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Summary: This open forum focuses on emerging U.S. GAAP issues, with emphasis placed upon implementation issues encountered by affected companies.

MR. DARIN G. ZIMMERMAN: I'm a managing actuary with AEGON USA. The thing that isn't always clear when I'm talking or editorializing about the old statement of position (SOP) is that I think this is a good regulation. There was a problem with Financial Accounting Standard (FAS) 97. In the beginning there was FAS 97, but then innovation happened, and over time FAS 97 lost the ability to address a number of the new product features that were innovated and developed. There was a definite problem.

There was a lot of inconsistency in the industry, and so the Accounting Standards Executive Committee (AcSEC), which is a committee of the AICPA, set out to address a number of the deficiencies that had evolved in FAS 97. One of the deficiencies was that there were benefits not being reserved for. There was a great diversity of practice among companies. The same benefits were being handled in very different ways at different companies. There was a definite problem that needed to be addressed. AcSEC came up with this benefit ratio method. It was an elegant method to address the problem. It could be applied universally to all kinds of life insurance, so the solution the committee came up with for the existing problem was a good one.

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I like this regulation because it's easy to understand. It does provide consistency across products, companies and even industries (in case a casualty company had to use this). It's a good regulation for addressing the variable annuity (VA) guarantees on death and annuitization and the accumulation ones out there. There are some accumulation benefits. There are some withdrawal benefit guarantees out there. It addresses UL secondary guarantees and the single-premium UL by basically taking the mortality charge out of the investment margin. I think it did a good job of addressing a more rational way to reserve for two-tier annuities.

The SOP was drafted. It was exposed. The AcSEC got some comments back from the exposure. The committee members made some revisions, and the SOP was adopted. They talk about the things that are actually in the SOP. The perceived problems (that I think were real problems) that needed to be addressed included the way the separate accounts were being handled at companies. To the extent that companies had seed money in the mutual funds, the companies were carrying that on the green book, on the separate account. Technically it's not a separate account. It is part of the company's general account assets, and they would be available to creditors should they go insolvent. The way that the separate accounts were handled, to the extent that that company has seed money going in and out of the mutual funds, was the SOP said that all transfers had to occur at fair value.

The SOP addresses the valuation of liabilities for death and other insurance benefits, for annuitization benefits, and it also addresses reinsurance. A lot of times a company would develop guarantees on its variable products and reinsure the whole thing, and there was a great diversity of practice across the industry as to how that was being accounted for. AcSEC came up with a sane, rational method to bring consistency to the industry.

I think "mini-scandal" is probably too strong a word, but for a long time it was obvious to everybody in the insurance industry that if you paid a percent of an annuity to a producer or to the consumer, it didn't matter. It was an acquisition cost. But the peculiarity of FAS 97 was that a commission could be deferred and capitalized. A sales inducement could not. It was obvious there was a practice out there. Most people just ignored it and capitalized them anyway because there was a ridiculous interpretation that whether you call it "potato" or "potahto" is whether or not you defer it.

This was one of the real issues that needed to be addressed. The SOP says that you have to defer and capitalize sales inducements. You do have to account for them separately from the deferred acquisition cost (DAC) because a commission, when it is amortized, is run through as an expense. A sales inducement, as it is capitalized and amortized, is run through as a benefit. You have to keep track of the different balances so that you can run them off through the proper accounts, expense versus benefit, but, of course, you capitalize them. It is an acquisition cost, an economic bad guy. Sales inducements are pretty straightforward. The regulation caught up with the industry.

The disclosures are straightforward. You have to disclosure how you're doing it and disclose what types of sales inducements you're capitalizing.

I would say, given my experience, that most of the meat of the SOP comes from the valuation of liabilities. A lot of those other things dealt with how they should be done going forward. The valuation of liabilities affected many more products—annuities and life insurance. One thing that I think is appropriate is that the new SOP is deferential to FAS 133. Our accounting regulations are in a transition. There are two ways you can go with it. You can have accounting that focuses on the balance sheet. What are your assets and your liabilities? You can have accounting that focuses on the income statement. What are your revenues? What are your expenses? We're transitioning.

FAS 97 was concerned with revenue recognition. How do you recognize profit? They defined the DAC and reserves so that you have a profit stream that makes sense. There's been a change in thinking, a change in mood. Currently the SEC likes the balance sheet view much better is trying to move the accounting to more of a fair value approach so that we'll get the balance sheet right. What is the fair value of liabilities? What is the fair value of assets? That is a big change, obviously, so we're going to have to get there in steps. FAS 133 was the first step. The Financial Accounting Standards Board (FASB) started out with grand ideas of how quickly we could get there, but as you look at a company like GE that has manufacturing, insurance and daycare centers—it has everything—what do you hold at fair value? Do you hold your manufacturing equipment at fair value?

As it became more obvious that the idea that we were going to go to fair value in one step was a pipedream, FAS 133 kept getting pared down. They took out manufacturing. They left banking in, but they took out all kinds of service industries. Finally they got down to defining derivatives, and insurance companies and financial services companies were going to start holding derivatives at fair value, but then it was the intent that that was going to keep expanding with the confluence of international accounting standards. We will get there eventually. The question is, How soon? The SOP is deferential to FAS 133. Virtually every section starts off for an insurance benefit feature saying it should be analyzed with respect to FAS 133, and if it meets the definitions in 133, hold it at fair value. If not, come back to the SOP and then decide what to do given the guidance in here.

