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Generally Accepted Accounting Principles: Implications for Mutual Insurance Holding Companies and Demutualizations

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Summary: Many mutual companies have considered going public, either by transforming into a mutual insurance holding company or through a full demutualization. Among the many challenges facing such an organization is the need to report financial results to shareholders using one or more applicable standards (U.S. GAAP, Canadian GAAP, etc.) to understand and explain financial results to outside audiences, and to do so on a timely basis.

Panelists from the U.S. and Canada describe their GAAP experience and address the theoretical and practical issues faced by companies moving to a stock company environment. Recent developments with the American Institute of Certified Public Accountants to standardize accounting for these reorganizations are also discussed.

Mr. Jason A. Morton: We offer a very timely and important topic to most or all of you, given the recent flurry of activity of mutual holding company transformations and demutualizations, at least in the U.S. This mutual-to-stock company activity is occurring in an era with a general lack of authoritative accounting guidance for such transformations, and many of the companies that are becoming public are doing so with a general lack of the necessary years of experience that it takes to manage a company optimally on a GAAP basis as a public entity.

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Among the many challenges companies are facing are financial reporting as a public entity, explaining results to public audiences, and doing all this on a timely basis. The result is substantial, fundamental change, as well as the introduction of processes and requirements that these companies have not previously experienced firsthand.

In this session, we will discuss these issues, focusing on financial reporting as a public entity. We will not address the decision to demutualize or convert to a mutual holding company structure or the advantages and disadvantages of various options. We also will not probe into the details of GAAP for mutuals or the mechanical issues involving deferred acquisition cost (DAC) calculations for the Statement of Financial Accounting Standards No. 120 (*SFAS No. 120*) business because there are other sessions for those topics. We will, however, discuss issues regarding DAC and how it interacts with certain accounting theory for closed blocks.

I am a partner with Deloitte & Touche. I will be the moderator for this session, as well as being a panelist discussing the practical aspects of financial reporting on a GAAP basis. I'll be followed by Ed Morrissey, a CPA and partner with Deloitte & Touche who will discuss recent developments within the American Institute of Certified Public Accountants (AICPA) and its Insurance Companies Committee Task Force regarding emerging authoritative guidance for mutual company transformations. Then we will discuss certain issues regarding DAC for closed blocks, which is emerging as a source of considerable debate. After this, Al Brinkman of Guarantee Life will describe the evolution of his company through the initial conversion to GAAP, through demutualization and subsequent public offering, and through its current operation as a public company. Al's remarks represent the "been-there-done-that" side of this presentation.

To begin, I will pose a question: Is GAAP required in the first place? GAAP financials are required if you are a public company. You also need audited GAAP financials as a mutual company if you want a clean GAAP audit opinion. Most mutual companies had been producing financials on a GAAP basis, even before demutualizing and going public. Even though they may produce GAAP financials, some mutual companies have their GAAP financials formally audited with an audit opinion and some do not, allowing an adverse GAAP opinion from their auditor. But if these companies demutualize and go public, obviously, they will need audited GAAP financials. Also, certain states may require GAAP financials as a necessary requirement for a mutual holding company conversion.

Much time and effort is required to implement GAAP. It takes a lot of effort just to generate the numbers and to get the necessary systems and processes set up. Once

the ability to generate GAAP financials is established, it is typical that processes and systems continue to evolve over time as you automate and improve, and as your company learns more about what it means to report on a GAAP basis. We saw that with stock companies in the early 1970s and later under *SFAS No. 97*; now we're seeing it with mutual companies.

I mentioned that some mutual companies are determining financials on a GAAP basis but not getting a formal audit opinion. These companies are doing this because once your audit opinion is signed on a GAAP basis, and as you go forward, you have much less flexibility in changing accounting principles, and you may find yourself somewhat stuck with accounting interpretations. As an example, a company may decide to use DAC for a block of business that was not previously "DACed" after the GAAP financials have been given an audit opinion. This would be no issue if the impact is not material; but if it is material, it becomes a serious problem. No company wants to restate prior-period audited GAAP financials; it's a mess and the reason why some mutual companies have not yet requested a GAAP audit opinion yet. But if they want to be public, they need to get the GAAP audit opinion.

What does it really mean to be performing financial reporting as a public entity? One consideration is that your financials are open to public scrutiny, and, depending on the situation, they could be scoured and challenged. The public needs and relies on this information to make investment decisions; therefore, they're going to be digging into the numbers and comparing your company to other companies. This scrutiny by analysts and investors is what drives the importance of solid financial results and painting a bright picture of the future for your company. Also to be considered are the additional filing requirements with the SEC and other entities. Quarterly financials are required. You might be doing them now, but they will be required for a public entity and will be subject to the same level of scrutiny as year-end financials.

