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## Session 7OF
## U.S. GAAP Update

**Track:** Financial Reporting

**Moderator:** Steven H. Mahan

**Panelists:** Richard D. Farrell, Steven H. Mahan, David Lawrence White Jr.


***Summary:*** *This open forum focuses on emerging U.S. GAAP accounting issues with emphasis on implementation issues encountered by affected companies. Topics covered include SOP on internal replacements, SOP 03-1 on nontraditional long-duration life contracts one year later, and the impact of SOX 404 on actuaries. The panelists discuss how life insurance companies are interpreting and applying these emerging accounting standards, their provisions and various actuarial techniques used to apply these standards.*


**MR. STEVEN H. MAHAN:** We're going to have three topics today. Rick Farrell, a senior manager at Ernst & Young, will be speaking on Standard of Practice (SOP) 03-1. Then David White, a director at KPMG, will discuss DAC on internal replacements. I'm a principal with KPMG focusing on financial reporting, and I will be speaking on Sarbanes-Oxley (SOX) Section 404.

**MR. RICHARD D. FARRELL:** There was a lack of clarity regarding the unearned revenue liability and how that fits in with SOP 03-1 and Financial Accounting Standard (FAS) 97. So there was a perceived potential conflict between what the SOP said and what FAS 97 did. This FASB Staff Position (FSP) helped clarify that. The bottom line is that you still may need an unearned revenue liability for reverse select and ultimate cost of insurance charges even if there is no SOP reserve. Reverse select and ultimate costs mean those that are loaded up with more profit in the first few years than in later years. In some cases, you may see a declining set of cost of insurance charges, or perhaps level, which then start to increase afterward.

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TPA 6300, which came out last September, again gave us a little more guidance where there was some lack of clarity. What helped a lot of companies was the indication that implicit assessments from other sources can potentially be used to consider whether there are gains or losses from the mortality function. The SOP states that if there are gains followed by losses with regard to the mortality function, then you need to set up a liability. It was written very literally, so you might think that it only pertains to the mortality function. So you look at cost of insurance charges and at potential claims, and you compare those two.

Those of you who have priced products in the past probably will automatically say that's not the way products are priced. Instead, companies tend to look at things more holistically. You might get a little more from interest margin or maybe from expense charges, and that might offset any shortfalls in the mortality function, particularly in later years. But because of the literal reading of the SOP, we couldn't take that into account, and some companies were faced with some fairly significant liabilities if it went that direction. So Technical Practice Aid (TPA) 6300 gave a little relief. If you met certain conditions, you could look at other sources of profit to consider that mortality gain followed by losses.

The topic of aggregation level wasn't exactly clear in the SOP regarding at what point you can zero out a cell or a group of cells and call your reserves zero instead of saying it's a negative. That TPA stated that it should be at the same level as the deferred acquisition cost (DAC) cell level. You can do it at an even more granular level if you'd like to. So that means that if you do a DAC at product and then issue your cohort and have all your amortization schedules on that level, that would be the point at which you'd calculate your SOP reserve and then zero out if necessary. You need a separate reserve for the no-lapse guarantees. You have to look at it separately, rather than commingled with the rest of the contract. The TPA helped clarify that as well.

FAS 113 has been around for quite a while. Some companies have followed it loosely; some companies have tended to ignore it. In the past, with some types of products, maybe it didn't make much of a difference. All parties could include FAS 113 on a purely literal basis or not, and it wouldn't make much difference. But it is a different story here. You can get much different results if you look at the SOP reserve with and without reinsurance. FAS 113 basically says you must look at it on a direct basis and on a ceded basis and calculate the reserve and reserve credit by themselves rather than calculate everything on a net basis. The reason this makes a bigger difference on the SOP reserve is because of the mortality pattern or even the charge pattern on reinsurance versus the direct side. You'll often have very high coinsurance allowances or maybe no first-year premium going to the reinsurer, and the whole mortality slope is skewed differently depending on the direct side or the ceded side.

The final point of clarification coming from the TPA was that the liability for the annuitization benefit applies to all FAS 60 products. A lot of people were a bit

misguided going in with the SOP. It's not just for variable annuities. This annuitization benefit goes back to traditional life products that you sold ages ago; it goes back to all types of universal life (UL), etc. So it applies to anything that falls under the FAS 60 umbrella, given that FAS 97 products are also a subset. For some companies, it made a difference because some of the old annuitization benefits were fairly generous. Not intentionally, but at the time that they were put into the contract the mortality guarantees were based on older mortality. Because of mortality improvements since then, those annuitization benefits now have a value.

Some companies faced some issues and surprises while they were implementing SOP 03-1, once they got past all the guidance of the TPA, the FSP and the original SOP. Some companies anticipated that it was going to be a big drain on their GAAP income. As it turned out, most were pleasantly surprised. It was not as large as they anticipated. One reason, possibly the main reason, was that equity markets were cooperative. They were rising at the point that the SOP was being implemented. Consequently, the rising equity markets made the guaranteed minimum death benefit (GMDB) liability go down in the other direction. From when they first started to think about it and worry about it versus when they actually had to implement it, the rise in the equity markets took out some of the liability they would have had to set up otherwise.

