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Summary: This session provides the attendees an opportunity to hear and ask questions about recent developments in the world of GAAP accounting.

MR. DAVID ROGERS: John Morris will talk about policy exchanges. Right now, an AICPA task force is drafting some additional guidance on policy exchanges. John, who is with PricewaterhouseCoopers, has been working with that task force and is familiar with the deliberations. He'll give us an update on where that process stands and what some of the current thoughts are in the draft Statement of Position.

Charles Carroll from Ernst & Young will speak about purchase accounting. This is really something that happened a year ago with the release of Financial Accounting Standards (FAS) 141 and 142, but there have been a lot of implementation issues over the last year that have clarified practice. Charles's practice is in the merger and acquisitions area for Ernst & Young, and he is familiar with how companies are addressing the issues of these pronouncements. He will speak about some of those issues and how companies have resolved them in more recent transactions.

Then David Brown, also from Ernst & Young in the Boston office, will speak about emerging accounting issues. He'll give us a flavor for some of the issues that are on the table at the SEC and the AICPA and talk about some of the dynamics and hot buttons, particularly in Washington. I think he will focus more on the ones with

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which we're not familiar, rather than the ones that have been in the paper, such as Enron and the like. We'll look at some of the implications of those very significant events in the accounting world as they have impacted our regulatory system.

Then, Shane Elenbaas from KPMG's New York office has been involved in understanding and interpreting the most recent draft Statement of Position from the AICPA related to accounting for various nontraditional products as well as nontraditional features on more traditional products. He did a presentation at the Advanced GAAP Seminar in New York recently, and he will repeat that presentation here and expand on it for the last session.

My name is David Rogers. I'm the emcee and moderator for this discussion. Without spending any more time on the introductions, John, if you could teach us a little bit about internal replacements.

MR. JOHN W. MORRIS: As Dave mentioned, I'm a member of the AICPA task force that's studying internal replacements. I happen to be lucky enough to be the American Academy of Actuaries' representative on that committee, so it's a bunch of accountants and me. I will review what the task force has been up to and try to give you my thoughts on what I think will happen in the future.

Let me give you a brief history on GAAP guidance on internal replacement, and brief is a key word. There's not much guidance on how to handle internal replacements. As you may know, FAS 97 specifically identifies that when replacing a traditional life product with a universal life product, you cannot carry over the deferred acquisition cost (DAC); Practice Bulletin 8 expands on that. One of the questions it poses is what do you do for other internal replacements? That guidance says that accounting for other internal replacement transactions should be based on the circumstances of the transaction. That certainly did not provide clear guidance, and that's probably why the task force was formed a couple years ago.

In 1999, the AICPA issued a discussion paper on internal replacements. It offered three views and asked people what their opinions were. View A was that you never carry over DAC, view B said you always carry over DAC and View C said sometimes you carry over DAC. There were 11 respondents. Most of them suggested that additional guidance was needed, although one respondent said that they thought additional guidance would only prevent them from doing what they wanted to do. I wasn't sure whether they meant that from a business point of view or an accounting point of view. Most respondents clearly favored Views B or C.

So, the AICPA formed a working group in 2000. I personally thought it would be a six-month working group, but it's been 2½ years, and we're still working. The Accounting Standards Executive Committee (AcSEC) is a panel of about 15 members that's made up of people from the various accounting firms and companies in many different industries. One thing that's important to note is that there are only one or two individuals on AcSEC who have insurance accounting background. So part of meeting with them is explaining the nuances of insurance accounting before you ask them to make decisions on how the accounting should be.

The guidance we received from AcSEC from the very beginning was that they wanted what they called narrow fences. They didn't want every internal replacement to qualify for DAC carryover. With that guidance from them, the panel worked to develop what we thought was the most appropriate type of guidance, and we'll get into that in a few minutes. We spent the first year reviewing issues among ourselves and with other members of the insurance industry. We started meeting with AcSEC about a year ago. After about six or seven meetings, they cleared a preliminary Standard of Practice (SOP). They did that in September 2002.

What happens from here is that FASB and the SEC need to clear the draft SOP before it is released as an exposure draft. While no one knows how long it could take to get that clearance, we've had some initial meetings with FASB and with the SEC. Things went smoothly in those meetings. One thing you should know is that FASB has representatives on AcSEC, so this isn't new to them. We're hoping they get back to us quickly, and we can get out an exposure draft in early 2003.

So, let's talk about tentative conclusions. One of our first problems was how do you define an internal replacement? It sounds like it should be simple, but it was something we struggled with. In fact, one of our members, when we were having trouble coming up with a definition, said, "It reminds me of a lot of pornography. I'm not sure how to define it, but I'll know it when I see it." So, with that in mind we went through and came up with a definition that an internal replacement can be a policy exchange, a modification through an amendment or a rider, and an election of a feature.

The inclusion of an election of a feature probably seems strange to you. Let me explain. What the accounting profession or AcSEC and FASB are concerned with is what they call gaming the system. They're concerned that someone will put a provision in a contract that says, if you elect this provision, you can change your whole life contract to a long-term-care contract, and therefore, it's not an internal replacement, I don't have to worry about meeting the guidance in this SOP. I was surprised that throughout the 2½ years that this committee's been meeting, we spent more time on trying to prevent people from gaming the system than we have in actually putting together real guidance.

We'll get into what substantially different versus what not substantially different is, but the general guidance in the draft SOP would say that if you qualify to be not substantially different, you treat the new contract or replacement contract as a continuation of the original contract. You need to think about what that means for a FAS 97 contract. It means that if you're doing DAC amortization, you would have to join the estimated gross profits (EGPs) from the old contract with the prospective EGPs from the new contract. That may be an issue for certain administrative systems. But because we're saying that the contracts are substantially the same contracts, that is the logical conclusion on how to account for it—to treat them as if they were one contract. If they are substantially different, the old contract will be treated as a termination, and the new contract will be treated as a new issue.

Let's talk about not substantially different. First of all, all internal replacements are deemed to be substantially different unless they qualify for being not substantially different. You're automatically different, as the guidance is currently drafted. We say that the replacement contract or the modification does not change the inherent nature. We'll get into exactly what inherent nature is, but basically, if you change enough features in a contract, you've changed the inherent nature. We also thought that if you charge for the transaction, other than fees that are commensurate with the increase in benefits, that is an indication that the insurance company has made a redetermination of the risk, and therefore, it should be considered a new contract. Similarly, if there's a decrease in account balance, that would be the same as charging a fee. And if you don't change amortization methodology or revenue classification, then it could be considered internal replacement. We originally drafted that to read that if you don't cross over FASBs, such as from a FAS 60 to a FAS 97, but the AcSEC said that you're not allowed to word things like that. So, now it just basically says that you're not changing GAAP models.