Another consideration is the pressure to maintain growth and profit patterns. It's really not so much a financial reporting issue, but may be more of a fundamental change in financial management. When dealing with insurance products, we are dealing with long-tailed liabilities. Many companies with a mutual company perspective have been used to very long-term management time frames. But now, if you are a public company with a publicly traded stock, your income statement has to be very solid and predictable in current periods as well as in long-term trends. You should be able to forecast earnings accurately, and you don't want volatility or negative trends even if you believe that long-term gains will result. Anything like that would tend to have an adverse effect on your stock price.

A corollary consideration is that public companies tend to follow shorter planning and operating horizons, again with the need for enhanced short-term earnings to help maintain and increase stock price. Also, pressure to release earnings earlier than before is increased. Most public companies are releasing financials by mid-February, and sometimes even as early as late January, which is earlier than what companies have been doing typically for statutory, especially given that the GAAP financials are more complex. Several iterations of GAAP financials are determined and reviewed before a final set is established, which takes more time than normal. If a public company has stated an earnings release date and misses it, negative press is the result.

Earlier I mentioned additional reporting requirements. I won't talk about these other than management's discussion and analysis (MD&A). Basically, it's a narrative description of the financial performance for the year-to-date and current quarter, and a comparison of these to the prior year and prior quarter and also versus budget or plan. The MD&A, of course, takes extra time.

Actuaries know the importance of reserves and are trained in the analysis of reserve changes. Explaining GAAP results includes analysis of reserve changes and analysis of DAC balance changes. Although not as large as reserves for most companies, the DAC balance is material to the balance sheet, and DAC amortization expense is material to the income statement. However, DAC tends to be more volatile and subject to variation than reserves are and, thus, require much more care in determination and analysis, especially for *SFAS No. 97* and *SFAS No. 120* business.

Every time the amortization schedule is changed, whether due to substitution of current information over previously estimated information, often defined as "tru-ing-up," or changing the future outlook on prospective assumptions, often referred to as "unlocking," the impact comes through current period income. Also, communication between actuaries and accounting staff is especially important with GAAP reporting. Too often, actuaries calculate the DAC and feel their work is done, leaving the financial accounting staff responsible for reporting the numbers and oftentimes explaining them. Actuaries need to start understanding a lot more of the accounting issues and assess how they might affect their work.

To help explain GAAP results, analytical tools, in addition to source data, are very helpful. Having source data in a database or some sort of data warehouse is important for ad hoc studies, and analytical tools and trend analyses generated every quarter are also very useful in analysis. Trend analyses can not only help to explain results, but also provide quick comfort in the numbers.

Also, training becomes very important. Training is useful for low-level actuaries and accountants as well as for senior management. To further improve the communication between actuaries and accountants, the best practice is to have all financial reporting staff go through the same training.

What does it mean to “manage on a GAAP basis?” It means performing certain work that you’ve been doing on statutory basis, such as pricing and corporate planning, on a GAAP basis. Managing on a GAAP basis also affects the way companies view a potential acquisition, focusing more on purchase GAAP considerations and accretion/dilution issues than just on the present value of profits from an actuarial appraisal.

With respect to financial reporting, GAAP becomes a priority over statutory. That means that GAAP financials are focused on first, but not necessarily calculated before statutory. Quite often this is not possible due to the way the valuation systems is set up or because GAAP is set equal to statutory. A different mindset is needed to report earnings as fairly stated and not purposely conservative, as is the case for statutory.

One of the industry’s best practices is focusing on GAAP before statutory. This means changing current processes and work steps for many mutual companies. Another best practice is the ability to determine financials quickly, bringing in preliminary results in five working days and final results in 15 or sometimes 10 working days. Getting final results in ten days is very quick, but may be required for business units and subsidiaries of a consolidated enterprise where extra time for consolidation is needed.

A very quick turnaround on financial results may require the proper use of lags and estimates. Quite often, there are some things that can be done that don’t materially misstate earnings but allow for quicker calculations. A typical example is using a one-month lag for the investment yield in determining DAC.

Also, studies and maintenance of processes and systems need to be considered and performed throughout the year instead of simply at one specific point in the year. Such work includes retooling systems, performing experience studies and unlocking exercises, and maintaining and improving and automating systems. Actual-to-forecast variance explanations are needed to provide explanations for the MD&A and for ongoing management of the business.

An obvious point is that much care needs to be taken with DAC unlocking, especially for *FAS No. 97* and *FAS No. 120* business. The calculation is very volatile and can result in significant deviations from expected profits. We’ve seen

companies that unlock one assumption one quarter, causing DAC to bounce up, then unlock another assumption the next quarter, causing DAC to come right back down. An unlocking exercise should always consider all assumptions. Two not so obvious points are that: (1) DAC unlocking should be viewed at the company or enterprise level, and (2) you need to be forward thinking with respect to DAC management. GAAP financials are published at the consolidated level, so it is at that level, at least, that DAC management must be viewed. A consistent company-wide approach to GAAP is important. Forward thinking refers to studying potential adverse impacts to DAC amortization before they happen, and adopting procedures to mitigate them. Prudent practices, such as limiting noncommission deferrals at pricing and managing the DAC down for annuities (particularly after the surrender charge period) are important to analyze and implement. Surveys of industry practice can be helpful here.