The SOP states that you should make the benefit ratio model and the DAC model consistent. However, that's much easier said than done. This was a big hurdle for many companies in terms of making the DAC model and the benefit ratio model match up fairly well. In some cases it was easy to do. There are certain assumptions that you do it in the DAC model, and you do it in the benefit ratio model, and it always comes out. But some companies had trouble and struggled with getting the pattern of claims and the pattern of reserve changes to match up between the two. A lot of that trouble came because the two were being calculated separately. They aren't generally calculated within the same system. Due to the rush and the need to get the SOP implemented, some companies did their own homegrown spreadsheet systems or Access databases just to get the job done. Consequently, the old, standing DAC model, which had been there for a while, kept being the fallback, but it was not integrated with what was being done on the benefit ratio model for the SOP reserve.

The other issue that tended to be tough was for those companies that used mean reversion in the DAC model. It became difficult to determine how to reflect that in the benefit ratio model. Consider that the benefit ratio model was typically based on a set of stochastic scenarios versus the one single deterministic set of scenarios that were used in the DAC model with, once again, the mean reversion trying to put a certain spin on it. To match up what the mean reversion model was doing with what the DAC model was doing was difficult and challenging. Some companies had some pretty interesting ways to put a little bias in the benefit ratio model, so that it tended to have a mean revisionist type of impact. However, I didn't come across

anybody who did a really nice job of matching the two and making them 100% consistent.

The guaranteed minimum income benefit (GMIB) is the benefit that, at a certain point in time, if you meet all sorts of criteria, you're guaranteed a certain income stream from your benefit if you so elect to take it at that time. There was a disconnect between direct and ceded. Direct is based on the SOP and its guidance. Ceded is based on FAS 133. The two tend not to give exactly the same result. For example, if you have a GMIB benefit and you cede 100 percent to a reinsurer, you think you're clean, right? That's not the case. There's a net impact on your income. Unfortunately, that's just the way it is with accounting guidance at this point.

If I had to indicate the No. 1 area that needs improvement for companies going forward, it would be that there was not much rigor in assessing the cost at annuitization. Companies tended to go through all kinds of work to come up with the stochastic scenarios, generate the scenarios and calculate the GMDB. But when it came to the point of determining what the cost of annuitization was going to be, there were a lot more shortcuts taken. It's as though they got tired of the first step or just ran out of time. The GMIB annuitization seems to be one area that was lacking in terms of the amount of work and effort that went in.

The liability for annuitization guarantees in general wasn't much. Most of the time, companies said it was zero or close enough to zero. This is because in calculating the present value, you can take the expected annuitization rate into account. As we've heard countless times, over and over again, not too many people in the United States opt to annuitize their deferred annuity contracts. If you've got a little bit of an annuitization that's in the money, such as those old, traditional products I spoke about earlier, once you apply a very low annuitization rate, then start to discount it, you don't have much left over. So, in most cases, companies did not put much of a reserve in for the annuitization guarantees at all.

As a side benefit, the SOP implementation brought to life the true cost of these benefits for some companies. They may have done some work in the ancient past, which is now three, four, five years ago, thinking what the cost of the benefits was. Now, with this current work, they've started to come to the realization that what their idea was or what worked before has changed dramatically. Thinking back to when I first started to understand the GMDB and GMIB benefits coming out, I was hearing quite a bit of talk that they are freebies. They're giveaways. They'll never come into the money. They're gimmicks. They sound good, but they just don't have any impact on the company.

We found out differently with what happened to the equity markets in the late 1990s and early 2000s. Consequently, companies use this information to leverage going forward and have a better idea of the true cost of the benefits. Some companies, where they have the ability to modify the charges for the benefits, in other words, the cost to the policyholder, are rethinking it and considering

increasing their charges to raise a little revenue. I don't know if anybody has actually made that happen with this information, but at least they've started to think about it.

There are a few more implementation issues. Data mining was a real issue as far as getting everything lined up in the right way so that you could do the SOP calculations. The other issue, which tended to be a bit of a challenge to some of the actuarial art rather than science, was that we had to recreate the past. We didn't think that we needed to capture these GMDB claims five years ago, and they never hit the ledger. Maybe there are little shreds of evidence that you could pull together to come up with fairly good idea, but it was difficult for some companies to go back to some of the earlier years when these benefits were offered to come up with the actual experience. You need to do that because the DAC amortization goes back to day one rather than starting at the end of 2003 or 2004.

Which stochastic generator should you use? Regime switching was one thought, but that tended to post much larger reserves. The choice of stochastic generator does have an impact on reserves.