Let's talk about inherent nature of the contract. There are three things in the SOP that define inherent nature. Type and degree of mortality risk and type and degree of morbidity risk are the first two. Type is fairly easy to understand. Even if you go from one mortality contract to another, it has to be the same type. You wouldn't allow carryover DAC accounting for an internal replacement. If you were to replace a whole life policy with a life contingent payout annuity, even though they're both mortality risks, it's not the same type of mortality risk. The degree gets a little tricky, and it depends on the contract. We'll get into some examples in a minute.

If you add a significant guaranteed minimum death benefit (GMDB) to a variable annuity that didn't already have a significant GMDB, that would probably change it from an investment contract to a universal life (UL)-type contract under FAS 97. We determined that replacement as not eligible for DAC rollover. However, if you were to add a GMDB to a variable life contract—because it was already a universal-life-type contract—as long as the GMDB didn't become the primary benefit and everything else in the SOP was satisfied, then that would qualify.

For the investment return rights and provisions, basically we're trying to say, has the way a policyholder is compensated from an investment point of view changed? Were the returns guaranteed in the contract, or are they now being set at the discretion of the insurer? Are they fixed by a formula, or are they a pass-through? If that provision changes, we deem it to be substantially different. Some of the language gets a little tricky with this provision.

Let's talk about some examples that do not change inherent nature and so would qualify under the guidance as it's currently written. And let me just remind you that these are tentative conclusions. For example, if you add a new investment election to a variable annuity, as long as you had options before, adding additional options is not a problem. The second example has two things mixed in at once. If you go from a general account deferred annuity at 5 percent to a market value adjusted (MVA) at 6 percent, it would qualify. We didn't think adding an MVA was significant enough to disqualify you. As for declared rates changing from 5 to 6 percent, companies change their declared rates all the time and don't have to write off their DAC when they do that. The third example was if you were to add a benefit, say, for example, a long-term-care benefit to a disability income policy. That's fine, as long as the long-term-care benefit doesn't become the primary benefit. We're still struggling with the exact definition of primary benefit under a contract. The last example is adding a guaranteed minimum income benefit (GMIB) to a variable annuity. Although it's similar to a GMDB, it doesn't change the policy from an investment contract to a UL-type contract. We think that does qualify as a substantially similar internal replacement, and so far we've gotten concurrence from AcSEC on that.

These are examples that cause a change in the inherent nature. Replacing term insurance with a whole life contract, we think, basically changes the degree of the mortality risk. We already talked about adding a significant GMDB. Replacement of a separate account product with a general account product fails to meet the investment return rights and provision portion of our SOP. Similarly, replacement of a general account deferred annuity with an equity-indexed annuity would not qualify for carryover DAC.

These are other conclusions that we'll talk about briefly. Attaching a rider to an existing contract generally doesn't cause you to have to write off DAC. Again, AcSEC is concerned that someone will attach a rider that says his whole life policy is now a long-term-care policy, and they don't want people saying, "Well, in that case I can keep the DAC from the whole life policy."

New deferral cost was actually a tricky issue with AcSEC. Most of them don't have insurance accounting backgrounds. It took a lot to convince them, first of all, that you're already allowed to defer certain renewal costs. Once we convinced them of that, they seemed to buy into the idea that any new costs associated with an internal replacement can also be deferred.

Unearned revenue liabilities and sales inducements are covered, but they're not in our title. First of all, our title is too long to begin with. The SOP as currently worded is titled "Accounting by Insurance Enterprises for Deferred Acquisition Cost on Internal Replacements Other Than Those Specifically Described in FASB Statement 97." As for transition, the SOP's currently worded that we would do this prospectively only—no going back. There would be a short disclosure describing what your accounting policy is on internal replacements.

I'm interested in getting comments. We're still drafting an SOP. Hopefully, we'll have an exposure draft early next year. We've gotten a lot of feedback from various actuaries. The American Academy of Actuaries' Life Financial Reporting Committee has been involved in this and discussed it several times. Laura Hay from KPMG had a lot of input on it. Actuaries from Hartford, Nationwide and Axa have had input into this, as well as other actuaries. All made valuable contributions, but we're still looking to see if there are any areas we missed or any places where you think we're going down the wrong road. We'll take questions at the end. So, thank you.

MR. CHARLES CARROLL: I will talk about FAS 141 and 142. As David mentioned, these were effective in the middle of 2001. I will provide a high-level summary of what the standards say. I will talk a little bit about emerging experience in applying the standards in practice and finally, I will talk about some developments, some new guidance, that might be in the works. But before doing that, let's step back to think about what the FASB and the SEC were trying to accomplish with these two statements, which are really the most significant changes in merger-and-acquisition accounting since the early 1970s.

Of course, number one on the hit list was the pooling method of accounting for mergers and acquisitions, an item that had disturbed the SEC for a significant period of time. As companies made more significant use of this, the view was that having two accounting methods for essentially similar types of transactions did not make sense. In the SEC's view, the pooling method was being applied too widely and inappropriately.

Second, and almost equally important, was the feeling that in doing purchase price allocations, there was too much of a tendency to lump everything except the kitchen sink in the goodwill bucket, which did not really accurately and representationally portray what the company was buying in a business combination.

Third, and probably a little less important, was harmonization with international accounting standards. I won't talk too much about how well they did here. I would say they did sort of a mixed job. International accounting standards still allow pooling, I believe, and it amortizes goodwill, which is different than what FASB came up with.

Let's talk about the two standards. The first standard is FAS 141. This is the standard that basically tells you what to do on the purchase date, how to set up the initial balance sheet and, of course, it defines a single approach for all business combination. It outlaws the pooling method, even for combinations of equal companies. Again, that was a primary motivation on the part of the standard setters. Of course, if you did poolings in the past, that's okay. You can still leave those as poolings. That's fortunate because companies probably couldn't deal with redoing those. But after June 30, 2001, there have been no more poolings.