Paragraphs 20 through 23 talk about the balance that accrues to the benefit of the policyholder. That's straight out of FAS 97. The reason that's in there is to clarify what that means. For example, there are the two-tier annuities. For a long time people thought the balance that accrues to the benefit was the higher tier, but so few people annuitize that it didn't make a lot of sense, and so it just re-characterized a lot of profit as surrender charge. I think the SOP takes a more rational view and says, "No, the benefit is the benefit that's available in cash, but to the extent that somebody will annuitize, you have to reserve for that."

Paragraphs 24 through 30 address additional liability for death or other, which includes guaranteed minimum death benefits (GMDBs) and UL secondary guarantees, any type of an insurance benefit. Paragraphs 31 through 35 deal with additional liabilities for annuitization.

The basic method employed here is the benefit ratio method, and, like I said, I think I characterized it as being elegant. It makes a lot of sense. It's simple. You take some sort of an actuarial projection that says, "Over the life of the contract, I'm going to have benefits that are this. I'm going to have revenues that are defined as total assessments. Of this, I get a benefit ratio." At each point along the way, my liability reserve is past assessments times my benefit ratio minus past benefits, so that when you get to the end point, past assessments times total benefits divided by total assessments minus total benefits equals zero. It's smooth. It gives you a rational answer. It makes a lot of sense. It's easy to use. I really do like this regulation. They did a good job.

I haven't gotten to the problem yet. The insurance industry fell for the old bait and switch. The exposure draft language talked about if the amounts assessed against the contract holder over each period are not proportionate to the insurance coverage, that was pretty clear. If you had a cost of insurance (COI) scale that increased with age, and you had a mortality charge that was some net amount at risk times your COI scale, that's not what we're talking about. What we're talking about is where you have some sort of a level charge. Where you have an increasing mortality benefit, but you have a level charge, you need to reserve for that.

I have heard people defending the change in language and saying, "The only reason we did it is because we had complaints from the industry that the test was a little too vague, so we wanted more of a bright-line test." The SOP language that was adopted was "if the amounts assessed result in profits in earlier years, followed by losses in subsequent years..." For a common understanding of UL products, those are pretty much interchangeable, but, as we found out, in the real world, they're not interchangeable. There are billions of dollars of difference between those two phrasings.

The problem is that many direct writers get good reinsurance quotes. The direct writer wasn't comfortable saying it is going to assume mortality improvement for the next 100 years, whereas a lot of the reinsurers were. The direct company could get rid of its mortality risk or the improvement risk, sell it to a reinsurer for an attractive price, and come up with a more competitive COI charge but, under its own assumptions, one that would produce a loss in later years. But it didn't care. It was going to be profitable in all years because of the reinsurance.

This one issue ended up literally being billions of dollars across the industry in additional reserves, and there was a lot of heated debate about the exact words of what this switch was. When it was exposed, nobody ever said anything about coming up with an additional mortality reserve for the base benefit. Everybody

within the insurance community, I should say, felt that the fund was adequate for covering the base insurance benefit, and that to the extent that there was a secondary guarantee, yes, there needs to be a consistent practice for holding additional liabilities. The new language swept base UL COIs into the SOP, which the industry thought were excluded, and it was after the exposure period. I'm a little facetious when I say bait and switch, but you can see how that characterization could be made by somebody who is extremely cynical.

A great uproar came from companies facing hundreds of millions of dollars of reserve increases. You have to know how these different committees fit together. Again, the AcSEC is a subcommittee of the AICPA. It wrote the SOP. Incidentally, the FASB has changed what it wants the AICPA to do. I think it's asked the AICPA to stop writing SOPs. That's correct. It said, "Whatever you're working on, go ahead and finish. The new thing that we want for official interpretation of the FASB standards is stuff written by the FASB," which are the FASB Statements of Position (FSPs). FASB wants to give the official interpretation of its guidelines. It no longer requests that the accountants do it.

The AICPA can come out with these technical practice aids (TPAs). They are supposedly a little less official than an SOP.

MR. MICHAEL A. HUGHES: I would think of it as almost analogous to an actuarial guideline where it doesn't set the requirement, but it helps interpret the requirement in different circumstances.

MR. ZIMMERMAN: Yes. That's a good analogy. The actuarial guidelines apply to the actuaries. The TPAs apply to the accountants. If you're a member of the AICPA, you have to comply with its TPAs. Of course, each of the accounting firms has its interpretation of those documents.

A lot of this has happened in the past seven months. The FSP from the FASB has been published and adopted. The first question that came up was a question about unearned revenue liabilities (URLs). The people on AcSEC said that the SOP prohibits URLs. The URL is for charges that occur in earlier years that do not occur in all years but are for services provided in later years. The hyper-technical interpretation is that since COIs are charged in every year, they don't go into a URL, and obviously the spirit of the regulation was that it's not so much the COI; it's the mortality margin within the COI that needs to be the opposite of capital, deferred and brought in revenue over the life of the product. The people at AcSEC said, "No way. The COI charge is made in every year. It is not eligible for the URL."