A final industry best practice is to determine and document internal standards of practice. These are your company's interpretations of GAAP, covering such topics as the definition of deferred costs, the level at which DAC is calculated, detailed definitions of amortization streams, amortization periods, treatment of reinsurance and riders, the level at which recoverability and loss recognition testing is performed, and so forth. In many cases, GAAP guidance is limited for these items, making industry practice more important. The standards of practice should be documented in writing, and should be revised and expanded as necessary.

There are several characteristics of an ideal valuation system for GAAP purposes, DAC in particular. A good balance between the level of automation and analysis capabilities is essential. Financial items need to be generated quickly once the quarter-end occurs, but at the same time, you need information to provide the understanding necessary to explain the results. As I have seen many times before, sacrificing analysis and detail for processing speed from a "black box" is never a fair trade-off. Similarly, the DAC system must provide for ease of calculation, and the process to determine DAC must be efficient. During an unlocking study, there might be five different assumption items to review, with several different combinations to run and many test iterations performed before feeling comfortable with the final set of assumptions you want to stick with. Quite often, the total unlocking impact will need to be broken down to each assumption change after the final assumption set is chosen, again necessitating several additional rejections of DAC margins. The DAC system needs to be robust, such that new products can be added without significant retooling. And I would be remiss if I didn't mention audit considerations. You need the ability to re-create the DAC numbers and provide enough information for analysis by a third party.

Many companies today are preparing for demutualization or are considering going public. Even if the planned trigger date is two or three years away, experience shows that it is never too early to clean up systems and processes for reporting as a public company. A good place to start is inventorying known issues, performing necessary analysis, and taking appropriate action, especially taking DAC write-downs where needed. This is also a very good time to streamline GAAP processes and reorganize functions. Enhancement of internal controls is always important in any environment, but it is especially important as a public entity.

Along with streamlining processes comes migrating to a common valuation platform. Maintaining several dozen valuation systems is time-consuming and inefficient. This includes the manual calculations and off-system adjustments that are prevalent for so many companies, typically for small closed blocks of business. Use good actuarial skills and judgment, along with a heavy dose of materiality, and get rid of unneeded systems and calculations. The “common valuation platform” is usually not one system or vendor but may be three to five systems.

I close my remarks with a few final practical considerations of GAAP reporting. I think of GAAP as a collection of ideas and principles with some guidance versus the prescribed, cookbook approach for statutory. Wherever there is a lack of specific authoritative guidance, it is important to understand the range of industry practice. Your company must take care to extensively study possible adverse impacts and industry practice before adopting formal policy. Key principles never to lose sight of are materiality and consistency. Finally, management on a GAAP basis requires increased resources. I referred to producing a greater amount of information, detailed unlocking studies, improving and revamping valuation systems, redesigning procedures, streamlining processes, and so forth, all of which take more time than ever before.

Specific guidance for GAAP comes from the AICPA. The most recent Actuarial Standard of Practice (ASOP), *No. 33*, deals with the actuary’s responsibilities with respect to closed blocks. It provides some information about assumptions and many other things that go into the determination of closed blocks, but doesn’t specifically address GAAP for closed blocks.

Ed Morrissey will discuss some of the recent developments of the AICPA’s work on mutual company transformation accounting guidance. He is the leader of Deloitte & Touche’s Tri-State Insurance Practice and also is the national practice partner for services to state insurance departments. Ed is currently a member of the AICPA’s Insurance Companies Committee and chair of AICPA the task force that is dealing with mutual holding company and demutualization accounting guidance.

Mr. Ed Morrissey: My discussion will cover the AICPA's Insurance Companies Committee task force that is in the process of updating the accounting guidance for demutualizations and mutual holding company transactions. The agenda includes a discussion of some practice issues and how the accounting profession is attempting to deal with them. I will also discuss some of the tentative conclusions of the task force along with a current best guess as to our timetable for completion. I will then discuss some practical issues concerning the interaction of DAC with closed blocks.

In December 1997, the Insurance Companies Committee of the AICPA agreed to add demutualization and mutual holding company accounting to its agenda. A working group was formed in May 1998, of which I was fortunate enough to be asked to chair. Since then, we developed a prospectus, which is required for approval by the Accounting Standards Executive Committee 9 (ACSEC), and obtained agreement from the FASB for the project. The prospectus was cleared by ACSEC in October 1998 and by the FASB in February 1999. At that point, the task force was formally established but, given the urgency of the topic and the transactions that have been announced, work had already begun on some of the issues during the deliberation process.

The task force is comprised of representatives from each of the Big Five accounting firms, plus industry representatives from Prudential, Metropolitan Life, and New York Life. Also involved are several other people from the accounting firms that have experience in working on these transactions, plus actuaries from four of the firms: Peter Duran from Ernst & Young, Carl Harris from Deloitte & Touche, Darryl Wagner from Arthur Andersen, and Steve Mahan from KPMG.

