1* there are some comments about the interest rates that are applicable for valuing the reserves and the mortality tables. I believe the interest rates have to be the interest rates behind the dividend scale used as a base

rate in the dividend scale, and the mortality rates have to be the rates used before cash values.

For *FAS 97* products it's much, much simpler. You change from your statutory reserves that you had been reporting to reporting the account values. Those data are relatively available. Where there's more effort required is on *FAS 60* products where you really have to do a reserve revaluation. For us there was a principal amount of effort involved in that on our immediate annuities and on our life income settlement options where we had to go back to first principles under GAAP to value those.

The real bulk of the work, however, was, as many of you are aware, in creating the DAC asset. The accountants might say, "Hey it's only one little number you're doing on the balance sheet; it can't be that much," but that's really a lot of work for the actuaries to do. What they have to do is create the expected growth margins (EGM) or expected gross profits (EGPs) for the *FAS 97* and *SOP 95-1* products. This is probably two-thirds the amount of work that's required in converting to GAAP. For New England, we were very, very fortunate in working with our historical data that our systems people were able to go back, on computer master files, to 1979. We took the data that came from that and really went and created our historical EGMs and EGPs by issue year. We needed, in effect, to ratio up or down the data that came out so that we hit account totals for premiums and for the various benefit pieces. I think only for one type of benefit did we need to make some sizable adjustments, and that was for surrenders. And that's because of partial surrenders, which occur where paid-up additions riders were being surrendered to pay premiums and policies. Doing projections was a whole other can of worms, and that's probably more in the actuaries' bailiwick. We're using TAS, the Tillinghast system, and we've developed some expertise with it over time. But first in doing the projections you must have a good model and validate your results and your actual in-force before you start your projections. I think we've probably come an awful long way in what we're doing in our modeling and our validation. We have many, many more cells now for model projecting forward than we had when we started GAAP.

When you get done with your historical on one hand and your projections on the other, you have to merge them together for your EGMs and EGPs. Well, we found that we had some differences here at the point where the two met, and we called it the seam. I have a feeling that where we used actual data, dollars and data for each historical issue year of data, we may have had more variation than other companies may have had if they converted their historical data into rates, which could have given them more of a congruous flow between the past and the future.

When we get done with all this we have to be satisfied with the results, and that means being satisfied with the results in two areas. First, the EGMs and EGPs. They must have a reasonable pattern going forward; that they are where we think they ought to be as the business runs off. Second, where the DAC asset is for amortizing the DAC expenses with the EGMs and EGPs. I'll end this section by saying that I mentioned we had gone back to 1979 and had done that with Coopers. When Deloitte came on the scene, Deloitte suggested that we go back 40 years for our traditional products since we were amortizing for 40 years in the future and had no easy way to do this. They suggested an easy way to do it was just to extrapolate from the earliest data that we had in building some assumed growth rates for the business in that period.

Now I'll move on to the practical considerations. New England has quite a bit of variable product business in-force in the variable life and the variable annuities. We get some variations in the results from the stock market fluctuations. There's always going to be stock market fluctuations. If we're assuming, say, an 8% growth rate, it either turns out to be 0% or 15% for the year. Let's say it's 15% for a particular year. For that particular year the asset-driven margins turn out to be higher than the 8% that we had assumed. But not only are they higher for that year, they're also higher for each year going forward since we're starting from a higher asset base and that affects the amount of DAC asset that's being held in the amortization.

Early in the process our consultants suggested that we might want to try a smoothing technique. One technique was to look back a few years and then project forward and use a smoothed rate of return for a number of years. They tried presenting us with some data, so we fooled around with some other data. We saw that that might smooth things for a year or two, but it seemed that we would replace one erratic pattern with another and in the process create a lot of work, and that just did not seem right. So we canned that. We found out about another approach that another company was using within the past year or so. We looked into that but didn't find that was satisfactory. At this point we're not bringing in any smoothing techniques in our variable business, but I'd say we haven't closed the window on it. We've just put it on hold for now.