The FASB came down on the side of the actuaries and said the SOP does not supersede FAS 97. To the extent that you're holding a URL that represents a heaped profit in the COI charge that should be smoothed over the life of the product because it represents services provided in later years, you still follow that URL, and then when it comes to the test in Paragraph 26 of the SOP, the deferral

and bringing into income of the URL is what you test against, not just the gross COI charge. That was a great relief for many companies because perhaps the COI charge failed the test, but when you took into account the mechanism of the URL, the mortality URL, you would pass.

After that there were still a number of questions. AcSEC wrote the TPA. I know the TPA is an AICPA document, but it was written by AcSEC. The way a TPA works is it is not approved by the FASB, but the AICPA has to submit it and give the FASB a chance to object, and the FASB did not object. What the TPA covers is six specific questions: the definition of an insurance benefit; the definition of assessment; the level of aggregations when you perform the Paragraph 26 test; losses followed by losses; reinsurance; and accounting contracts that provide insurance benefits. The definition of assessment is that, again, you would think plain vanilla UL is a transparent contract. The COI is the mortality charge. The expense load is for expenses. The surrender charge is for when they surrender, and you need to recoup your commission.

The TPA says that it is possible that a UL contract has such a design, that just because the common name says this is mortality, other elements might be incorporated for mortality. It's clear that you can't do that for UL secondary guarantees. There's something in there that says it specifically. Forget the UL secondary guarantees—you have to hold a liability for those—but for the base benefit, it's a rebuttable presumption. The rebuttable presumption is the COI covers mortality, but you can rebut that presumption and say interest margin. This product was designed so that interest margin will also contribute to mortality profits as they are defined in Paragraph 26, and, thus, you can pass the test. I think single-premium UL is a perfect example of that.

For losses followed by losses, it clarified that some people thought to the extent you don't charge something, there is no charge for benefit. Then you have losses in every year, so it's not profits followed by losses. They clarified that. They said, "No, 'losses followed by losses' is exactly what we mean. It's profits followed by losses." You need to hold the liability if you have a benefit that does not have an explicit charge. To the extent that reinsurers were assuming these contracts, there are specifics about holding them, whether you use the benefit ratio or whether you use the fair value.

MR. B. ROGER NATARAJAN: Do we address higher profits followed by smaller profits?

MR. ZIMMERMAN: That's a good question. The answer is, No, it does not. Way back when we talked about the problem, we substituted a general description of the shape of the profits with a bright-line test. Is there a profit followed by a loss? Technically, if it's a one-penny loss, you have to hold up a reserve.

That's also a good segue into the other important thing here—the aggregation level. Clearly when you're talking about a benefit ratio method, it has to be applied in aggregate. You cannot talk about the benefit ratio for an individual policy. It's like reserves. It has only meaning when you're talking aggregated across a block of business. The proper interpretation of FAS 97 is that it applies contract by contract, and so when we talked about the Paragraph 26 test originally, they thought that that had to be applied contract by contract. If your five year olds failed, but everybody else passed, you'd have to hold a mortality liability for five year olds. If smokers passed and nonsmokers failed, you'd have to hold one for them. This says basically we're reasonable about this. You do your aggregation for testing at a level that is no higher than your DAC cohorts. If you have a DAC cohort for this group, and the mortality profits for that group are positive in all years, you don't have to go policy by policy and say this one does; that one doesn't. To the extent that this group passes and this group fails, but if you put them together, they pass, you can't do that if they are different DAC cohorts. That was another important thing to come out of that. Again, I think it makes sense. I think you got to the right answer.

Don't be fooled by the cynicism. I think this is a good regulation. It's not perfect. It's not great. There was one major flaw with the whole bait and switch that caused a lot of consternation, but I think it's been resolved to the point where we're left with a good regulation that is going to leave us with a bitter taste in our mouth regarding the transition period, but it gives us good guidance going forward.

MR. HUGHES: Roger, let me respond to your question. It had to do with whether there's any requirement for dealing with larger gains followed by smaller gains in later years. I would say in general there isn't that type of a requirement. There used to be in GAAP a concept known as the matching principle. Those of us who started 10 or 20 years ago used to pay a lot of respect to the matching principle, and if you basically got a level pattern of earnings, you felt pretty good about the way you'd applied the guidance. But I think the accountants would say nowadays that the matching principle has been largely thrown out. It's no longer a principle that's adhered to.

I think, as Darin said, there's much more emphasis on getting the balance sheet right. There's a slow migration to fair value, and I think that's causing a lot of pain as we get some things on the balance sheet at fair value and other things not on the balance sheet at fair value. Some would say the inmates are running the asylum as we go through this period of pain. I would say, though, that the FSP related to the SOP does deal with the issue of whether or not you need to consider some portion of your COI charges as unearned revenue. Some would say that it reemphasizes the need to examine whether some portion of that COI charge should qualify as unearned revenue, but you shouldn't defer COIs just to get a level mortality margin or to get a level pattern of earnings. That would be my response to that.

I'm from the Chicago office of Ernst & Young, and my main topic this morning will be purchase accounting, but I'll touch on a few other items.