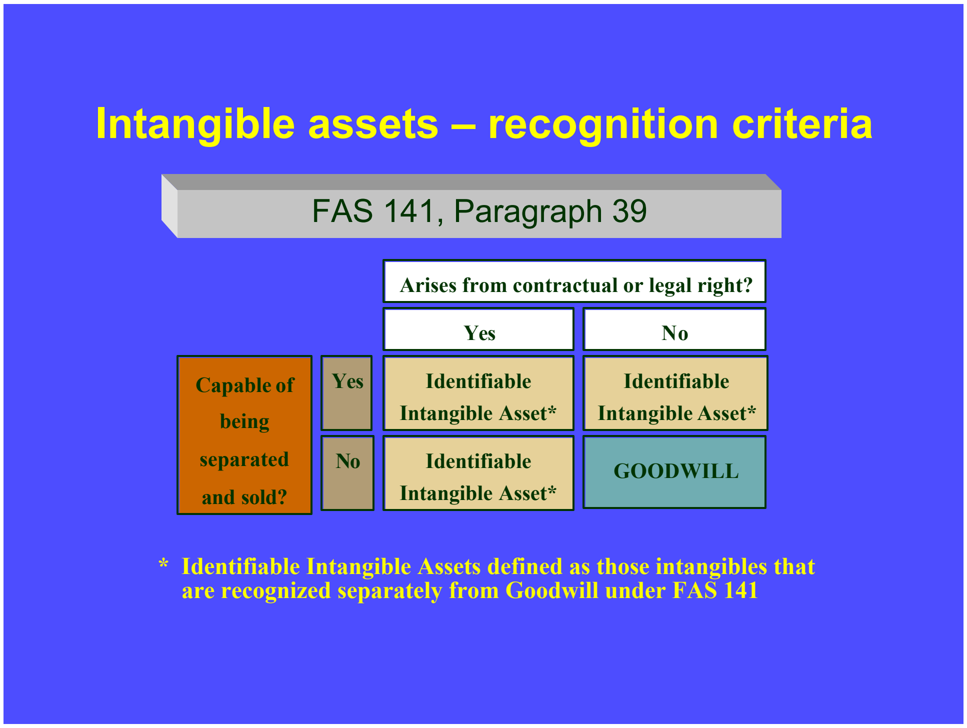
FAS 141 also introduces a bit more clarity and definition around what a business combination is. This can be a key and sometimes complex factor in life insurance company acquisitions. In certain cases, you have a transaction that takes the form of a reinsurance treaty or a set of reinsurance arrangements while, in substance, the transaction is a business combination—a transfer of control of a complete business from one entity to another. Correspondingly, you can have transactions that are, in form, the legal purchase of a corporation, which effectively would not be defined as business combinations. The two elements of the definition of a business combination are that you have to have an exchange, a change of control, and second, what you exchange must be a business.

There's an Emerging Issues Task Force (EITF) pronouncement that defines a business. The critical element is that the entity being exchanged has the elements of a complete business, that it could operate independently after the transaction, even if it does not. Of course, the important part of 141, from a practice point of view, is its definition of how to go about allocating the purchase price to the various assets and liabilities of the acquired entity. There are two critical elements of that procedure. One is the basic principle that all assets and liabilities on the purchase balance sheet should be at fair value, which is a market concept. This is not really new. That principle existed before, under Accounting Practices Bulletin (APB) 16 and 17, so FAS 141 is really just carrying that forward.

The second leg, though, is different. FAS 141 has a clearer definition of what qualifies as an intangible asset to be recognized at fair value on the purchase balance sheet, and it has a lot of discussion about types of assets that qualify. So, what is an intangible asset? An intangible asset is an asset other than a financial asset that lacks physical substance. It would include things such as customer relationships, patents, trademarks, trade names and favorable agreements. It could include reinsurance agreements, for example. Another prime example in life insurance company acquisitions of an intangible asset is value of business acquired (VOBA), or what is sometimes referred to as present value of profits (PVP).

The definition in 141 of what constitutes an intangible asset that must be recognized on your purchase balance sheet has two criteria (Figure 1). If an asset meets either one of these two, it must be recognized. The first one is the contractual or legal criteria. If the asset arises from a contractual or legal right, it must be recognized as an identifiable intangible. An example would be a patent, because the patent holder has the legal right to prevent others from copying his product and thus has the ability to reap profits in the future, which is an asset.

Figure 1



The second criteria is the separable criteria. If the asset can be packaged and sold, rented out, leased or transferred in some way, separate from the rest of the set of assets and liabilities of the company acquired, then, even if it's not contractually based, it's an identifiable intangible. An example of that might be VOBA. One of the characteristics here is that if the asset or liability can be sold in combination with another asset or liability or set of assets or liabilities, even though it, itself, is not separable, the whole package would meet the criteria. So it's only those items that fail both of those two tests that get lumped into goodwill. An example of that is workforce in place. In fact, 142 specifies that workforce in place is not to be recognized separately from goodwill.

So, FAS 141 is about setting up the initial balance sheet; FAS 142 is about what happens the day after. What happens to the assets and liabilities? How do they change? And how do those changes work their way through the income statement? The big news in this area is that 142 eliminates regular amortization of purchase goodwill. It applies not only to new goodwill that is created by acquisitions after June 30, 2001, but also to all goodwill that currently exists. The existing goodwill is to be frozen at its value as of the adoption date, which for life insurance companies would be January 1, 2002. From that date forward, there's no more amortization.

An important aspect of FAS 142 is that it requires that all of your goodwill be allocated to reporting units because, as we'll see, it's at the reporting unit level that a test for impairment is imposed. A reporting unit is a term of art in accounting.

There are EITF and FASB pronouncements that define a reporting unit. It's generally a level below an operating segment. For those of you who are familiar with public company reporting, it would generally be below your reportable segments. It would be at a more granular level because the operating segment is below that level, and reporting units can't be above operating segments. They may, in some cases, be one level below.

The annual testing for goodwill is meant as a discipline against over-allocation to goodwill. As you can appreciate, now that goodwill is not being amortized, there is an advantage to allocating purchase price to goodwill, as opposed to an amortizable intangible asset. One will hit income eventually. Goodwill will not, unless there's an impairment. The impairment test is a two-step test that is applied annually. The first step is simple. You look at your reporting unit. You look at its GAAP carrying value and compare it to the fair value of that unit. If the fair value is greater, you're done. If the fair value is less, you go on to Step 2, where there's a full-scale reallocation of the value of the unit, as if you were purchasing it today, and you determine if your goodwill is impaired and, if so, by how much, on that basis.

With that very high-level view, let's talk about what's happened in practice. First of all, there have been very limited applications of FAS 141, just because there hasn't been a lot of activity in the acquisition sector. I'm only personally familiar with a handful of deals where FAS 141 has actually been applied. Based on this limited experience, my observation is that the amounts of goodwill are comparable proportionately to what we were seeing before FAS 141. In other words, they're relatively high proportions, which means that at least one of the motivations or the goals of the standard setters doesn't seem to be accomplished in practice. Despite that fact, there is a much broader definition being applied to what constitutes an intangible asset. This is, without question, a major effect of FAS 141. For example, in life insurance acquisitions, it was very rare, prior to FAS 141, for an intangible asset to be set up representing the value of the distribution system. Now, you basically have to set up the value of the distribution system in some way to comply with FAS 141.

FAS 141 has done nothing to clarify some of the murky issues surrounding the valuation of blocks of business in force, the so-called VOBA assets. If you're calculating VOBA, what profits do you discount—stat or GAAP or something else? Should you take cost of capital into account in calculating the value of VOBA? And should it be pre- or post-tax? There's really no new information or guidance along those lines. In fact, these days you hear conversations about whether VOBA actually meets the definition of an asset in Concept Statement 6. A lot of people, me included, think it probably doesn't meet that strict definition. Yet, we have it on balance sheets all over the place in the life insurance industry.