There are some other special implementation requirements for a couple of products. First, the unearned revenue reserve. It's required in *FAS 97*. It's required for us on our variable life, which is a front-end load where many of the products of variable life are front-loaded where we in effect have to take in those loads and smooth them over the life of the business in relation to the EGPs. On traditional life, we pay terminal dividend for policies that have been in-force for at least 15 years when they terminate. Under statutory there's no particular provision. You just set up a dividend liability for what you expect to pay out that year. In GAAP under the SOP

if a certain condition's met you have to set up an accrual for this terminal dividend. In fact, we at New England have to do that and this is amortized over the period of EGMs. I mentioned our EGMs go for 40 years, our terminal dividends really end at the end of that 40 years. We maintain a liability for the remainder to be paid out over the remaining life of the business and just amortize that with a simple procedure following that 40-year period.

Financial Reinsurance

Reinsurance for reinsurance ceded is covered under *FAS 113*. It doesn't apply to reinsurance assumed, just to ceded. To my way of thinking, *FAS 113* was written from the property and casualty companies' point of view and life companies were added as an afterthought. And I think that's caused some difficulties to the actuaries and accountants in practice. I don't know whether Mr. Reznicek would agree or disagree with that; a couple conditions have to be met for reinsurance to be in fact treated as reinsurance. First, is it risk-bearing and second, *FAS 113* requires that the reinsurer realize the significant loss. I don't think reinsurers are going to be in the business of doing life reinsurance if they have a good chance of realizing a significant loss in some business. Some possibility yes, but a reasonable possibility, forget it. With a type of financial reinsurance we had done at New England, we ended up going round and round with our auditors on this and finally came to what I think is a satisfactory conclusion. If experience was worse than anticipated the reinsurer would not lose money, but not make as much money as otherwise would be the case. The accountants seemed to be satisfied with this. Finally, I would say if reinsurance is not really risk-bearing, it has to be treated as deposit accounting and I believe that that was first mentioned in *FAS 60*, but only very recently has the AICPA come out with a pronouncement of this just last year in *SOP 98-7*.

Next I'd like to get into loss recognition for a minute or two. I know the previous two speakers have talked about this briefly. Loss recognition is defined and discussed in *FAS 60*. The later pronouncements in *FAS 97* and the *SOP 97* also talk about loss recognition, but they'll refer you back to the paragraphs in *FAS 60*. You test for loss recognition by doing a gross premium valuation if you think you're in this position. When you do that, as opposed to *FAS 60* where you would maintain a provision for adverse deviation, you're in a loss recognition situation. You do it with the best estimate. You do not maintain any provision for adverse deviation. We faced this early on in our GAAP conversion effort. We faced it with our immediate annuities and life income settlement options. We were doing this in the mid 1990s. The bulk of these products were written during the 1980s and interest rates had dropped substantially. In fact, the rates earned on the blocks of business had dropped. So we found that we had to revalue these at a higher rate than they were written for.

We found this also in the case of guaranteed investment contracts (GICs). What happens with loss recognition under *FAS 60* is you find you need to set up additional reserves. You first reduce your DAC asset. If need be, reduce your DAC asset to zero and if you still need more reserves then increase your benefit reserves. But with GICs you can't do this; GICs are treated under *FAS 91*. They're referred to *FAS 91* when you value them under *FAS 97*. *FAS 91* is really written for loans written by securities firms and banks. With GICs if you have losses you can write down the DAC asset to zero, but you can't increase your benefit reserves. In effect, on these products you can only leak in the additional losses as they get recognized one year at a time. We also had to face loss recognition on disability income. We looked at this at the time of our conversion. We were testing each issue year separately and since conversion for new business we're testing each issue year to make sure it's self-supporting.