Purchase accounting continues to be an area where there are a number of challenges. There's no clear definitive guidance. There's a disparity of practice in terms of how it's applied, and this is likely to continue for the foreseeable future. FAS 141 and 142 provided some important new guidance that came out a few years ago, and I'll talk a little bit about that. Initially when those standards were issued, it wasn't clear how they'd be applied to insurance company transactions. Now there have been more precedents. It's a little bit clearer how the industry is interpreting that guidance, but I would still say that the results can vary significantly from transaction to transaction, and even with regard to some of the more traditional issues like the value of business acquired (VOBA), there's disparity of practice.

With respect to FAS 141 and 142, this deals with business combinations. This is a quick refresher for those of you who haven't been involved in purchase accounting recently. These were adopted in 2001. One of the most important aspects of this was that it eliminated the pooling-of-interests method. Under the pooling-of-interests method, you would basically combine the historical GAAP (HGAAP) treatments of each company, and the combined statements would reflect the sum of the pieces on a historical basis. It requires the purchase method be used. It also established new criteria by which you would determine whether or not you have an intangible asset that would need to be separately identified and valued on the balance sheet.

There was always a requirement that you consider the need for these intangible assets. From that standpoint it wasn't new, but in practice companies weren't putting anything up other than VOBA and goodwill on an insurance transaction. Basically the criteria are that if this intangible asset relates to contractual or legal rights or if it is separable, meaning that it is capable of being separated from the acquiring entity and being sold, transferred, rented, what have you, if it satisfies either of those two criteria, you would determine its value at fair value and place it on the balance sheet.

The other major development with FAS 141 and 142 is that goodwill is no longer amortized. Goodwill and other indefinite-lived intangible assets are not amortized. They're just checked for impairment on a regular basis.

If you're going to purchase GAAP (PGAAP) a transaction, the first thing you need to do is figure out who bought whom. If you're in a merger of equals, that's not always clear, but for accounting purposes, you do have to determine a purchaser. You also need to determine the purchase price, and depending on the nature of the consideration, that might not always be immediately clear either. The next thing you do is figure out what the market value of the net assets acquired equals. For the net assets acquired, you could think of this as your tangible assets and

liabilities, and once those are marked to market, that value would reflect the market value of the net assets acquired.

The next step is typically to figure out the VOBA, sometimes referred to as present value of future profits (PVFP) or other things, but this is the value of your in-force book of business on an insurance transaction. You then determine other intangibles, and this is the new part of FAS 141 and 142. This basically requires that you think about the intangibles that meet these separately identifiable criteria, and, most important, for insurance transactions, this would be the value of your distribution channels. But there could be other intangibles such as brand that might meet the criteria. The remaining item is goodwill.

What is goodwill? You can think of it algebraically as the residual, the remainder of the purchase price after you've allocated value to the other three components: the net assets acquired, the VOBA and other separately identifiable intangibles. You could also think of it conceptually as the fair value of the intangibles that don't meet the separate criteria for deferral. The presumption is that you paid fair value when you acquired a property, and so by definition the value assigned to goodwill would reflect the fair value of these other intangibles. It might be the value of the work force. It might be the company's ability to recruit and train agents and things like that.

It's interesting to note that when the standard setters developed FAS 141 and 142, there was a long litany of things that could meet the criteria for being a separately identifiable intangible asset. They were expecting a significant portion of the purchase price of transactions to be separately identified and valued. As a result, they were expecting that goodwill would be a lot less than it had historically been, because historically you'd set up VOBA, and everything else went into goodwill. One of the reasons why they weren't so concerned about not amortizing goodwill is that they were expecting all these other intangibles to be valued and amortized based on their own useful lives. That's not exactly what's happened. We haven't seen significant other intangibles with the exception of the distribution channel.

Let me spend a minute talking about some of what I'll call real-world issues that you get into in a purchase accounting setting, and this speaks to some of the challenges that companies face. The first issue is whether or not you even have a business combination for accounting purposes. In a number of instances, if you're acquiring a book of business, you might not meet the definition of a business combination. You may default to reinsurance-type accounting treatments. In some respects that impacts the accounting, and in other respects it might not. You might get a similar treatment if you use reinsurance versus the business combination guidance, but there are some differences.

Another issue that's come up recently is the more fundamental question of whether or not you should even have VOBA on your balance sheet as a separate item or whether the fair value of the liabilities that you set up on the opening balance sheet

should be net of VOBA. I think the prevailing view is that you would still establish VOBA on the balance sheet.

There are all kinds of questions related to the valuation of VOBA. There are issues with the valuation method. I think one of the more common methods currently is the Milholland method or the actuarial appraisal method. Another approach is to discount the estimated gross profits (EGPs) on a FASB 97-type book of business.

A related question is the discount rate. The discount rate should be tied to the valuation method that you're using. If you're using the actuarial appraisal method, you'd normally use a discount rate that's reflective of the cost of capital, and some might think of this as an after-tax discount rate. If you're discounting pretax EGPs, you would typically use more of a so-called pretax discount rate. There are plenty of issues involved in selecting the appropriate discount rate.

There's some question about whether cost of capital should be reflected in your determination of VOBA. I think standard practice today would be to reflect cost of capital, but that sometimes arises as a question.