The task force agreed to take on and study five specific issues: 1) financial statement presentation; 2) reporting of earnings; 3) expenses of the demutualization/mutual holding company; 4) treatment of retained earnings; and 5) accounting for dividends. I will focus on the first two issues. I am giving the other three for your information because they are not as actuarially driven.

Before we discuss the two specific task force issues, let me give some background on a few related practice issues. The first is that the GAAP accounting model currently does not provide explicit guidance on how to account for a demutualization or a mutual holding company transaction. There is no FASB statement or SEC guidance that you could specifically look to that tells you what to do. In fact, it is the SEC's influence on historic transactions (such as UNUM, The Equitable, or State Mutual) that companies look at to see what the SEC accepted for filings. This has become de facto GAAP accounting policy. Specific guidance on how to account for these transactions is needed.

Other practice issues deal with the diversity in practice around the deferred dividend liability (DDL), and whether, in fact, it is appropriate to hold a DDL. We are also faced with trying to resolve the conflict in existing literature involving *FAS No. 60* and the *FAS No. 120* regarding the DDL, as well as the question of whether a demutualized company should be viewed for accounting purposes as a stock insurer or a mutual company.

The first task force issue deals with financial statement presentation: Should the closed-block financials be consolidated with the rest of the company, or should the one-line presentation that exists today continue? To answer that question, you need to address an earlier question dealing with why a closed block is formed and what the closed block is intended to do. The reason for the closed block is, of course, regulatory, and it also deals with the inherent conflict between shareholders and policyholders.

Currently, there is no revaluation of any of the assets or liabilities that are transferred to the closed block. They continue with their historical values when the demutualization transaction is completed. So there is no purchase accounting.

A single-line “contribution from closed block” presentation is currently used for both the income statement and balance sheet, due to the influence of the SEC’s acceptance to date. It is the tentative conclusion of our task force that we should move from the current presentation to a consolidated presentation. This means presenting closed block results with full-blown income statements and balance sheets instead of single-line reporting. I think the motivating factor is that many believe the single-line income statement presentation is very misleading and that a full consolidated presentation would be more meaningful to the users of financial statements. On the single-line presentation, you could see the contribution from the closed block and assume that this was the earnings related to the closed block business when, in fact, many of the expenses that relate to the closed-block policies are outside of the closed block and in the open block. This is unlike a separate account, which does utilize single-line reporting, where all of the operations of the separate account are contained in the separate account results.

The second issue deals with two sub-issues surrounding the reporting of earnings. The first relates to the applicable accounting guidance the company should follow after demutualization for participating business—*FAS No. 60* or *FAS No. 120*. The second sub-issue deals with how the earnings of the closed block should be reported and whether a DDL should be established.

The first sub-issue comes down to whether a mutual company that converts to a stock company can choose to apply the provisions of *FAS No. 60* to its participating

contracts, where *FAS No. 120* was followed before conversion. The *FAS No. 120/SOP 95-1* guidance does make it optional for a stock insurer to follow *FAS No. 60* or the *SOP 95-1*, but mutual companies do not have a choice. They must follow the *SOP*.

This is a very important issue, because there is quite a difference between *FAS No. 60* and *FAS No. 120* in terms of how *DAC* is amortized, how reserves are determined, and so on. So it does matter which statement a post-demutualization insurer would use. The tentative conclusion of the task force is that the former mutual does not have a choice and must follow *FAS No. 120/SOP 95-1* for its participating contracts.

The basis of our conclusion is that *FAS No. 120/SOP 95-1* was written specifically for these contracts and, in fact, this is the guidance that should be used in accounting for them. It is also the view that, in the case of the mutual company that will have demutualized and gone public, it will have historic financial statements that will already be using *FAS No. 120* to account for the participating business.

The task force also considered the concept of preferable treatment. Is *FAS No. 60* a preferable accounting model for a converted mutual insurer? *FAS No. 60* has only a few paragraphs devoted to participating contracts, but *SOP 95-1* has been written and devoted entirely to how the accounting should work for those contracts. The history of *FAS No. 120* allowing a stock insurance company to choose *FAS No. 120* or *FAS No. 60* relates to the fact that, at the time that the *SOP* was about to be issued, certain stock insurers stated that they had been omitted from the due process of that *SOP*. The *FASB*, in an effort to get the guidance out as soon as possible, accepted the fact that there could be a lack of comparability of stock insurers and mutual insurers that have participating business. However, it was accepted on the view that the number of companies writing participating contracts was fairly limited, and *FASB* didn't think that there would be many (or any) companies that would use *FAS No. 120* to account for this business.