One of the areas to focus on in practice in this intangible asset area is the tremendous complexity and subjectivity that exists in the definition and measuring of these assets. Consider, for example, the value of the field force. As actuaries, we'd like to think that the value of the field force involves taking their production, calculating the value of the profits on that production and discounting it. But you run into questions, such as how many years of production should you use? And what discount rate should you use? Should the discount rate reflect the riskiness of being able to achieve those levels of production? Then, once you set it up, how do you amortize it? Do you amortize it over the profits? Do you amortize it with interest? Some of our technical people have looked at these issues and said you should calculate it that way. You should amortize it over the profits on the business produced by the agency force—by the way, the amortization period could extend beyond the period that your current agents are around—but you shouldn't do it with interest. Only with certain assets, including VOBA, are you allowed to amortize with interest.

Customer relationship asset is another slippery concept. Theoretically, you have these customers to whom you're able to sell products. What's the value of that? One way of thinking is that it's the profits on the products that you can sell to your customer list. There's an EITF discussion about this issue that tends to conclude that it's not the gross profits; it's just the excess profits you can earn in addition to normal profits. Think about that concept in terms of how you would measure the profits that you can earn in selling to a customer because he's your customer rather than somebody off the street. It's a very difficult thing to measure. In some cases, these intangible assets are ephemeral. In practice, the fair values being assigned to them tend to be rather small, which may be appropriate.

Only a few companies had to deal with FAS 141 so far. On the other hand, any company with goodwill on its balance sheet has had to do the impairment test under FAS 142. In fact, the deadline for completing Step 1 of the impairment test was the second quarter of 2002. In my zealousness to substitute demonstrations for impressions, I slogged through the second-quarter 10-Qs of 26 publicly traded U.S. life companies to see what they had said about their impairment testing of goodwill. Interestingly enough, there's not much news here. Not much happened. Of the 26, only seven had some transitional goodwill write-off, only one really significant. Conseco wrote off about 80 percent of its goodwill, which, by the way, was all associated with insurance. The Green Tree transaction, I assume, was a pooling. Principal and Phoenix had small amounts, which were attributable to investment management entities rather than insurance, and the others were minimal.

I was also interested in what companies had to say about how they did the impairment testing. Seven described their methods; 19 basically said nothing. Of the seven, two indicated that they use multiples based on comparable companies; three indicated that they use some discounted cash flow approach; and two indicated that they actually use three methods, including an allocated market value of their equity. However, the sample of seven really isn't representative of the total, because six of the seven had impairment issues. So those six, by definition, will apply a more rigorous method, and they also will describe more of what they did.

My general impression is that most companies are just using a comparables approach and doing a fairly minimal amount of work in Step 1, which I think could be a potential problem down the road. Comparables probably look good at this point for the life insurance industry, even better a couple of months ago. Equity markets are fickle and sometimes will undervalue the intrinsic value of a reporting unit. Unless you have developed a separate or multiple-path approach to determining fair value, you may run into a problem when that occurs. We would recommend a consistent process that uses multiple approaches, including comparables; some form of discounted cash flow, ideally a full-blown actuarial appraisal; and an approach based on allocation of market cap to reporting units. Of course, it's important to document this. The time to develop and document a multi-path approach is not when you are first running into problems with recoverability. You need to do it in advance and set it up as part of your regular annual routine.

I picked up some other miscellaneous bits of information from my reading. Interestingly enough, one company wrote off part of an indefinite life intangible. This is another new creation of FAS 141, in which you can have an intangible asset that has no specific end point to it. An example in the insurance industry is state insurance licenses. One company wrote off part of one of its indefinite life intangibles, and those have to be tested for impairment on essentially as rigorous a basis as goodwill.

There is an AICPA task force on issues surrounding business combinations for insurance entities. I happen to be the American Academy of Actuaries liaison to that committee for life insurance issues. It's been in place for a couple of years now. It's focused a lot on property casualty issues so far, but it is now approaching some of the life insurance issues with PVP. I would say, though, that the future of this task force is at risk at this point. The FASB has announced that its intention is to go to principles-based accounting standards. In a principles-based accounting standards world, with the Public Company Accounting Oversight Board, et cetera, it's not clear what the AICPA's role will be. In a principles-based world, industry-specific accounting pronouncements are sort of dubious. If you're basing all of your accounting on basic principles, these generally would not be industry specific. So it's not clear what will happen. The task force has done a lot of work. It was intending to issue an SOP. Whether or not it will is up in the air at this point. So, I'll pass it over at this point to David.

MR. DAVID BROWN: I'll be talking about the recent activities of the SEC and FASB. The events of the last year have increased immediate attention related to the SEC. We'll talk about some of the SEC hot buttons, some of the recent actions, and then we'll talk about Sarbanes-Oxley, which you've probably heard a lot about. We'll also talk about the consolidation of special purpose entities (SPEs) and the new rules that are being developed there. Obviously, the Enron debacle has highlighted the importance of the accounting and the interpretations related to the SPE guidance. Lastly, I'll follow up with a few of the FASB initiatives primarily related to guarantees and derivatives and tell you where those projects are going.

When Harvey Pitt was elected SEC chairman, one of his top priorities was to improve financial reporting. He also wanted to improve the process of preclearance of issues, to have an open-door policy that would allow investors to get it right the first time. And then Enron hit. With Enron, WorldCom, Tyco and the others, the SEC has been focused on trying to restore confidence, both to the investor markets and the U.S. capital markets. As part of that attempt, in May 2002 the SEC published some rules related to disclosing critical accounting policies in a company's management discussion and analysis.

These new rules required extensive disclosure about sensitive and subjective accounting estimates. They also required companies to look at alternative accounting policies that could have been used, what the difference would be, and their rationale for using the policy they did adopt. Also, the new rules establish disclosures for the initial adoption of an accounting policy. It's very much the same principle—looking at what other accounting alternatives were out there, why a certain policy was adopted, and the impact of that adoption.

We did a survey of the 10 largest life and health public companies to determine the critical accounting policies that are being disclosed. You could probably guess what they would be. I believe all 10 had future policy benefits, DAC and investments. After that, a number of the companies, but not all, would have disclosed as critical accounting policies items such as derivatives, taxes, goodwill and others.

Another recent activity of the SEC was to accelerate the filing of certain requirements—principally the Form 10-Ks and Form 10-Qs—and on August 27, these rules were adopted. Essentially, you have 90 days to file the 10-K. That would continue for the first year, and then that would reduce to 75 days in Year 2, and then to 60 days in Year 3 and thereafter. The 10-Q is currently at 45 days. It would stay at 45 days for the first year and then reduce to 40 days for the second year, and then, for the third year and thereafter, it would be 35 days.