There are issues with what expenses to use in the valuation. The guidance in FAS 141 says to use the assumptions that a typical market participant would use in valuing the business. Typical market participants would probably look at the expense structure that was there at the acquired company and look at what they're able to achieve on a unit-cost basis on their other business and probably reflect some kind of a transition from the existing cost structure to the acquiring company's cost structure.

Contributory asset charges are an interesting concept, and this reinforces the relevance of the cost of capital. There's a line of thinking that says that if your VOBA reflects the value of a certain earnings stream, if you need to set aside certain assets to generate that earnings stream, and if those assets are earning less than your hurdle rate, you should include a contributory asset charge in the valuation that reflects the difference between your hurdle rate and the after-tax yield on those assets. If you think about it, that's exactly what we do when we determine the cost of capital. But in some cases there may be other contributory asset charges that would be relevant. I think work force might be one of those, but I'm not sure. I haven't run into that recently.

Another question is deferred tax. If you think about it, VOBA is typically deferred-tax-adjusted on the balance sheet. If you put up a $100 million VOBA, you'd normally have a deferred tax liability equal to 35 percent of that, so that the net carrying value would be $65 million. If you're trying to get the fair value of the business that you're acquiring, do you want the VOBA net of deferred tax to equal the fair value, or do you want the VOBA on a stand-alone basis to equal the fair value? Once you defer-tax-adjust it, the net carrying value would be less than the fair value of the business. We've traditionally thought of it on a net basis, that the

net value should be reflective of the fair value, but there is some guidance out there that would suggest that VOBA should be placed on the balance sheet at the fair value, and then you would defer-tax-adjust it. There's some conflicting guidance out there.

Another interesting but somewhat obscure item is the amortization tax benefit. As you may be aware, if you do a coinsurance transaction, you can get an accelerated deduction of the purchase price. Largely a good share of the ceding commission is amortizable for tax purposes at the date of the transaction, and that's known as the amortization tax benefit. There's some guidance that says that even if you're involved in a company transaction, and even if you have no intention of selling off any of the blocks of business, when you set up your VOBA you should take into account the amortization tax benefit because a buyer could take advantage of that benefit, and, hence, it should be reflected in the fair value. That would probably be a nonstandard treatment, but I think there is some guidance which would point to that.

The fair value of liabilities is an interesting item. In a low-interest-rate environment when you have large, unrealized gains on your fixed-income securities, when you mark those fixed-income securities to market, the yield for GAAP purposes gets reset to the market yield on the portfolio. That can essentially suck out most of your interest spread on the block of business that you're PGAAPing, if you do it on a one-sided mark-to-market basis. If you're holding the account value, mark the assets to market and write up the value of the assets, you're going to have depressed spreads and skewed patterns in emergence of earnings on the block of business. What a number of companies have been looking to do is not hold the account value as the fair value of the liabilities but rather mark the liabilities to market on some appropriate basis. But it's not appropriate to do so by just taking the mark to market on the asset side and trying to apply that on the liability side, but if you do mark to market the liabilities, you can preserve your normal interest spread on the book of business and get a more normal emergence of earnings.

The valuation of distribution channels is again one of the more significant items that's called for in FAS 141. With an independent agent, brokerage or career agency, you would typically have a requirement to determine the fair value of that channel and reflect that on your balance sheet, but depending on the nature of that channel, you may or may not assign that much value to it. In general terms and in an actuarial appraisal context, we're used to thinking of the value of new business as being a significant component to the purchase price of a meaningful property, of a property that has strong distribution capabilities, but for PGAAPing purposes, for a variety of reasons, you typically would not see the value of new business, per se, from an actuarial appraisal find its way onto the balance sheet in a PGAAPing exercise.

One of the reasons for this is that the intangible that you put on your balance sheet reflects only the value associated with the agents that are currently licensed with

the company, and so as those agents terminate on a regular basis over time and are replaced with new agents as you continue to grow the distribution channel, more of the sales in the future are going to be coming from agents that you don't currently have a contract with. The value associated with that would not be put on the balance sheet.

The last item, which is an interesting one, is mutual mergers. As I said, pooling of interests is generally not allowed. Even in a mutual merger situation, you can find yourself having to apply purchase accounting even though, in effect, there was no consideration paid for the company.

For goodwill impairment testing, once you've determined the opening balance sheet and are off on your merry way with the new accounting, you do need to do periodic testing of the goodwill balance to make sure that it's not impaired. This is a two-step approach. The first thing you need to do is carve up your business into reporting units, and then you look at the fair value of the reporting unit relative to the GAAP book value of the reporting unit. If the book value is less than the fair value, you proceed to Step 2. In Step 2 you effectively do a new purchase accounting for that unit to see whether or not you have impairment. You take the fair value as of that date. You assume that that's the purchase price. You re-PGAAP the balance sheet for that reporting unit, get the implied goodwill and then compare the implied goodwill to the reported goodwill. If the reported goodwill is more, you write down the value of the reported goodwill. It's a bit of a complicated test, but it is a test that needs to be performed periodically. There have been some significant write-downs of goodwill from insurance company transactions.