Let's move on to how earnings are to be reported. At the date of demutualization, the assets of the closed block are less than the liabilities. The difference between the assets and liabilities represents the contribution that will emerge to shareholders from the closed block. The key issue involves the method and timing for recognizing that difference. If the performance of the closed-block assets turns out to be better than originally thought, excess earnings will emerge, unless the dividend scales are adjusted, because these excess earnings cannot be distributed outside the closed block to the shareholders. A timing problem results because dividend scale changes do not happen quarterly in conjunction with financial reporting, but several years apart. The practical solution in the eyes of the task force

is to establish a DDL to match the realization of those gains with the ultimate payout of dividends so that you don't wind up with a spike in earnings in the year of the gain and a reduction in earnings in the future years when increased dividends are paid.

Although it seems obvious that a DDL is needed, there has been confusion on this issue related to existing accounting guidance, *FAS No. 60 v. SOP 95-1*. Paragraph 42 of *FAS No. 60* says that it is appropriate to accrue a DDL. However, preferable accounting is to continue to follow *SOP 95-1*, and paragraph 42 of that statement tells you that you're not allowed to record any kind of a DDL. However, in the *SOP*, ACSEC did acknowledge that the segregation of undistributed accumulated earnings of a stock insurer may be meaningful once shareholders are introduced into the equation.

There are two alternatives for the second issue surrounding the emergence of earnings. The first alternative essentially is not to allow a DDL and let the earnings of the closed block rise and fall. The second alternative is to record a DDL. The recording of a DDL would prevent an up-fronting of profits and reflect more of a matching of expected revenue with expense.

The tentative conclusion of our task force is that it would be appropriate for a DDL to be established. In all likelihood, *SOP 95-1* will need to be amended to state that, in the case of a company that has demutualized, it would be appropriate, as it is under *FAS No. 60*, for a DDL to be accrued.

Several open issues remain to date. The task force is working on disclosure requirements, which have become more significant under a consolidated presentation of all assets and liabilities of the open and the closed blocks. The task force is also working on transition provisions for how this new guidance affects companies that have already demutualized. Another open issue is the applicability of the tentative conclusions to companies that have restructured or plan to restructure via a demutualization or mutual holding company, but have not set up a closed block.

Regarding our timetable for completion, our hope is to go back to ACSEC in June 1999 with our conclusions, and then in September 1999 with a final document. Hopefully, it would clear at the September 1999 meeting. Then it would go on to the FASB for exposure and public comment in the fourth quarter of 1999. After the comment letter period and the raised issues are addressed, ACSEC could approve the final *SOP* as early as the second quarter of 2000. Then, without objection from the FASB, it could be final by the third quarter of 2000. Unfortunately, the standards-setting process takes a long time to work, but given the number and size

of the transactions that are likely to occur over the next few years, the standards-setting bodies have been giving this project a priority.

Mr. Morton: I'd like to introduce several issues concerning DAC and closed blocks. I will refrain from stating firm conclusions at this point for these issues, as many of them are currently under study.

The first issue is whether or not the formation of a closed block has any impact on DAC amortization. If the answer is "no," then many or all of the rest of the issues go away. Fundamentally, there is some sort of change when a closed block is formed; a new guarantee has been put in place and a line has been drawn between policyholders and shareholders.

Next, assets will be less than reserves for a closed block; the difference lies in the closed-block funding amount. Does that have an impact on DAC? Obviously, you have fewer assets supporting the same liabilities, but the investment income component of the amortization stream for both *FAS No. 97* and *FAS No. 120* business uses GAAP reserves, not assets, as a base. One might conclude that there is no issue here, other than the fact that investment yields may be different due to a different mix of assets, and allocated realized capital gains and losses may not be the same as before a closed block was created.

The next issue is whether or not any unlocking effects should occur at the time of the closed-block formation. Such an unlocking effect would occur if the company's outlook for the closed block changes at the date of closed-block formation, if different expenses are allocated to the closed block, if treatment of renewal deferred expenses is changed, or if negotiations with your state of domicile lead to real changes in investment yields between the open and closed blocks. So there might be an unlocking situation at formation date, but it depends on the situation.

Next are the closed-block formation assumptions and the best-estimate assumptions that should be used for DAC. Do you (or should you) use the same assumptions? I've seen this one go either way, but even if you do not believe that you must use the same assumptions, you at least need to review differences between DAC and closed-block assumptions and be comfortable that each is appropriate.

The next several issues deal with the interaction of the DDL with DAC. The first thing to consider is whether or not amortization streams should reflect the change in the DDL. The change in the GAAP reserve is included in the *FAS No. 120* amortization stream, and the DDL is another GAAP reserve (if the final conclusion of the Insurance Companies Committee task force is to require a DDL), so it makes

sense that the change in DDL be reflected. Also, including the change in DDL will produce a more reasonable amortization stream.

Regarding determination of the DDL, should it be determined pre-DAC and on a GAAP basis instead of a statutory basis? The DDL is an accumulation of actual earnings over “glidepath,” a term that’s been used to define the pattern of earnings that supports the initial funding of the closed block. Glidepath is determined on an after-tax, statutory basis, so adjustments would be needed to convert the glidepath to pre-tax, pre-DAC for use in the DDL calculation.