Finally, in the practical considerations, I'd like to consider DAC for a moment. Actuaries have always been concerned with DAC or their acquisition costs, which they amortize in their pricing, and for mutual companies according to their dividend scales. DAC defined for pricing and dividend purposes is different from DAC defined under GAAP. For pricing you can use what you want to use in there for your DAC. If you're using CRVM reserves you have a reserve allowance that provides for some issue expenses. Under GAAP, the expenses have to be related to and vary with the production of new or renewal business. From them you deduct out the ultimate expenses.

Second, the period to amortize the expenses is probably going to be different under pricing than it is under GAAP. GAAP tells you you have to really amortize everything over the life of the business. In reality it may not be quite the life of the business, but it has to be something pretty darn close. When we had started our investigation work into GAAP, we had talked with our consulting actuaries about amortizing over 30 years, which I thought was exceptionally long and, in fact, is longer than I think we're using in our pricing. We ended up on traditional life and on variable life amortizing over 40 years, and even at that point at the end of 40 years there's some business still left in-force. Finally, in pricing in a GAAP environment, we're finding now that we have to go and price on an ROE basis. ROE versus ROI, which is different than the prior days.

Let's talk a bit about financial management. Both prior speakers have spoken about this. We're focusing on GAAP now rather than statutory. Previously we had also reported on an internal GAAP basis or modified GAAP, which was really pricing. Right now we're in the process of developing a gains by source analysis for management. This is just a natural from *FAS 97*, where you have your basic data right available. Our accountants, when they first started producing GAAP

statements, took an exceptionally long period to go do this. They first produced statutory and then made GAAP adjustments in statutory. We just started in fact last year-end in this year to develop a GAAP ledger and produce GAAP accruals right from scratch. So, we go off on statutory on one hand and GAAP on the other. We find that where this used to take us two to three months to do, we can now do this in less than a month. Management really requires this information rather quickly.

If you're considering changing your assumptions for your DAC asset, your interest factors, or your mortality or lapse rates, I'd suggest with comments that a small change in these assumptions could have a big change in the resulting DAC asset. And I suggest the way to do this is not just to tell management, "Hey, this is what we've done." Rather, get management to buy in. Communicate with them; involve them in the process. Let them know what the various changes mean. Maybe give them an option as to how to value what assumptions they want to end up with.

Realized Capital Gains

For the income statement presentation a stock analyst likes to see them. DAC being amortized resulting from the gains are normally offset right against those gains, so that the operating net income is really exclusive of any DAC being amortized on the gains. That's because stock analysts, particularly for companies who were going to convert or were thinking of converting to become stock companies, will throw away the realized capital gains and say the companies' earnings really is the operating earnings and these capital gains can't be counted on. As a last topic I'd like to touch briefly on shadow DAC.