Dynamic policyholder behavior is often ignored. I didn't see too much of that being used; it was basically just deterministic going forward. Will policyholders act a little differently if the equity markets do X or do Y? I don't think anyone really went to that point and thought through some of those questions. Perhaps that's the next level and maybe we'll see that coming out, but not much of that was taken into account in the first go-round.

The issue I think a lot of people will say is a problem is model run times. It takes much longer than most people hoped for, much more than people had anticipated. In a lot of situations where a bunch of computers are all hooked up together, they flip the switch and it still takes a day, two days, three days to run the model. Some companies took the position early on that they were going to run a very large number of scenarios. I heard some early on saying they were going to do 500 or even 1,000 scenarios. They backed off. Of course, one way to speed the model run time is to use fewer scenarios. Maybe where they thought 500 to 1,000 scenarios would be good, eventually they settled on something like 50, 100 or 200 scenarios. There is also some movement now about going with a representative scenario set and using some other shortcut methods. Looking at the model law, companies are seeing what they can do to squeeze it down so they don't have cells with very low numbers of population in it, and they merge those with something else. But it's still a big issue for a lot of companies trying to get the model run time down to something manageable.

Another approach I've seen is to run the benefit ratio model a month before quarter-end. This is especially useful if you've got tight deadlines for a public company where you've got to report three or four days after a calendar month-end. So you run the benefit ratio model the month before, and when it comes time to do

the valuation, you just import those same benefit ratios and apply them to the current inforce as of quarter-end. Of course, you still are faced with three or four days' run time, but it's not in the middle of the rush when you need to get the quarter-end numbers booked.

One item that seemed pretty universal was that implementing the SOP took a lot longer to do than anticipated. A lot of these little issues that I've mentioned crept in. Initially, the GMDB seemed pretty straightforward. You think you've got the methodology down, you do steps 1, 2, 3, 4, 5, and it's done. Instead, you've got issues about gains followed by losses and old annuitization benefit guarantees. A lot of these other nagging issues came in, and those tended to take more time in some cases than the original GMDB reserve calculations. Many companies got caught in a tough situation as it became close to the end of the year, and they were still not ready or not quite at the point they wanted to be with everything buttoned down. It was somewhat of a fire drill, somewhat of a rush at the last minute to get things done, and that was really not what was planned.

David is going to talks about the internal replacements and the parallels between the internal replacements and SOP 03-1. Perhaps we'll see a little more conservatism toward project plans and project management than what we saw in SOP 03-1.

**MR. DAVID LAWRENCE WHITE JR.:** Let me start by giving a little background behind the issue on internal replacements. The groundwork was laid with FAS 97 when a brand-new accounting model was introduced and consideration had to be given to what you would do with business that was written according to FAS 60 guidance and that would be transferred to business written under FAS 97 guidance. FAS 97 indicated that because the contracts would be substantially different, the DAC balances on the old contracts could not be carried over into the replacement contracts. This guidance was following and referred to under the guidance in existence at the time for extinguishment of debt. Essentially, if there are terms that are not substantially different, then the new debt is a continuation of the old debt. If it is substantially different, then you have an extinguishment of the debt, and you start again with your new accounting.

AICPA Practice Bulletin 8 indicated that FAS 97 addressed only the replacement of traditional contracts by universal life-type contracts and that accounting for other replacement transactions would be based on the facts and circumstances of the transaction. That is a euphemism to say that companies came up with their own methods and there was a diversity of practice as to how the internal replacements were accounted for. Several years ago, a project got underway that is now in its second exposure draft, which was issued Nov. 29, 2004. There was a time period for comment letters. The effective date was originally stated to be Dec. 15, 2005. In other words, Jan. 1, 2006 would be the implementation date. However, because of the comment letters that were received, there are number of points under discussion. They are mostly points of clarification, but the one thing that's been

publicized is that the effective date will now be deferred by one year. So it will be for fiscal years beginning after Dec. 15, 2006. Some changes may come up before the final is issued, which is expected to be in June 2005, assuming they get all of the definitions cleared up.

This SOP is very definitionally intense. In other words, it's fairly simple to explain the SOP. In summary, if you have an internal replacement and the terms of the contract are substantially unchanged, then you continue the amortization of your DAC from the old to the new. If you have an internal replacement and the contracts are substantially changed, then you write off the DAC from the old contract and begin again with the new contract. Everything in the SOP hinges around defining internal replacement within the scope of the SOP and defining what makes up a substantial change, then they go into some other components, as well as integrated and nonintegrated features of the contract.

The first major definition is of an internal replacement. They made it fairly broad. It's defined as a modification in product benefits, features, rights or coverages that occurs by the exchange of a contract for a new contract, by amendment, endorsement or rider to a contract, or by the election of a feature or coverage within a contract. So there are basically three ways you can get a modification. You can do a physical exchange, one contract to another. You can amend through an amendment, endorsement or rider. Or there can be an election of a feature or coverage within a contract.

The following paragraphs provide clarification of the definition of internal replacements. Paragraph 9 provides guidance on which modifications are not considered internal replacements. That would be primarily if the feature is not subject to underwriting, for example. In another example, the life insurance company can't decline the coverage. It's fairly well defined as to what modification would not be an internal replacement.