To sum up the discussion of PGAAP, there's more precedent for how to apply the FAS 141 and 142 guidance, but there is a disparity of practice with regard to PGAAP generally. The way in which you PGAAP a transaction can have a significant impact on the results that you get going forward. it's important for both buyers and sellers to have a good understanding of what the purchase accounting issues are and to try to factor them into their thinking. A lot of times the buyers are thinking about whether or not a transaction is going to be accretive to earnings. Many buyers will not want to proceed with a transaction that is dilutive to earnings after a short period of time. If you understand the PGAAPing ramifications of a transaction, you can get some insight as to how buyers might be thinking about it and what they might be willing to pay. It's important to understand the alternatives. It's important to understand the rationale used to justify the different alternatives, and it's important to understand the financial implications. Finally, it's important to select an appropriate PGAAP methodology, one that reflects the underlying economics of what you're looking to do.

Let me touch on a couple of other GAAP topics, a catch-all because Bob's going to cover internal replacements, and we had the SOP covered by Darin. I'll discuss B36 and Sarbanes-Oxley (SOX) 404 a little later. I mentioned Emerging Issues Task Force (EITF) 03-1 at the start of the program. How many of you have heard of EITF

03-1? This is catching the industry by storm. It's an important development. If you're not aware of it, you should probably talk to your accounting friends and get a handle on what's going on. Basically EITF 03-1 deals with the valuation of investments, of assets, and it requires that you look at the fair value of your investments. If the fair value of your investments is less than the book value, and if there's a possibility that you're going to have to sell that asset going forward, there's a proposal out there that would require you to mark down the value of your investments to the fair value.

If you think about it, if we're in a rising-interest-rate environment, and we have unrealized losses on the portfolio, this requirement could, in effect, force companies to realize those losses, not just for balance sheet presentation purposes like they are for FAS 115 currently, but for income purposes. One chief financial officer (CFO) explained to me that this is essentially forcing us to hold our assets at the lower of cost or market, and it's going to wreak havoc on our income statement going forward. It's a big deal. I think the adoption has been deferred. There are some exposure drafts out there on how this should be handled. It's not resolved yet, but it's a hot topic. From the actuarial standpoint it could impact the amount of DAC amortization that you're taking.

I'm not going to spend much time on FASB Interpretation (FIN) 46, but this deals with special-purpose entities and companies that had special-purpose entities that were off-balance-sheet. A number of those are now being required to be recorded on-balance-sheet. VAs with guaranteed minimum withdrawal benefits (GMWBs) are getting popular in the market. That's just a heads up that you should be thinking about the FAS 133 embedded derivatives that exist with these contracts.

B36 in essence is kind of old news. It was a big deal last year because for companies that had modified coinsurance (modco) or funds-withheld reinsurance treaties, it was determined that those treaties essentially had embedded derivatives. The industry had to jump through all kinds of hoops to value those embedded derivatives for GAAP reporting purposes, but that was, in effect, a requirement at year-end last year, and it's still applicable now. The main point I'd make is that the market is much less receptive now to modco and funds-withheld treaties because of the GAAP accounting treatment that you can get.

Sarbanes-Oxley isn't technically a GAAP valuation-accounting-type issue; it's more of a reporting-type issue. But with Sarbanes-Oxley Section 404, both management and the audit firms are required to certify to the existence and the effectiveness of a company's internal control structure around their financial reporting process. To do this, management needs to identify and document its significant accounts and its significant processes that feed into the financial statements. It needs to think about and identify the risks. What can go wrong with that financial reporting process? Management needs to identify the controls that it has in place to mitigate those risks. It needs to identify the key controls and then perform tests on a

regular basis to make sure that those key controls are being performed and that they're effective. Then it needs to evaluate the results of its testing and determine whether it can certify to the controls. Again, both the company and the audit firm need to do it. It's not just an audit requirement.

How many of you are involved in a 404 process this year? It affects most of the big companies. I would say it's taking a lot more time and effort than most companies expected going in, more than most of the Big Four firms expected going in as well. I've heard some indications that the average 404 process is now taking about 60 percent of the annual audit time. It's like a 60 percent increase to the audit, and the audit time itself has gone up. It's a lot of extra work. You need to get on track quickly. If you're not on track, you're running out of time because if you identify problems in your controls, there's not much time left to remediate those controls and complete the additional testing to get a clean certification. Companies are scrambling now to bring this under control.

I would say that actuaries are good at a lot of things, but we're not as good at processes as we think we are. I think a lot of our actuarial processes are messy. We know how to do stuff, but we haven't automated it. There are a lot of spreadsheets and manual movement of data, a lot of undocumented processes, etc. I think we have a long way to go. To be honest, if you looked at the flow charts for some of these actuarial valuation processes, you'd go screaming into the night. They're messy. I think companies are going to look to improve those processes going forward. I would say that most of us are probably bad at documentation and that the documentation standards are going to have to improve.

The last thing I would say is prepare yourselves because we're used to getting clean audit opinions, and things have to be dicey before you get a qualified audit opinion. Things don't need to be so dicey before you get a qualified certification on your internal controls. We are going to see a number of companies get indications that they have material weaknesses with their internal control processes, and those are issues that the companies are going to have to deal with. I've heard estimates that between 5 percent and 15 percent of the companies might end up with a material weakness on their controls.