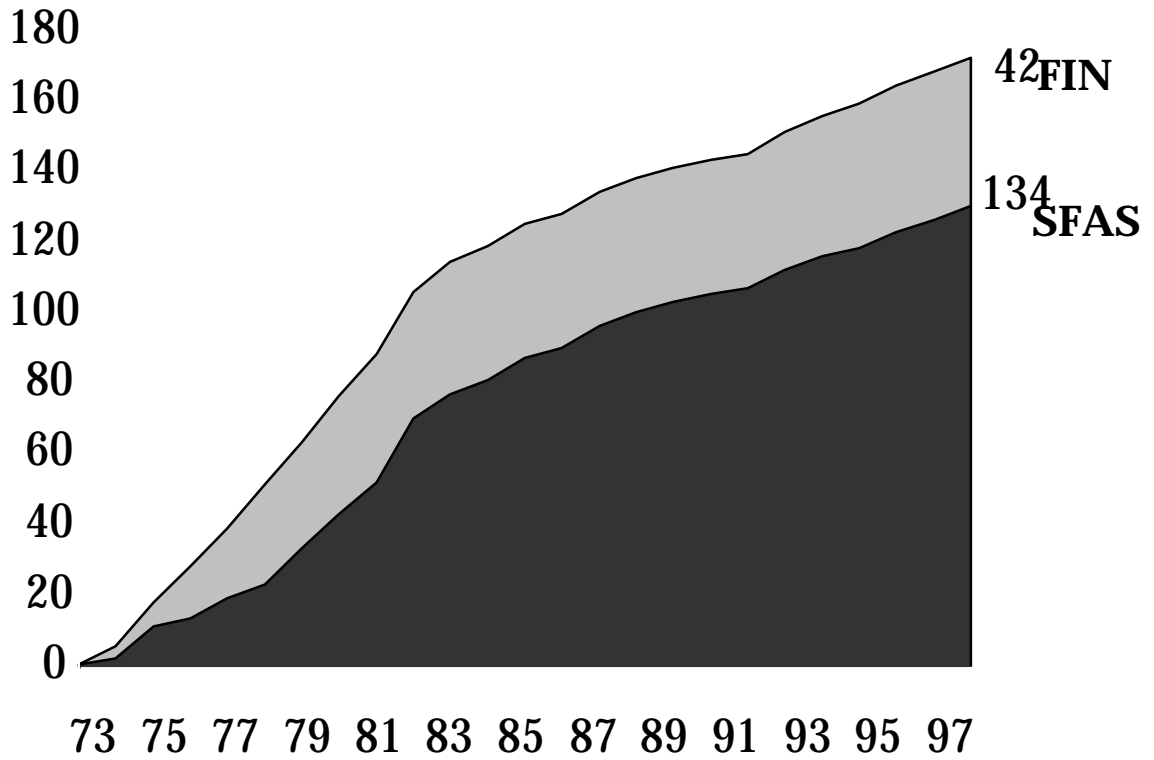
Shadow DAC is an offshoot of *FAS 115*. *FAS 115* was developed by the accountants. It applies to the securities; it doesn't apply to mortgages or real estate and only applies to the available-for-sale securities. It's just an adjustment to the balance sheet. It affects the DAC on the balance sheet as far as actuaries are concerned. It also affects the available-for-sale securities assets on the balance sheet. The adjustment that the actuary has to make is the k factor multiplied by the unrealized gains.

Mr. Darak: Are there any questions from the audience?

Ms. Lynn A. Pogas: I have a question for Ken and it probably doesn't apply to most people, but you briefly mentioned reversionary and terminal bonuses. I was wondering what your GAAP formula is for the reserve for those? You seem to have an amount in mind when you are pricing it, but then they can vary because of the contribution principal.

Mr. LaSorella: Right, what it amounts to is because they don't follow the contribution principal on an annual dividend basis we can't use *FAS 120*. Therefore, you're using *FAS 60*. And if you're using *FAS 60* everything becomes twice as easy because you look at what's in a fund. Basically, it's almost like closed-block accounting. You subtract from what's in the fund your best-estimate assumption. We'll call it best-estimate reserves for all the guaranteed benefits, including reversionary bonuses which are guaranteed. It's like a paid-up addition; once the money's allocated there's an obligation to pay it. What's left over happens to be a potential dividend fund. It's like a deferred dividend liability. You could say that is the dividend liability. Therefore, it's available for future reversionary bonuses or terminal bonuses; it doesn't make any difference. That's paragraph 42 in *FAS 60* where it says to the extent that there's income that can't be distributed to shareholders. You have to accrue liability for that. And that's a dividend liability. Now if that were a *FAS 120* situation it wouldn't be that bad because the terminal bonuses would still be accrued, just like DAC, so a piece of the gross margin would be set aside to include terminal bonus, but it would be a very different approach. It wouldn't be as accurate.

CHART 1
FASB STATEMENTS AND INTERPRETATIONS



FIN-Financial Interpretation Number X
SFAS-Statement of Financial Accounting Standard