Paragraphs 10 through 12 define contract modifications other than contract exchanges. They also introduce the terms "integrated contract feature" and "nonintegrated contract feature." Integrated contract feature refers to those for which the benefits can be determined only in conjunction with the account value, for example, a universal life policy that has the right of an insured to raise the face amount. A nonintegrated feature, for example, could be an option to purchase additional insurance on a traditional plan or a variable annuity with a long-term-care rider. In that case, the long-term-care rider would be a nonintegrated contract feature.

Looking at the definition of "substantially unchanged," you have to meet all of six conditions, and if you do, then your contract is considered substantially unchanged. The essence of these conditions is that there's no material change in the mortality or morbidity or insurance risk. For example, if you have a variable annuity with a GMDB, and you're going to exchange it for a different type of GMDB, then you have

to evaluate whether there's a material change in the mortality risk that you're assuming. If you go from one that is a relatively low value GMDB to one that is a rich GMDB, then you would violate this provision, and it would not be substantially unchanged.

Another point is the investment return rights. For example, if you have a single premium deferred annuity (SPDA) that is exchanged for an equity-indexed annuity, that would be a material change in the investment return rights, and that would be a substantially changed contract. In a third example, if there's a net decrease in the account value, that would be deemed to be the same as a surrender charge, and so there would be a substantial change. If there's a change in the dividend features or if the amortization method or revenue stream is changed, those are examples of substantially unchanged versus substantially changed contracts.

In another example, if you exchange a UL contract for one with a secondary guarantee, that would be considered a substantially changed contract. In that case, you would write off the DAC on your old contract and begin again with a new contract. Let's suppose in a second case that you had a UL plan with a rider with a secondary guarantee. This rider would be deemed to be an integrated benefit, and if the company offered this rider, it would be a substantially changed contract. In a third case, let's suppose that you had a UL contract that had a provision where the policyholder could elect the rider. It's in the original contract. The mere fact that the policyholder elects the rider means it is not considered subject to this SOP. Of three different cases, the first two get the same result, and in the third case the election of the rider is presumed to be accounted for already under the existing accounting methods that you're using.

Consequently, if you have an internal replacement that is substantially unchanged, then the unamortized balances associated with the original contract continue to be deferred and amortized, including your unamortized DAC, unearned revenues and unamortized deferred sales inducements. If it's substantially unchanged, then you're going to have an implementation problem matching up your estimated gross profits from one contract to the other. Other balances such as the liability for GMDBs and GMIBs are accounted for in a similar manner, as if the replacement contract is a continuation of the replaced contract.

The draft SOP gives two methods for changing your stream of estimated gross profits or estimated gross margins. The first case is where you actually have a stream of estimated gross profits. If you have, for example, an exchange in the fifth year, then you have years one through five gross profits, and then you have years six and beyond gross profits under the exchanged contract. That would be complex, to say the least, and it may not be easily implemented. So the draft offers a secondary method. If it's not reasonably practical to use the method described above, then you allocate your unamortized DAC, and you just begin from that point on with a new contract. The first method they give is retrospective and prospective; the second one is prospective only.

The assumptions should be unlocked, and so you would evaluate whether the remainder of the period is sufficient for the amortization or not. In other words, if you're starting over with a new contract, as in the second method described, you still go to the point at which the DAC is mostly amortized. That's not been defined in the SOP, and it likely will be one of the implementation issues that companies will have to deal with.

By the way, the second method here is one in which there's no discontinuity, per se, between the before and the aftereffect of the exchanged contract. It gives you a different pattern than the first method does, because in the first method you have an amortization ratio that's computed over both the old and new contracts, and in the second method the amortization ratio is only computed over the new contract.

For FAS 60 contracts, for long-duration contracts, they've defined a method that is commonly used for health insurance plans and adjustable premium life plans where the term used in the SOP is "prospective revision method." In other words, for FAS 60 contracts you will start with your DAC at the date of exchange, and for anything that happens at the exchange, you recompute a new amortization ratio based on projected future premiums for FAS 60 at that time. It allows you to use only a prospective approach in the contract exchanges for FAS 60 contracts. One of the controversial components of the second exposure draft issued in November is the introduction of short-duration contracts, but they would be handled in the same fashion. Short-duration contracts would have a prospective revision approach for accounting for contracts that are substantially unchanged.

There's one element about which I haven't heard a whole lot of discussion. For a contract that's substantially unchanged you carry over the old DAC, but if you have new acquisition costs for your exchange program, those cannot be deferred. I don't know if it's just not receiving a lot of attention yet, but it strikes me as an unusual approach in light of FAS 60, where you had both new and renewal premiums and acquisition costs that would be considered. In this case, if your contract is substantially unchanged, any costs that you have incurred with the internal replacement are maintenance costs, so they're written off.