MR. ROBERT B. THOMAS, JR.: I'm with Milliman, and I'm going to cover the new proposed internal replacement SOP, and I'm going to cover this at a high level in the interest of time so we'll have time for a few questions at the end. I'd like to point out that there is a session this afternoon (Session 81) that deals with this SOP in more detail. It deals with some of the practical issues related to this SOP.

I'm going to start here with an overview of the SOP. It has a long name: "Accounting by Insurance Enterprises for Deferred Acquisition Costs on Internal Replacements Other Than Those Specifically Described in FASB Statement No. 97." That's the official title, and this was originally exposed in March 2003 and was supposed to be effective as of the beginning of this year. Obviously that didn't

happen. About three weeks ago a revised exposure draft was issued, and the new proposed effective date is the beginning of 2006.

The current situation refers in the title to "other than discussed in FASB Statement No. 97," and as you probably are all familiar with, FAS 97 deals only with the replacement of a traditional policy with a UL-type policy. Essentially it says that you can't continue to defer any of the DAC in situations like that. This new SOP is intended to address all the other issues that do occur in real life.

Briefly, the proposed SOP has a definition of what an internal replacement is. It introduces a concept of integrated versus nonintegrated contract features, and it talks about "substantially unchanged" versus "substantially changed." Accounting for substantially unchanged contracts and substantially changed contracts is the essence of the SOP. It tells you how to deal with that. There are some disclosure issues and also an effective date and a transition period.

You probably would typically think of the definition of an internal replacement as an actual replacement of an old policy with a new policy, and, indeed, that's probably where most of the internal replacements will come from, but not in all situations. You have a situation where an internal replacement can be defined as an amendment or a rider to an existing contract or even the election of a feature within a contract subject to certain conditions that are specified in the SOP. I have an example of things that wouldn't qualify typically as an internal replacement. A partial surrender or a contract reduction, like a face amount reduction on a UL policy, typically would not be considered an internal replacement.

There's this concept of integrated contract features that's introduced here, and it's essentially benefits determined only in conjunction with the base contract. Examples of integrated contract features would be a GMDB or a guaranteed minimum income benefit (GMIB) on a VA contract or a waiver-of-premium provision. All of those would be considered integrated features. The bottom line on this particular concept is if you have an internal replacement that occurs by contract modification other than the actual exchange of one contract for another, and if the contract feature modified is considered integrated within the contract, you need to analyze and determine whether or not the contract itself is substantially changed or substantially unchanged.

As you would expect, a nonintegrated feature is the opposite of an integrated feature, and it means that it's not related or dependent on the base contract. These types of benefits would be accounted for separately from the base contract. A few examples of what you would typically have as a nonintegrated contract feature would be a long-term-care (LTC) rider on an annuity or disability contract or perhaps a term rider on an annuity contract.

For a substantially unchanged contract, all of these conditions have to be satisfied. The insured event cannot change. The nature of the investment rights cannot

change. An example of that might be where you had a contract that had a formula-driven credited rate that was guaranteed within the contract versus the company having the discretion to set rates at whatever level it wanted to. If you had a change in that area, that would not qualify under this requirement. No additional deposit premium or charge related to the original benefits is required to affect the transaction, and no reduction to the contract holder's account value or cash surrender value is necessary.

This doesn't mean that a contract holder couldn't take out a partial surrender as a result of an exchange, but it means that there can't be a requirement that it take place. There must be no change in the participation or dividend features—in other words you can't have a par for a nonpar exchange and have that be considered substantially unchanged. There can be no change in the amortization method or revenue classification, in other words a FAS 60 contract versus a FAS 97 contract. To reiterate, if all these conditions are not satisfied, the contract will be considered substantially changed.

Let's talk about what the accounting implications are for a substantially unchanged contract. As I said a minute ago, this is the essence of this SOP, and the key takeaway here is that these contracts are supposed to be accounted for as a continuation of the replaced contract. The DAC, the deferred revenue liability or deferred sales inducements would continue to be deferred, and for a FAS 97 or a FAS 120 contract, the EGPs or estimated gross margins (EGMs) would be revised based on the entire lifetime of the contract, taking into account the old contract as well as the new contract. It's like you're putting the two together and determining how you will amortize the DAC.

One of the changes that took place in this revised SOP draft versus the original one was an exception that says if it's not reasonably practicable to utilize this methodology, you can use a different methodology that would essentially allow you to carry forward the balances and use the future EGPs or EGMs to do the amortization rather than combining the old policy and the new policy. There had been a number of comments to the AICPA saying that the methodology proposed initially was too complicated for companies to utilize. There is an exception that's provided here.

As far as FAS 60 contracts are concerned, these are subject to this SOP proposal, as well. It's a prospective revision whereby you take the balances as of the exchange date—that would be both the DAC balance and the benefit reserve—and those are unchanged. Then you utilize the future revised revenue at the time of replacement to determine the amortization going forward. This approach preserves the lock-in principle that typically applies to FAS 60. I'd like to mention that loss recognition still applies to all of these contracts, whether they're a FAS 60, 97 or 120, in the normal way.