FAS No. 115 treatment, regarding the impact on DAC resulting from unrealized holding gains or losses for available for sale assets, may need to be altered after closed-block formation. Under the same *FAS No. 115* logic, many believe there is a need for a “shadow DDL” in addition to the shadow DAC.

The last issue deals with recoverability and loss recognition testing for the closed-block DAC. If projection assumptions are the same or similar to closed-block assumptions, and given the “closed-block guarantee” from the open block, is there ever a need to write-down DAC?

The purpose of this discussion was to note that many DAC/closed-block issues exist, and I have not covered all of them here. Although some companies have adopted certain positions on these issues already, there is no accounting guidance and not a large enough industry practice for companies to follow.

With that, I’ll turn it over to Al Brinkman, who has been through GAAP implementation, demutualization, a public offering, and subsequent management of the company as a public entity. Al is vice president, corporate actuary, and appointed actuary for Guarantee Life in Omaha. Prior to his current role, Al was vice president and financial actuary for the individual line where a majority of the company’s business resides.

Mr. Alan D. Brinkman: First, I'd like to give you a little background on Guarantee Life to help put my comments in perspective. Guarantee Mutual Life Company became Guarantee Life Insurance Company, a subsidiary of The Guarantee Life Companies Inc., on December 26, 1995. At that time, we were one of only a handful of mutual companies to fully demutualize, and the first to do so in Nebraska. Now that there is a flurry of demutualizations being done or being contemplated, I'm glad that our transaction is behind us.

We are a small- to medium-sized insurance company group of about \$2 billion in GAAP assets. There are actually two holding companies in our structure for life companies, but Guarantee Life Insurance is the flagship company.

I was with the company before, during, and after the demutualization, so I'm in a good position to compare and contrast those environments. And, with the benefit of hindsight, I can point out a few things that we may have done differently in our transaction. We've only been a public company for 13 quarters, so our GAAP reporting processes are still evolving and improving.

First, I have a few comments on our GAAP conversion. We all know that it's a major effort. Your internal people will be responsible for producing and maintaining the GAAP financials, so you want to use your internal staff as much as possible during the conversion project, if you can. As a practical matter, though, many companies aren't going to have the bench strength to do all the work themselves, and they may not have the GAAP expertise. My view is that consultants are best used for project management, since they've been through these conversions before, and certainly for technical advice, if not for much of the work involved.

In Guarantee Life's case, we are a fairly small company without a lot of bench strength, so the majority of the work for our GAAP conversion was done by consultants. The mutual companies that have been doing GAAP for a number of years already may have most of this work behind them already. As you are doing your GAAP conversion project, if you can, plan for life as a public company.

As Jason said, if you can build all the processes and acquire all the systems before you're a public company, you'll be better served. What works to get historical information during the conversion project may not work as well when you're a public company trying to report GAAP every quarter. We used an actuarial projection system to come up with some of the historical GAAP numbers, and that proved not to work all that well as we went live. You're going to have to pay, at some point, for getting processes and systems in place properly and allowing for timely generation of financials. One choice is not to invest money in improving all your processes, but that choice has a cost, too, because you'll be stuck with labor intensity and dated information, and living with that on an ongoing basis can be costly.

We had deadlines on a very ambitious project and our initial public offering date was pretty much set. We wanted to get everything in place prior to the transaction but were not able to due to time and manpower constraints, so we've been reengineering and improving processes ever since. If the mutual companies in this

room have the time and money to invest in building GAAP reporting capabilities before going public, they certainly should take advantage of that.

As Jason mentioned, make sure that your GAAP assumptions are where they need to be before becoming a public company, and make sure that your DAC balances are where they need to be. You don't want to have an adverse unlocking out of the box as a public company.

At some point prior to demutualization, you're going to know that that is coming. At that point, you want to do the best job that you can analyzing the current and proposed dividend scale changes. Make sure that all work is documented, including the experience basis that lies behind the dividend scale. You may not be allowed to decrease dividend scales if you do it too close to the date of demutualization, even if, justified by experience, it appears as though you are artificially cranking down dividends to decrease funding. In a decreasing interest rate environment, not keeping the dividend scale current and being locked-in on the existing out-of-date dividends can be detrimental to future performance.

Needless to say, documentation is vitally important for a demutualization, as actuarial advisors have to sign off on the planned conversion, on the closed block plan, and on the assumptions that underlie corresponding projections.

The funding project itself for the closed block is a major effort. It will take your models and your model-building skills to places that they've never been. It involves a 70- or 80-year projection of the business. You must solve for the initial assets that you need in order to get the surplus to zero at the end of that period. You also must tie the initial balance sheet items in your model to the initial balance sheet at the effective date. Do not underestimate the effort of setting up closed blocks. After the closed-block work is complete, you have a sophisticated and detailed model that you want to maintain going forward.