With respect to sales inducements, if the surrender charge assessed on a replaced contract is offset by the sales inducement to a contract holder, then you consider both the surrender charge and the sales inducement in determining whether there's a net reduction in the contract-holder's account value. In other words, you have to consider both the surrender charge and the sales inducement to see if there was a net reduction. If there's a net reduction in the account value, then the contracts are substantially changed. If the contract is substantially unchanged, then the replaced contract is accounted for according to the SOP 03-1.

Again, it's fairly simple. If your contract is substantially changed, you write off your DAC, any deferred revenue and deferred sales inducement assets. They're not deferred in connection with the replacement contract. Other balances, like the

GMDBs and GMIBs and so on, will be accounted for in a similar manner, as if the old contract was extinguished and there was a new contract that was issued. In this case, your benefit ratio will be computed on a prospective basis on the new contract.

Front-end fees associated with internal replacements should be evaluated for deferral in accordance with existing literature. There's nothing really new here. Both new and existing front-end fees on an internal replacement that results in a replacement contract that's substantially unchanged from the replaced contract should be adjusted to reflect the revisions to the estimated gross profits (EGPs). By the way, one of the things that is a bit problematic in terms of potential implementation issues, as I read the exposure draft, is that the perspective taken here fits nicely into those companies that do a seriatim analysis of their DAC. But if you do any kind of grouped analysis, how do you go through and allocate in a more refined manner on the business that has been grouped for some reason?

Of course, there's the recoverability throwaway line, where you still have deficiency testing required under the DAC and present value of future profits (PVFP). Most of the comments about unamortized DAC would be the same with the PVFP. In other words, if it's a substantially changed contract, any PVFP is written off and would not be reestablished. It'd be a new DAC established, if anything.

I've mentioned that there have been a number of changes from the original exposure draft to the revised exposure draft, mostly in terms of definitions. The changes that are currently being considered are mostly explanatory changes. It's expected to be issued in June, although there were a number of changes, and there's still a question about how far they go and whether they can get to that.

**MR. MAHAN:** I'd like to state that any opinions you hear from us are our own and do not necessarily represent the opinions of our firms, although I haven't heard any that I would disagree with so far. The other thing I'd like to say is that I am sincerely grateful to those in the actuarial profession -- and there may be some of you in this room -- who have worked hard on committees for these SOPs, and I am grateful to the accountants who have put in many volunteer hours on these. Having said that, I think you've come up with two real bears of SOPs to deal with. That's why I am grateful to talk about a subject that we all considered really pretty easy, which is SOX 404.

It's easy to talk about, but that's about the only thing easy about it. But what now? I am presuming in these comments I'm making that most of you are SEC registrants or want to hear what we went through. I'm not prepared to address SOX 404 issues such as where we're going with the NAIC and so forth. My comments are focused for the most part on people who did a total pressure-filled 404 that was audited. Those of you who fall into that category may ask "what now?" What is there to talk about? We're well into 2005, and we have to worry about where we're going from here. I'm going to suggest that from here, whether

it's in 2005 or maybe beyond, that there are three areas that might catch your attention going forward: remediation, sustainability and transformation.

During the 404 process, deficiencies were sometimes identified, and if they were mere deficiencies, management was notified. If the auditors found deficiencies, then discussions were held with management. If they were significant deficiencies, the audit committee was notified. That's escalation; you get them involved. Of course, if it was a material weakness, the public was notified; it was public disclosure. So, the question arises: Why remediate? The auditors have already signed off. Why should we be remediating something that they didn't say needed remediating? One reason is that last year was our first time through. Probably what resulted in many cases was what it took to get by — the least common denominator. In some cases, remediation can actually result in better controls. So that's one reason to remediate existing deficiencies that got passed on.

Another reason is that some audit committees and auditors get concerned if they learn of repeated deficiencies. If it didn't get changed since last year, it can escalate. What was a deficiency this year, if it remains unremediated, next year may be deemed to be a significant deficiency. If a significant deficiency or group of significant deficiencies last year, is left unremediated the next year, the fact that it wasn't remediated may by itself be deemed a material weakness. That's why companies might find themselves in a position of worrying about remediation.

Even more important than that, the remediation probably ought to take place in a process of sustainability. What do I mean by sustainability? Last year was a special event that took every ounce of energy everybody had: the company's, the auditor's and so forth. It's hard to believe you'll have to do it again. It hasn't necessarily been put into a repeatable process that can be sustained. One of the items that could cause this to shift to a sustainable process and that the leading-edge companies are going to be considering is a shift in ownership. It will go from a central project team to get a massive project done — internal audit may have been that team or maybe representatives from different business units — to the various functions, the business units. Where there are actuaries who may have been put in the awkward position of answering questions from project teams and internal auditors, now you may start seeing a movement toward those actuaries becoming the owners of the internal controls for 404.