As far as policies that are substantially unchanged, once again the costs associated with an internal replacement are treated as maintenance costs and are charged to expense as they're incurred. For a sales inducement, a lot of times you might have an exchange where there is a surrender charge applied to the old policy, and at the same time there maybe is a sales inducement. What you do is you offset the surrender charges against the sales inducements to determine if there's been a net reduction in the contract value. You may recall we talked about all of the criteria that had to be satisfied for a policy to qualify as substantially unchanged. If you end up with a reduction in the cash value, you would fail the requirement that's under Paragraph 15 of the SOP, and then it would be a substantially changed contract rather than a substantially unchanged contract.

For policies that are substantially changed, it's essentially the equivalent to what exists now where you're talking about an exchange of a traditional policy going to a UL policy, except it applies to all types of exchanges or other types of contract benefits. The essence is you extinguish the old contract and write off the DAC or the deferred revenue liability, the deferred sales inducements. I haven't mentioned it yet, but also the VOBA would be affected. If you have a purchase block, you would also have to write off the VOBA associated with those policies that were being exchanged.

As far as assessments related to internal replacements are concerned, front-end fees are evaluated for deferral in accordance with the existing accounting literature in the normal way, and under FAS 97 or FAS 120 new and existing front-end fees are adjusted to reflect the revisions in the EGPs and the EGMs.

There are some disclosures that are required. The notes to your financial statements are where you would describe the accounting policy that is in place here. The primary area of disclosure is: Is this alternative approach being utilized? A few minutes ago we said that if you don't utilize the normal procedure of combining the old policy and the new policy, you have the alternative of just rolling over the balances and utilizing the future EGPs for amortization purposes. That would need to be disclosed, as well.

As far as the effective date and the transition, the effective date for practical purposes is the beginning of 2006. The actual wording is "for fiscal years beginning after December 15, 2005." That applies for all internal replacements beginning after the effective date. As with most of these SOPs, it seems like earlier adoption is always encouraged, but they're always running right down to the last day to determine whether it is going to be adopted and what the rules are going to be. I'm not sure how realistic that will be.

Finally, the restatement of previously issued annual statements is not permitted. The requirement is that you start this at the beginning of the fiscal year. If you adopt early, and it's other than at the beginning of a fiscal year, you have to go back and restate the interim financials that had been issued since then, but, as I

said, you don't get to go back and restate prior annual statements that have been issued.

MR. ALBERT PAK-CHUEN LI: I haven't read the FSP or the TPA yet. From the SOP, the way I interpret it is that's an item-cost assessment for the amortization base for the loyalty bonus reserve, the sales inducement. I think I have to subtract the change in the unearned revenue reserve so that the amortization base assessment will be correct. I think there has been a discussion because the EGPs to amortize the DAC need to be adjusted, as well, with the change of the sales inducement reserve or the loyalty bonus reserve. There will be a circular issue over there. From a practicality purpose, have you guys seen this problem before?

MR. ZIMMERMAN: Yes. At my company, at AEGON, that was a problem for quite a while. For those of you who couldn't hear the question, there's a situation where you get a circularity in calculation. To calculate your K percent for amortizing the DAC and the K percent for amortizing your URL, you need to know how the mortality profits are going to emerge, but, of course, you don't know how the mortality profits are going to emerge until you have your SOP benefit ratio set up. Part of the SOP benefit ratio is the mortality assessments subtract the benefits. That depends on the URL, and you get this circularity issue.

I'm aware of two methods for solving this problem—the practical method and what I'll call the mathematical method. There was a gentleman who wrote a report in the *Financial Reporter*, which was the mathematical method, as I call it. Basically, if you make the assumption that all the discounting happens at the right rates, the benefit reserve will have a present value of zero. That means that your K percent won't change. If you assume that there is no SOP mortality liability, and you do the calculations, you'll come up with a percentage for amortizing your COI URL. If you assume that number doesn't change, you can come up with a series of two simultaneous equations and solve for the benefit ratio. The article in the *Financial Reporter* tells you how to do the math so that you can solve a system of two simultaneous equations and get the proper DAC balance, URL balance and SOP balance.

There's also what I call the practical method where if you set it up in an Excel spreadsheet, and if you set it up right, you're going to get a circularity reference. I solved for my SOP reserves, and I solved for my URL reserves, but then I would copy them and hard code them here, and then I would copy these and hard code these, and that would change these, and after 20-some iterations I got it to converge. There can be a problem with the practical method if, even after the SOP mortality liability, you still have a number of losses out in the future where you have to zero them out. You might not get convergence if you zero out your future losses. You might alternate between this solution and that solution, and it'll never converge. You could have problems in that situation. Does that answer your question?

MR. LI: I'll read the *Financial Reporter*.

MR. THOMAS: I have a question for Mike. I'd be interested in your comments about discount rates that you've seen in practice. You talked about some of the theoretical issues there. What have you seen in your recent actual experience?

MR. HUGHES: I would say that in the heyday, before the market correction and things like that, discount rates were getting into the single-digit range. It was not that uncommon to see a 9 percent discount rate used for PGAAPing, something like that, plus or minus a point or so. With the market correction and the drying up of the transactions and risk aversion that resulted, I think the discount rates jumped up reasonably significantly by probably a point or two. My sense is they might have settled back down a little bit but probably not to where they were before. What's your take?

MR. THOMAS: You have a lot more experience in this than I do in terms of practical issues, but I think what you said is consistent with what I've observed, as well.