Dividend analysis work in the future, as a public company with a closed block, will require all the same components it did prior to being a public company, but with a few additional considerations. The "glidepath" has been defined earlier as the stream of profits that result from the projections underlying the closed-block formation. As time goes by, actual performance of the closed block will need to be compared to the original glidepath. And, as different dividend scale change choices are contemplated, a projection model will be needed to determine whether or not the closed-block assets are sufficient to pay the new dividends.

The funding date for the closed block does not need to be the same as the effective date of the demutualization. In Guarantee Life's case, we funded the closed block

at the end of 1994, but the demutualization did not become effective until the end of 1995. Having a year to practice with the operation of the closed block and the reporting of the closed block before we were a public company was valuable.

After the demutualization, the actuary responsible for the closed block needs to ensure that the operation of the closed block is as it was laid out in the plan of conversion. For GAAP reporting, we applied *FAS No. 60* to the closed-block business because we demutualized prior to *FAS No. 120* and *SOP 95-1*. For our 10K and 10Q SEC filings, we do show the contribution from the closed block as a one-line item in the income statement. But the only place that we really do that is for the SEC required reports. For all other presentations, we show a full-blown income statement for the closed block. It is important to remember that the one-line "contribution from closed block" statement in the SEC filings is not really the true economic performance on the closed block. It is the GAAP version of the accounting construct that was set up for policyholder dividend expectations following the plan of conversion agreed upon with the state. As such, it has assets less than liabilities, explicit expense charges or no expense charges, and other aspects that are not in line with normal operations. For internal reporting, however, we show a normal income statement for the closed block, which is treated like any other line of business: Invested assets equal reserves plus target surplus, and expenses are allocated consistent with other lines of business.

Guarantee Life does not currently have a DDL on the books, due to actual performance of the closed block lagging the original funding projection. The DDL should not be negative. We realize that we need to continue to track the actual-to-original funding glidepath and establish a DDL, if positive, but we haven't had to do that yet.

Initially, we determined GAAP financials by adjusting statutory. Other companies had been doing that, and it was certainly easy for us to do since we had the statutory processes already in place. But it proved cumbersome, because we had to perform many additional calculations in a myriad of spreadsheets and systems, adding several new items to old processes. At the end of 1997, we decided to purchase a commercial accounting software package and convert all of our reporting to it. Now that everything is ledgerized, we don't have any reserve or DAC balances that are standing alone on somebody's spreadsheet anymore, and we have a common repository of financial data.

It was not an easy conversion, but now that it is behind us we are enjoying the benefits. From a mechanical standpoint, we now do our reporting backwards from where we started: We do GAAP first, then do statutory by adjusting GAAP.

As a public company, the focus is on GAAP, and developing an efficient GAAP reporting process was the motivation for our new accounting system. In focusing on GAAP after the demutualization, we didn't pay enough attention to the statutory side and had to play a bit of catch up over the last year. While statutory doesn't carry the same sense of urgency as getting the GAAP numbers done, they still have to be done every quarter, and done right.

Acquisitions are done through our holding company, and the internal source of capital from the insurance business is the dividends sent up from the insurance companies, which are based on statutory earnings. So my advice is to not ignore the statutory side as you're building a GAAP reporting capability.

I mentioned the sense of urgency involved in getting the GAAP numbers done. That is certainly true. When we started doing GAAP reporting prior to the demutualization, it took us maybe a month to close. We're now down to about two weeks, with the first close within eight or ten days. And we would like to get that two-week close time down to a week or even to a day or two eventually. There are companies that do close their books in a couple of days. There's no question that there is a lot of pressure to get these numbers quickly, but you must never lose sight of the fact that they must be done right. In getting the numbers done quicker, our goal is to allow more time for analysis. We currently have only a week from the time numbers are calculated to the earnings release and auditor sign-off.

Developing an efficient GAAP reporting system is a process improvement project like any other. We've all been through process reengineering projects at our companies. You need to map out all the work flows, find the critical paths, investigate and automate data sources, and talk to your customers and suppliers. Communication is the key here. You may be currently receiving a piece of information on the 10th of the month only because the person providing it didn't know you wanted it earlier. As the time to close shrinks, automation becomes more important. And because it is difficult to automate everything, estimating numbers using accurate and reliable methods can be a viable method to incorporate into the financial process.

In a GAAP environment, the actuary's relationship with other finance staff is one of mutual dependence. Neither side can afford to operate in silos. In a public company, the actuaries will learn a lot of accounting. It is important to understand where all of the actuarial items go in the balance sheet and in the income statement and what their effect is on the financials.

On the other side, your accounting partners will learn quite a lot about how insurance products work. Writing the MD&A every quarter is a shared effort

between the actuaries and the accountants. My staff does a lot of accounting work at Guarantee Life. You don't have to be a CPA to do this. The actuarial staff does create journal entries, but that's more a function of automating the process. Some of our spreadsheet work automatically feeds journal entries, but it's still the accountant's responsibility to make sure that the journal entries are doing what they're supposed to do.