Another shift in sustainability is that because this was our first year through, in many cases there were important processes that somebody would discover needed a control. Then they would develop a control and superimpose it on top of the process. It got by, and it was tested and deemed to be a proper control. But that's not the best environment. The best environment for sustainability and repeatability is to design the control as an integral part of the process itself instead of having it superimposed. Companies are going to be looking for ways to make that control part of the process, buried within the fiber of the process, as opposed to something superimposed on it.

In the first year of 404, there were a tremendous number of detective controls. That's where you do all the work, but you have people doing reviews and tests on the back end. Those are your controls, just looking for possible errors. We expect there to be a shift over time from detective controls to preventative controls. Of course, that shift will require less effort and save costs if you figure out a way to do it right.

Another thing we expect in a better, sustainable world is better communication between the company and the auditors. When the 404 process started last year and tackled this enormous project about certifying the effectiveness of your internal controls, it started out with great communication between auditors and the company. The auditors were helping with documentation and giving advice and so forth, but gradually, accounting guidance started seeping into the language. That almost suggested avoiding the auditors, because if they see what appears to be missing controls and deficiencies, then that has to be reported and it has to be remediated. We can remediate it, but we may not have time to remediate it to meet the 404 deadlines of having it remediated for 90 days, for example, depending on the control.

Consequently, being open with your auditor in September was deemed to be a bad thing, in case they noticed a deficiency, and then you would no longer have time to remediate it by Dec. 31. The Public Company Accounting Oversight Board (PCAOB) and the SEC both have focused on this area of communication between company and auditors and feel that there was an overreaction in that area. They're encouraging as we move forward that auditors still be in a position to advise. They can advise, but they can't make the decisions. It's not their financial statement.

Going forward, therefore, we expect a better mutual understanding. As we all improve, we expect to see the auditors integrate their review of 404 and internal controls with their review of the financial statements. Under law, they're supposed to be one and the same, but in 2004 that was difficult. As we all become more sophisticated and more refined, that'll be easier to do, and it'll make it easier for the company and easier for the auditors.

My last comment on sustainability has to do with the role of risk assessment. When I gave talks at the beginning of SOX 404 about certifying to the effectiveness of internal controls, one of the key steps was identifying your processes and identifying the risk and focusing on the controls in those areas where there was risk. This could happen at a couple different levels. It could happen at an enterprise level. Huge conglomerates with operations in multiple countries did a good job of saying, for example, our Taiwan operation is immaterial and there isn't risk of an error there affecting our whole organization. But there's another level of risk assessment, particularly for companies where the business is material. The companies, the auditors, all of us didn't do robust enough work on risk assessment of the processes. Part of the reason is because the whole mind-set was so new to both the company and the auditors. In many cases, we were identifying the

processes for the first time. Some companies do their financials the same way every time, but the processes weren't written down. So it inhibited their ability to do a risk assessment on those processes. Now that we've been through it all, we have a better understanding.

This is an area where the SEC and PCAOB have given us a strong focus. A comment made at one of the forums related to concern over controls, saying we had 90,000 significant controls. The SEC's response was that something is wrong there. If your organization has 90,000 significant controls that could result in a more-than-reasonable chance of risk of material misstatement, you're not doing risk assessment properly. The SEC wants it to be top-down. They start at the financial statement level where these assertions are being made and look at risk downward. Too many of you are starting at the bottom, a process through which you build a very mechanistic check-the-box way of moving to the top without that risk assessment. Risk assessment is a top-down process. It has to start at the highest level where you're producing your financial statements because those are what you're worried about misstating. If you start at the bottom, you're not going to be able to assess the risk. You might end up at the bottom, but you shouldn't start there.

Along the lines of sustainability, for those of you who say, hey, we've done it, we can do it again, what happens when people leave? What happens when processes change? If you're a company with 25% turnover, or even 15% turnover, and your detective controls are based on those people doing reviews, you're in a bit of trouble. What happens when new systems are implemented? Businesses are sold or acquired, and processes are outsourced. What happened last year probably didn’t leave us in a good position to address these everyday events. That's another reason we're looking not only for sustainability, but at some point for transformation in the way we look at it.

The way we look at it today is project-driven. The way we want to look at it tomorrow is that it is the way we do business. Today, we might have inconsistent treatments that are superimposed upon the controls. The way we want it tomorrow is to be integrated into the process. The way we do it today is very document-centric. In the future, it should probably be a little more data-centric. The document is the check-your-box mentality. The data is substance risk. Where is the risk? Today we have manual controls. Tomorrow they've got to be more dynamic controls. Instead of being owned by what we call support areas such as internal audit or a special project team, it has to be owned by the business.

Another way of looking at how we need to transform as we move forward is to look at the cost versus the number of controls. The cost of doing your assessment of internal controls is going to go up as the number of controls you're dealing with varies along with how you deal with them. Last year we relied very heavily on manual controls. It’s steep. Each individual control had an exponential level of cost associated with it because we were so manually oriented. What do we want for

2005? We want our controls to be embedded into the process. If we do that, we feel like that cost structure will come down. The curve will not be as steep, and we can deal with change better if the controls are embedded into the process.