Also, the rules from December 2001 related to equity compensation will now be effective this year, and companies will have to disclose in their SEC filings—the 10-Ks and the proxy statements—equity compensation plans. The purpose is to disclose what dilution of the stock price would occur related to these equity compensation plans. Also, for any of you who have electronic filing responsibilities, foreign filers on November 4 will have to use electronic data gathering, analysis and retrieval (EDGAR) and file electronically.

One other item of note is related to 8-K requirements. The SEC is proposing to shorten the 8-K timeline to two days. They would give you an automatic two-day extension if you filed a late-notice filing. Probably more meaningful is the fact that they're expanding the items that would be required in the 8-K. I won't go through all of those, but generally, it requires disclosure of any new significant contracts or the termination of any significant contracts that have a material effect on the financial statements. If you changed stock exchanges or for some reason were delisted, those types of things would be required to be filed.

As far as some hot topics, revenue recognition continues to be a focus at the SEC. If you recall, Standards Accounting Bulletin (SAB) 101 dealt with revenue recognition. We looked at all of the public filings and the impact of SAB 101. I believe more than 300 companies changed their revenue recognition as a result of SAB 101. Most of those weren't too significant, but there were some that had changes to revenue of more than $100 million when they adopted 101. Revenue recognition continues to be a focus. Obviously, the WorldCom and Enron issues have highlighted that for the SEC.

The next hot topic is on segment reporting. The SEC is interested primarily in ensuring that companies are disclosing all of their operating segments. The SEC is going as far as to look at the chairman's letter, company Web sites, analysts' reports and presentations that companies give to analysts. If they find inconsistencies, they're challenging the companies and asking them to demonstrate to them what their CEOs or chief operating decision makers look at in managing the business. That continues, and there continue to be SEC comments there.

Restructuring impairment charges have been a focus over the last three years, especially with big charges. The SEC is really looking at the timing of when the charge occurred, whether it happened too early or too late. I won't go into any more detail than that, but they're also looking at the disclosures around those and the estimates that were recorded as a reserve and whether those changed over time.

The next item is one that I'm dealing with quite a bit this year, and I'm sure you are. It is other-than-temporary investment impairments. Because of the stock market decline, especially as it relates to technology stocks and others, almost every company is having some type of other-than-temporary investment charge. I think you've probably seen those in the paper this year. We continue to work with our clients, looking at their policies to ensure they have a proper policy in place. The SEC, in most of the speeches by its officials, says that if your equity investments decline by more than 10 percent for a period greater than six months, you should look to those securities and determine whether or not you have other-than-temporary impairment. Other-than-temporary does not mean permanent, and a lot of people think that it does. We're also seeing some cut-and-paste jobs in SEC comment letters, in which they're asking for a number of disclosures, whether or not they agree with your other-than-temporary impairment conclusions. They're asking for many more disclosures, especially in situations in which you have an unrealized loss.

Next, let's talk about Sarbanes-Oxley. What started as a response to Enron turned into a significant item with these other corporate mishaps. Probably the most significant thing that Sarbanes-Oxley does is to create a Public Company

Accounting Oversight Board. President Bush signed the legislation in July, and the board was to be formed within 270 days. After that, the accounting firms have about 180 days to register with the Public Company Accounting Oversight Board. I don't know if you saw in the *Wall Street Journal* this morning, but they named Mr. Webster as the chairman for the Public Company Accounting Oversight Board. They also had the other four members—generally politicians, attorneys and people who have had some exposure to the SEC in the past. It is a five-member board, and at no point in time can any more than two of the members be accountants. The SEC would oversee this Public Company Accounting Oversight Board, and the board would be responsible for monitoring the quality of audits.

The next significant issue related to Sarbanes-Oxley that you've heard a lot about is auditor independence. We've been discussing that with a number of audit committees of our clients, both public and non-public, because it seems like even though it applies to public companies, non-public companies are looking at their corporate governance and trying to run it somewhat similar to public companies. But under Sarbanes-Oxley, all audit and non-audit services have to be pre-approved by the audit committee.

In addition, Sarbanes-Oxley lists nine services that we, as auditors, are specifically prohibited from performing for our clients. Most of these were already proscribed by the SEC, but the new ones are information technology (IT) consulting, internal audit outsourcing and providing expert service. The SEC is still defining expert service. I thought I'd give you some information on what our firm has done related to a couple of these additional items. We actually sold our consulting arm about 2½ years ago, so we do not do IT implementation consulting. We're really ahead of the curve and had made a decision not to take on any new internal audit outsourcing engagements for our public audit clients.

One other of the prohibited services that I'm sure you're interested in - is actuarial services. At least under the definitions that we are going by at this point in time—and obviously they will be further defined as we go forward—accounting firms, if they're your auditors, can still do reserve certifications and those types of services, to the extent that the company has competent actuaries on staff and management takes the responsibility for booking the reserves. That really is no different than it was in the SEC rules prior to that. So, that's one significant item.

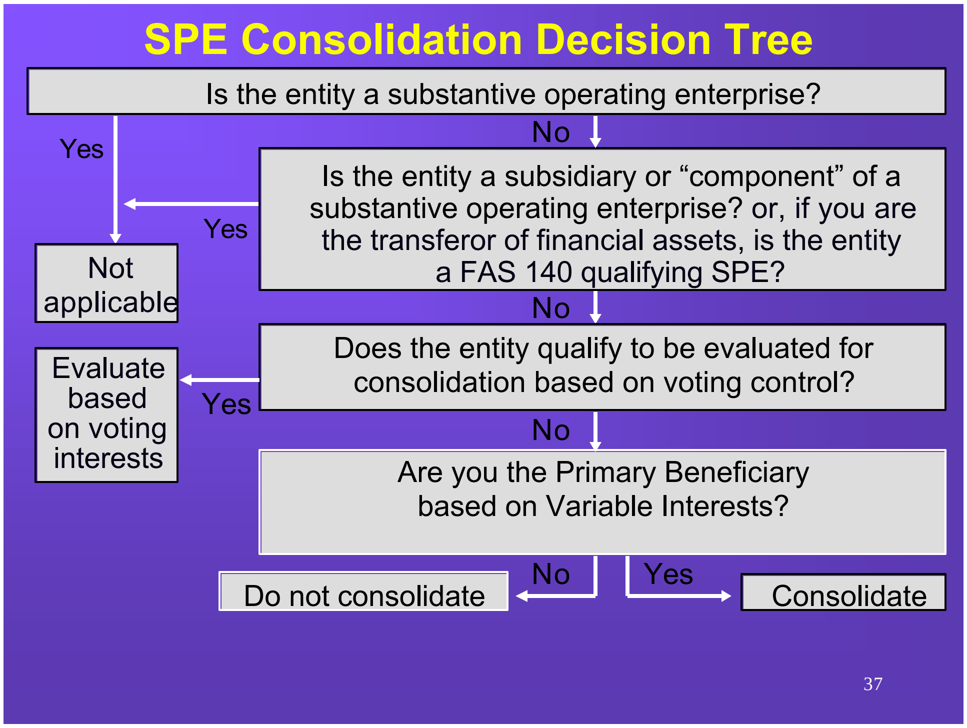
I'll touch on a couple of other items on auditor independence before I move on. Audit partners will now have a five-year rotation. Obviously, this is for public companies. But I know the NAIC is looking at Sarbanes-Oxley and how they're going to apply it. I would be surprised, really, if the NAIC didn't take a lot from Sarbanes. Another item is that auditors have kind of a one-year cooling-off period before they can accept employment with audit clients that they served.