Another area where a team approach is needed in a GAAP environment is in acquisitions. Traditional actuarial appraisals are still done, but in the GAAP environment that's not the focus. The focus is trying to create a pro forma look at what the acquisition will do to the GAAP income statement. Is the acquisition going to be accretive? What expense takeouts are needed to make it accretive? The answers to these and other questions involve actuarial plus accounting expertise. Also, in the due-diligence phase, a combination of actuarial and accounting expertise is needed to assess the target company financials.

In addition to our accounting friends, with whom we're joined at the hip in this process, in a GAAP environment, the list of customers has expanded and the information that they require has changed. The CEO and the chief financial officer deal with the investment community at least once a quarter, and they need to be intimately familiar with the numbers behind the financials. The product line or division managers need to provide answers to questions about their GAAP results and explain current results and deviations from expectations.

As a public company, you're going to have an investor relations department with which to interface. And, in most public companies (including Guarantee Life), employees may participate in an incentive plan that's tied to GAAP results. In that case, rank-and-file employees become very interested in GAAP results and what they can do to affect them.

Another important customer of the GAAP results is the rating agencies. One important thing to be able to do as you provide this information to your customers is show them good, meaningful line-of-business results. Also, non-actuaries like to calculate ratios from GAAP income statements, such as expense-to-premium, benefits-to-revenue, and others. Ratios such as these do not work well if you're mixing life, annuity, and health businesses. When we first started doing line-of-business GAAP results, we built a lot of spreadsheets. Now our new accounting system does most of that work for us, so we're spending a lot more time analyzing the numbers instead of creating them. As soon as you have good line-of-business GAAP income statements, it's natural to want to calculate return on equity by those lines. Coming up with a denominator for that calculation will likely fall to the

financial actuary. Starting points are typically statutory surplus or RBC, but these must be converted to a GAAP basis.

The benefit of managing on a GAAP basis is the discipline that it imposes on risk management. This is especially true for *FAS No. 97* business. In order to do GAAP, you have to gather actual margins and marry them to projected future margins. As I mentioned earlier, rating agencies like to see GAAP numbers, not just because GAAP does a better job than statutory in quantifying the ongoing operating results of the company, but also because of the risk management activities that stand behind GAAP. Managing on a GAAP basis also means enhanced importance for the experience studies that stand behind your *FAS No. 97* work and recoverability testing.

At Guarantee Life, our approach to managing distribution costs has changed a bit since going public. We're conservative, I think, in that we only defer expenses that are truly variable with sales. So the focus over the past several years has been to get our distribution costs as variable as we can so we can defer them as we grow.

And there's an intense focus on expenses across the whole company. Being a public company, we're always beat up by the analysts in that area. The line managers learn quickly what they can and can't do to influence their bottom-line results. A strategy to widen interest spreads and strive for good claims experience shows up over time, whereas if they can find a fixed expense to avoid or eliminate, that goes straight to their bottom line.

Pricing hasn't changed too much at Guarantee Life since we've become a public company. The product area still does most of their pricing on a statutory basis with statutory internal rate of return (IRR) being the primary profitability measure. But, because the overall company focus is on GAAP, we're really saying that we think statutory IRR is a pretty good surrogate for GAAP ROE. When the pricing area has tested that theory and priced on a GAAP basis, we have found that the IRR/ROE comparison lines up better for certain products than for others.

There is a closer link now between the product actuaries and the financial actuaries. When a new *FAS No. 97* product comes out, the financial actuaries want to have the future gross profits modeled as an amortization base, which comes from the pricing side as a starting point, and similarly for the assumptions that are going to be the starting point for the *FAS No. 60* GAAP work. Even though the product folks usually price on a statutory basis, if they come out with a major new initiative—something that's going to cause a large consumption of capital—we want them to provide aggregate statutory and GAAP financial projections so we'll know where that investment and the company's money is going, and when it's coming back.

Mr. Morton: Based on my experience as a consultant and external auditor, the points raised in your presentation were right on. We have time for one question.

Mr. Thomas G. Kabele: I have some questions for AI on your closed block. What products went into the closed block? Were they term, whole life, group, single-premium deferred annuities, or other business? And what was your asset-to-liability ratio for the closed block? What expenses were charged against the closed block?

Mr. Brinkman: In the first year of the conversion, we did write some new business into the closed block, and had acquisition expenses built into the plan. The lines of business that went into the closed block were just the dividend-receiving individual policies. All of our business was nominally participating, but only the dividend-paying business went in there, which was mostly whole life, a small amount of term business that has dividends, and a small amount of old annuities.

Regarding expenses charged to the closed block, we ended up charging a per policy expense in the funding projection and the ongoing operation that was buried in the dividend scale. Our closed block on a statutory basis is about \$350 million of liabilities with a surplus of negative \$79 million.