Where do we want to be beyond 2005? We want to be in a transformed environment where we look at controls differently, and where the controls are just a part of the way we do business. We could be in a transformed environment where we don't think of internal control compliance as a cost because it's part of all of our processes anyway. Controlling will be so embedded, so much a part of the way we do business, that the cost structure is even lower. This is where we want to move to the future.

In 2005, we want to move into a more operationalized environment — an improved environment. It's got to be better in 2005, and we're going to do the things I've talked about. We're going to have better risk assessment. We're going to decentralize. We're going to have embedded controls. As businesses grow, processes will change and systems will be upgraded. Ultimately, we want to be in a transformed environment where CEOs, CFOs and the audit committee and boards demand better, faster and cheaper information. Too often we think faster, better, cheaper doesn't apply to us because we have our methods and they take time. But that's not going to be acceptable – the CEOs and the environment are going to demand faster and cheaper information.

The common expression I hear today is we want to comply, but don't you dare make us do more than you're making our competitors do. But don't think that, because when you're in a transformed environment the concern is going to be are we doing more than our competitors? I hope your answer is yes, because if you're not, then you're at a competitive disadvantage. If you get wind that your competitors are doing more, that's a red flag that you are at a competitive disadvantage, and the audit committees and the boards should be looking for that. You will need a total flip in the mind-set from, "We don't want to do more," to, "We have to do more." Otherwise, you're no longer going to be in business.

**MR. WHITE:** Let me go back to a question that was asked about the amortization period for the contract exchanges. The illustration that's given in the draft SOP uses a 20-year amortization period for all of the work that's shown in the example, but the exchange also occurs relatively early in the period. I thought I ought to clarify that.

**MR. BRUCE R. DARLING:** I've been around since before GAAP and I saw GAAP get implemented with the FAS 60 audit guide, best estimate with provision for adverse deviation, FAS 97 and best estimate, and now SOP 03-1 where you're supposed to look at a range of outcomes, which I guess everybody is interpreting as stochastic rather than a deterministic mid-range. There was an article recently in *The Financial Reporter* about that. In dealing with consistency with DAC, do you see your clients or people in the industry trying to do some stochastic DAC on FAS 97? I remember

that somebody wrote an article a year or two ago where he proposed that or said that he was doing it.

**MR. MAHAN:** Yes, it was Alastair Longley-Cook, when he was at Aetna. They implemented that, and he wrote an article about a stochastic DAC based on corridors. It wasn't the stochastic result where you ran it and booked it. Instead, you ran it, observed it, compared it to certain corridors, and if it stayed within a corridor, then you went with your deterministic result. It was sort of like that, but there was a very heavy stochastic element to it. They've since sold all that business, so whatever he was doing isn't being done by them anymore, though somebody else may be doing it.

**MR. DARLING:** I was curious about that because one side of me says to follow the guidance that says to use management's best estimate, which seems like deterministic.

**MR. MAHAN:** What you're dealing with is the problem with all of our guidance. Until SOP 03-1, all of our guidance was written in a 1940s environment mind-set where there is such a thing as best estimate. As the economic environment changed and we got more sophisticated, we suddenly realized in many of our activities such as cash flow testing and all these things that the clarity of what was best estimate wasn't clear anymore. Yet we were stuck with FAS 97, which acted like it was clear and doesn't even breathe the word stochastic. I know there are many people who say that you can't use stochastic because FAS 97 says best estimate, and there's a debate about that. My personal view is that our views of best estimate have to become more sophisticated and encompass the latest tools we have available to come up with what we think best estimate is.

**MR. FARRELL:** I would like to echo Steve's comments that it does say best estimate, and it is being interpreted as one single deterministic scenario as far as FAS 97 goes. But with SOP 03-1, I think a lot of people are encouraged that maybe this is the break, the crack in the wall, so we will see the next round or a future round of changing guidance that will open it up more and allow more in the direction of stochastic scenarios, perhaps maybe even going back and revisiting the universal life and annuity contracts that have been accounted for in the method for so long. Another catalyst that might cause it is mean reversion, which I think just isn't working the way some people had hoped for and wanted it to. To the extent that that's not the solution, and we still have the same set of problems before and after mean reversion came about, there may be further reason for FASB to consider some modifications.

**MR. MAHAN:** You don't hear it said very often, but it's true that accountants and actuaries have never demonstrated the ability to handle accounting issues that require the prediction of future equity performance. We can do mean reversion and pretend all we want, but the truth of the matter is that we're just fish out of water. How well are accountants dealing with the expensing of stock options? They didn't

deal with it well. They struggled, and they didn't address it for a long time. Now they've addressed it, and within the accounting profession nobody knows whether the way they addressed it is the right answer or the wrong answer. They're dealing with financial reporting for items that involve predicting future equity experience, and that's an area where none of us have gotten to a comfort level yet.