Lastly, I'll mention corporate responsibility. You've seen a lot in the paper related to CEO and chief financial officer (CFO) certifications. The last thing that will be coming up very quickly is internal control assessments, essentially certifying to the internal control of your organization. That really goes down within the organization. The auditor will have to attest to the company's assertion that they have strong internal controls in place.

Next, let's talk about the consolidation of SPEs. What started out as a project to cure some of the difficulties in interpreting the existing guidance suddenly became more important when everyone discovered all of these off-balance-sheet partnerships at Enron. So, the FASB fast-tracked this project and expects to have it finalized by the end of 2002, to be effective for the second quarter of 2003. You will see a change in accounting for a number of transactions, primarily leases, if any of you deal with synthetic leases or securitizations. In general terms, more entities will be consolidated than before. It will impact the income of your companies, and it will very probably affect some of the key ratios, especially debt-to-equity, if you think about debt that was previously off the balance sheet and now must be consolidated on the balance sheet.

This slide is really the SPE decision tree and represents where the exposure draft is right now (Figure 2). In general terms, if the entity that we are considering for consolidation is a substantive operating enterprise or a subsidiary of a substantive operating enterprise, it's really exempt from this. Otherwise, you go through a process. There are certain types of transactions in which you can just look to the voting control, and those are defined in the exposure draft. If they do not qualify to be looked at just based on voting control, you look at who has the largest variable interest to determine who is the primary beneficiary.

Figure 2



The way I look at those is who really stands to lose the most out of this transaction? The purpose is to look at the economic substance of the transaction and see who should consolidate that entity. I've seen the consideration of this in certain reinsurance transactions recently as well. The guidance related to this is still developing. If you have any reinsurance transactions for which you're keeping most of the risk through some type of off-balance-sheet entity, you might stay close to this SPE project.

I just want to touch briefly on a couple more issues. If you have derivatives, and I'm sure most of you do, you need to stay close to an amendment that's going on related to Statement 133. This statement is not nearly as large as the amendment to 138, but they're still looking at the definition of a derivative. Whenever something that fundamental is being amended, some of your instruments will be affected by it. One of the significant items relates to loan commitments in this guidance. So, if that's applicable to you, you should take note.

Lastly, on guarantees, the exposure draft really deals with the initial measurement of recording a guarantee. If you sell a product and agree to guarantee something, the exposure draft says that you would record that at fair value at that point in time. So, if that's applicable to you, stay close to that project.

MR. PHILLIP SHANE ELENBAAS: Thanks, David. My topic this morning will be the proposed draft SOP on nontraditional, long-duration contracts. This SOP was developed primarily to address various product features that have emerged recently on FAS 97-type business, which may not have been anticipated when FAS 97 was written. We'll also expand upon and clarify some of the concepts found in FAS 97.

As Dave Rogers mentioned, I did talk on this topic at the Advanced GAAP Seminar. At that time I copresented with Dave Sandberg of Allianz. We had an hour for that presentation, and we took it all, so we won't be able to talk about every aspect of the SOP this morning. I will just try to hit on what are perceived to be the hot topics. The first has to do with annuitization features and annuitization guarantees. The second, which is probably one of the most crucial to a lot of people, is when to establish an additional liability above the account balance for various insurance guarantees, such as minimum guaranteed death benefits (MGDB). I'll talk briefly about sales inducements, and then we'll close with some comments on timing and transition. For each of the topics I'll give a little background on what the SOP says, but then I'll also try to turn to what some of the perceived concerns are with each of those topics.

Our first topic has to do with annuitization features, and the draft SOP clearly defines what constitutes an account balance. FAS 97 didn't give an explicit definition of account balance. It sort of defined an account balance through a paragraph indirectly, but the SOP goes a step further and clearly defines the elements in the account balance. It starts at the accretion and states that the account balance at any point in time includes all deposits made to date, net of all withdrawals, reflecting all credited amounts, be they contractual or additional, and less all fees and charges to date. It makes a few more clarifying statements and says that you only reflect the rate that accrues to the account balance that is available in cash or cash equivalents. Similarly, on products that have multiple account balances, you must hold the highest account balance that is available in cash or cash equivalents. Consistent with FAS 97, there is no reduction in account balance held for future surrender charges or credits. A final point, and one of the most contentious points that you'll see as we go along, is that we cannot hold an additional liability during the accumulation phase for any annuitization guarantees.

I will talk quickly through some examples of annuitization features. The first has to do with market value adjusted (MVA) annuities. Most of you are familiar with this. This is an arrangement wherein the contract holder is guaranteed a certain return if he holds the contract to maturity. If he surrenders prior to maturity, then there's an adjustment, generally based on the then-current credited rates. The SOP says that you consider this market value surrender adjustment as a surrender charge or credit and, therefore, you do not reflect it in the account balance. So, you hold the account balance based on the contractually specified rate.

An example of an annuitization guarantee has to do with two-tier annuities. Here, you have two different account balances. One accumulates at the lower tier if the contract holder takes his funds in cash, and another account balance accumulates at a higher tier if he elects annuitization. The SOP states that you hold the account balance based on what's available in cash or cash equivalents, so the liability held in this case is based only on the lower-tier rate. The SOP also says that the annuitization guarantee is to be considered an elective benefit, and that's part of the reason it states that you don't recognize a liability during the accumulation phase.

Another example of an annuitization guarantee has to do with guaranteed minimum income benefits (GMIBs). In this arrangement, the contract holder is guaranteed certain minimum periodic payments upon annuitization, regardless of whether the underlying funds have accumulated to provide for those payments. The SOP states that if the GMIB cannot be net settled, and that's the general case, then you can only hold the account balance. You can't hold anything in addition to the account balance for the GMIB feature. However, if the GMIB can be net settled—for example, in the case of reinsurance—then you consider the feature to be an embedded derivative, and the contract would be subject to FAS 133 accounting.

I'll touch on a couple of other points on annuitization features and guarantees. First, the SOP will result in a change of accounting principle for various features and guarantees for many insurers. And, more crucially, the SOP defines how to develop the payout phase reserve. The SOP states that you equate the present value of the payout stream to the account balance at that time and solve for the valuation rate. This is crucial. For example, in the case of a two-tier annuity, you equate the lower-tier balance to the payout stream, and you'll often have aggressive earnings during accumulation phase and losses upon annuitization. So, this is one of the primary concerns with regards the SOP.

So, the concerns with regard to the annuitization features can be broken into two broad categories: recognition and measurement. When do you recognize a liability? And how do you measure it? First, let's look at recognition. The task force referred back to FAS 97, paragraph 7, and they've interpreted that paragraph to mean that you must consider the accumulation phase as a separate contract from the payout phase. It's not clear whether the underlying intent really was just to consider them separate contracts for the purpose of determining mortality significance or whether it was really, as the task force is interpreting it, to indicate when to recognize an economic event.

So, this gives rise to a different accounting treatment. You have two different contracts for accounting purposes. First, there's one from the legal standpoint. If you have an annuitization guarantee in your contract, it's there, and it's a legal guarantee. There's also been some discussion about the relevance of FAS 5, accounting for contingencies. FAS 5 states that you must establish a liability when an event becomes probable and estimable. So, consider the case of a two-tier annuity that is very much in the money, say one month prior to annuitization. At that point, it's clearly probable and estimable. At what point in the contract's development do you recognize the liability?

The second area of concern with regard to annuitization features revolves around measurement. The SOP has a paragraph that basically says they thought it would be very difficult to estimate various things. How do you assess the probability of annuitization? What's the appropriate discount rate to use? It's almost as if the task force said, "Well, we can't measure it. Therefore, it shouldn't be recognized." But most of the actuaries we've been talking to feel that there are reasonable approaches for estimating annuitization guarantees.

My second topic has to do with when to establish an additional liability for insurance benefits, such as the MGDB feature. FAS 97 did talk about when to classify a contract as an investment contract versus an insurance contract. However, it did not give a specific test. It basically said if the mortality risk was other-than-nominal, then you had an insurance contract. This SOP goes a step further and gives a specific test that must be applied for determining the significance of mortality and morbidity.

The test is defined only once, at contract inception—other than at adoption of the SOP—and the test is basically a comparison of the present value of excess insurance payments to the present value of contract holder assessments. Excess insurance payments refer to insurance benefit payments over and above the account balance. So, you just basically take a present value of insurance payments divided by present value of assessments, and if you have something over 100 percent, you may have significance. The SOP goes on to state that you must look at all reasonably possible outcomes, which would strongly imply stochastic valuation, but there is some room for company discretion.

There are some concerns related to the mortality and morbidity significance test. Most actuaries we've talked to feel the test is too prescriptive. Some people feel there should be no test at all. Rather, if you have an MGDB guarantee, then you should do stochastic valuation to assess the corresponding liability. We've also seen that the test can be quite sensitive to assumptions. For example, if you use base assumptions, maybe you get a result that says that you do have significant mortality risk. If you then use best-estimate assumptions, say 70 percent of mortality, perhaps the test is no longer significant. So, there is some sensitivity to assumptions.

Finally, while the test is explicitly defined in the SOP, the SOP doesn't take the next step and say what is to be considered significant. Is it 102 percent or 110 percent? So, there's room for varying company practice there. Some actuaries have recently said perhaps the MGDB risk is, indeed, a tail risk, and it's more of a threat to capital. And if you have a test, perhaps the test should be measured against capital rather than against assessments.

Once you've determined that you have an insurance contract, the draft SOP then goes on to state when and how to establish an additional liability for the MGDB. First, it says that you look at your future insurance streams and revenue streams, and if they're not proportionate, then you establish a liability for those assessments in the early periods that accumulate to fund for benefits to be provided in the future.

The approach that the task force determined should be used to accumulate an MGDB reserve is basically a FAS 60 net level premium approach. It's a retrospective approach, and it accumulates the reserve based on assessments. The reserve is accumulated as the current benefit ratio—which I'll describe in a moment—times cumulative assessments, less all cumulative insurance payments to date and related expenses, such as settlement costs, and reflecting all accrued interest. The benefit ratio, which is always determined over the entire life of the contract, is defined as the present value of total expected excess insurance payments and related costs over the present value of total expected assessments. The use of the term "expected" here is a little bit misleading, because the SOP states that in determining the benefit ratio—and this is a key point—you use actual historic experience from contract inception through the valuation date (or the date of adoption of the SOP) and expected experience thereafter.

Here are some additional points to consider with regard to the MGDB liability. First, the MGDB liability can never be less than zero. There's been some discussion as to whether this applies on a contract-by-contract basis, but the general emerging consensus seems to be that you would apply it for a block of policies. As with the significance test, the SOP says you should consider a range of reasonably possible outcomes, again, strongly implying stochastic valuation. It also says that you must regularly reevaluate for experience. So, we really have kind of a hybrid approach. You have a FAS 60 net level premium reserve with FAS 97 dynamic unlocking overlaid that says that any changes due to emerging experience are incurred as a charge or credit to benefit expense. Finally, the SOP states that changes in the MGDB liability are now a component of estimated gross profits (EGPs) and, therefore, DAC is also affected.

So, there are two major categories of concerns with regard to the MGDB liability. One has to do with the determination of the benefit ratio, and one has to do with regular reevaluation. With regard to the benefit ratio, most actuaries I've talked to don't feel that using revenues is the appropriate base. Several people feel that using a subset of revenues, such as the assessments that are there to fund the benefit, would be more appropriate. The task force did consider this. But due to varying company practices and how various charges are defined—one contract might have an explicit mortality charge, while for another contract, it might be part of the expense charge—the task force felt that the only way to ensure consistency was to require total assessments as the base.

A growing number of people feel that the appropriate base for accumulating the reserve would actually be EGPs. If you have assessments that are not for the complete period of the insurance benefit, then you have an Unearned Revenue Liability (URL), and the SOP clearly states that the change in URL should be a component of your assessments. So, if you have a URL, and it's considered to be a part of your assessments, and you're accumulating the reserve based on the assessments. You then consider changes in your MGDB liability as a component of EGPs, which is the stream over which you amortiz e your URL, so there's circularity there. Thus, the EGP would be a simpler method.

Another area of concern has to do with regular reevaluation, and what FAS 97 dynamic unlocking means in this environment. For example, how often do you unlock the benefit ratio? If economic conditions haven't changed from one quarter to the next, and you reperform your stochastic scenarios—but you really have a reasonably stable underlying economic environment—do you unlock the benefit ratio just because you've gotten a different output from your stochastic evaluation? Some have suggested a corridor approach of setting some model parameters, that you only unlock your benefit ratio when it falls outside of certain parameters. For instance, if you have a benefit ratio at 80 percent, and it stays within that—between, say, the 60th and 90th percentile—at each evaluation, maybe you don't unlock. But if at the 80 percent, somehow the economic environment has changed drastically, and it's only at the 40th percentile, at that point maybe you do unlock.

And another concern with regular reevaluation is that it can lead to counterintuitive results. If the market is in an upswing, you'll have higher assessments and a lower benefit ratio. So, you'll accumulate a lower reserve during periods of economic prosperity. Some actuaries feel that is exactly the time you should be increasing your reserve for the future.

I want to talk briefly about sales inducements. The task force did recognize that insurers have already been capitalizing, deferring certain items as sales inducements, and there have been varying practices in this regard. So, they set out to set forth two criteria for which items can qualify as sales inducements. One is that the amount credited must be incremental to amounts credited on similar contracts without the inducement, and a second is that they have to be higher than the credited rate beyond the period of the inducement. Some examples would be a day-one bonus, a persistency bonus and an enhanced credited rate.

The task force has clearly stated that if you have deferred sales inducements, they cannot be shown combined with DAC; they must be shown as a separate item. You have a separate asset, a deferred asset, for sales inducements. However, it is amortized using the same methodology and assumptions as DAC, and the amortization of the sales inducements asset is a component of benefit expense.

We haven't seen too many concerns around the treatment of the sales inducements. One potential concern that has been raised is that you don't reflect lapse in determining the amount to defer. If you consider the example of a 10-year persistency bonus, the SOP would indicate that you must consider that all policyholders at issue will still be in force and be eligible for that bonus at the end of 10 years, so you capitalize the entire amount. Yet you're amortizing it over an EGP stream, which does reflect lapse.

I'll close with some comments on timing and transition. First, the effective date is for all fiscal years beginning after December 15, 2003, with early adoption encouraged. The draft was first publicly exposed July 31, 2002. It's available online. The comments are due back by the end of October 2002. Transition rules are a little different for the MGDB liability versus sales inducements, so I'll talk about them separately. With regard to the additional MGDB liability, you must reperform your mortality significance test upon adoption of the SOP. In so doing, you use actual historic experience from contract issue through adoption and expected experience thereafter. Any increase that you might have to your liability due to adopting the SOP is reported as a change in accounting principle and, as such, has a cumulative effect on income. It also has a cumulative effect on EGPs, so DAC will also be adjusted upon adoption.

With regard to sales inducements, as I mentioned, the task force does recognize that insurers have already been deferring various items. The SOP recognizes that, and they do not indicate that you have to eliminate something you've deferred if it fails either of the criteria. The SOP states that, if you deferred something that fails the criteria, you do not eliminate those outstanding balances upon adoption of the SOP. However, going forward, those outstanding balances are subject to the amortization guidelines given in the SOP. Conversely, if you had items that historically would have met the criteria for capitalization that you failed to capitalize and defer, you can't go back and retroactively defer those items. So the transition rules for the sales inducements, in the SOP, are completely prospective, and you won't have a cumulative effect on income or DAC, as with the MGDB liability.

Some concerns with regard to timing and transition: One of the biggest concerns revolves around reperforming the mortality and morbidity significance test upon adoption. If you have a big change in the economic conditions since policies were issued, you could end up having a different conclusion for your in-force business versus your new business, even if the contracts are materially the same in all other respects. That seems counterintuitive.

There is some concern about adopting the SOP as of 2003, when International Accounting Standards (IAS) will be coming down the pike just a couple years later. Many global insurers have adopted U.S. GAAP or are currently converting to U.S. GAAP, and there's some concern that the SOP hasn't fully anticipated various product features in other countries. For example, in the U.K. and Germany, for many accumulation products, the only option is to annuitize. There are no cash settlement options upon annuitization. So in that case, it seems really egregious not to be able to hold an additional liability during the accumulation phase. In closing, if you still have any questions or concerns with the SOP, you still have about 72 hours, I think, to get back to the task force. Thank you.

MR. ROGERS: We have a few minutes for questions.

MR. MICHAEL DUBOIS: I have a question for Shane. It's more just a feel for where the committee working on the SOP is coming from. A lot of the information that's been coming out with respect to the GMIBs is causing some concerns at the insurance companies and such—what you've explained with regards to the annuitization, where the process seems to be setting up a potentially lower reserve when there's a potential benefit coming up with the election of an expected range. I believe the Academy had a response to the SOP, which I think covered some of my concerns. What type of feel are you getting from the working group on the SOP to those types of concerns, about not providing enough room for the risk, not taking that into account as much as one would hope?

MR. ELENBAAS: First, let me start by saying that you're right, that the Academy has drafted a response on this, and they outlined their concerns very clearly. Several of the companies that we work with are also submitting responses directly to the task force with this concern, and our global counterparts—our KPMG offices—are also drafting a response on this very issue. But I haven't been in touch with the task force, so I don't know if they're taking it to heart. I'm not sure of the direction there. I don't know if Dave noticed if they've had any ...

MR. ROGERS: No, I think that they're waiting until they receive all the comment letters before they go through each of them and evaluate any changes that might be made. Any other questions?

FROM THE FLOOR: Is there any room for a materiality question in terms of the GMDB reserve? There were some estimates that the GAAP reserve would be about half the stat reserve. So if your stat reserve is less than X percent of your total company's reserve, would there be some room for a shortcut instead of going through the whole modeling process?

MR. ELENBAAS: There has been some discussion on that and, indeed, it's also related to the significance test. The view of proponents who feel that you shouldn't even have a significance test is, skip the significance test, do the stochastic evaluation and see if it results in a material liability. The SOP, as written, doesn't go down those roads, but there has been some discussion along those lines.

MR. ROGERS: There's always a materiality consideration with any accounting pronouncement, which this would be.

FROM THE FLOOR: In terms of sales inducements, what if a company doesn't offer any products without sales inducements?

MR. ELENBAAS: The Academy response actually suggests some alternate wording—just to change the wording slightly to address that very concern—that if you don't offer without sales inducements, the wording should be there to still allow that to be capitalized.

FROM THE FLOOR: I have a question for John Morris. When you set up a new DAC for a contract that is significantly different, would that have to be in a separate DAC cell from other new issues that are brand new issues? And if so, would they have to be in separate cells from different types of rollovers from different products? Would they have to be in different cells, or can they all be put together?

MR. MORRIS: Are you saying that's significantly different so it doesn't qualify for rollover?

FROM THE FLOOR: Correct.

MR. MORRIS: Then I think you would treat it like a new issue, and you combine the way you currently combine. I mean there's no guidance in GAAP that says what you can combine and what you can't combine. Any companies that I've seen have a wide variety of what they combine into one cell and what they don't.