**MR. DARLING:** We're starting to see a lot more stochastic valuations like the NAIC variable annuity Commissioner's Annuity Reserve Valuation Method (VA CARVM) and risk-based capital (RBC) C-3 Phase II. But everybody's heard of Moore's Law; that computer firepower doubles every 18 months or so. I proposed Darling's Corollary, which is whatever computers allow us to do they'll make us do. I was wondering if anybody was jumping the gun by pushing for stochastic DAC at this point, but thanks for your comments.

Another question I have has to do with the significance of mortality in SOP 03-1 and the determination of whether an additional reserve is required. It seems like you're reclassifying, for example, variable annuities with significant mortality from investment contracts to UL-type contracts by determining that. It seems to me if you do that, then you're opening the door to loss recognition, which has been denied to investment contracts ever since Practice Bulletin 8. I was wondering if you looked at it that same way. Also, do you think some of these companies that have been hurting so badly ought to be taking loss recognition at this point on some of these contracts with toxic waste attributes, as I heard one actuary call it?

**MR. FARRELL:** Are you alluding to the variable annuities?

**MR. DARLING:** Yes, in particular, but any investment contract that has significant mortality, you're essentially reclassifying as UL-type which then makes loss recognition possible.

**MR. FARRELL:** I think in most cases they could always make the argument that they could still break even or even make a little profit. So even if it looks like it's hurting now with a lot of contracts in the money, and seemingly they're going to be paying a lot of death benefits in the future, conceivably they could just increase their charges and bring it back into good graces. There's also the grouping that I think I've talked a bit about aggregating before, and there may be a problem case from way back, but that may be washed out with enough "good" blocks of policies, so that in the aggregate that looks OK. I don't know if anybody's in that position yet, ready to jump on loss recognition, but I believe, as you indicated, it probably opens the door.

**MR. MAHAN:** Regarding your comment about it not being applicable to investment contracts, the spiel I've always given is that you can't strengthen reserves on investment contracts, but you can write off DAC.

**MR. DARLING:** Two parts of it, but, it's the second part that I was thinking would now be applicable if you had this additional mortality reserve, that you might end up with loss recognition as well.

For FAS 97 contracts, a lot of companies use a worksheet method where they have one worksheet for each product for each issue year, and they're dealing with this replacement issue where you can have all these little pieces of this kind of contract from that old form rolling over into the new one. Do you think people just roll them into the DAC for the new policies of that replacement type and just amortize it altogether, or do you think we're supposed to make people create their own worksheets for each little combination of replacement policy and original policy?

**MR. MAHAN:** The way I read the draft SOP, they assume you do it seriatim. If you don't, then you have a number of practical issues. I would not be happy walking into a company and insisting they create a number of new segments if they're using a worksheet method. There are some practical issues to work through, and when we get ready to work through them there may or may not be guidance at that time to help us with that.

**MR. DARLING:** So what you're saying is that at this point people just see that as a cloud on the horizon?

**MR. MAHAN:** Right.

**MS. MARY H. SIMMONS:** This issue that he was just bringing up — the DAC being calculated in the aggregate, yet somehow we're supposed to adjust at a policy level — seems to me to be a very heavy cloud on the horizon. Given all the problems that happened with SOP 03-1, is the accounting profession looking at trying to address this proactively at all to avoid the same kind of nightmare? Or are we looking at another nightmare?

**MR. MAHAN:** I don't know quite how to answer that. They're addressing a number of comments that were received subsequent to the second draft. The comment letters are public, and I don't know that I saw a lot there that would flag this as a major issue. But it strikes me as something that is going to take a lot of care in getting into a practical solution. If you're doing a grouped method already, it's going to take some care to get where they say you should be.

**MS. SIMMONS:** Is the actuarial profession looking at doing any kind of proactive work with the accountants to try to come up with guidance earlier rather than later?

**MR. MAHAN:** There is a group with the Academy that is following this very closely. There likely will be some practice note guidance prepared by the Academy that will try to address some of the practical issues. I don't know that we'll find a prescriptive solution in the SOP. It seems that the more they write, the worse

things get, and so you'd almost rather have the implementation after the issuance of the SOP.

**MR. FARRELL:** Let me just point out, too, with the literal reading of the draft SOP, you've got to take the group method and almost go seriatim to make things feasible and make them work. Practically speaking, if you have a low volume of internal replacements, then maybe it's not a big deal. Similarly, once in a great while, there's an internal replacement campaign where there are significant volumes. Maybe you make special deals and split that out separately. But as far as seeing the final version looking different than the two exposure drafts, all I've heard is that we're not going to see that. The parts that pertain to this issue are going to be, for the most part, as we have seen them already. What's done is done. People supposedly had their opportunities to write in and to campaign against it over the past three years, but it seems like the AICPA has made up its mind.

**CHARLES D. FRIEDSTAT:** I agree with everybody's comments so far. I think you are going to see an implementation. It's my opinion that you'll see more emphasis on practicality. I think the inclusion of the prospective option that David talked about was a direct reflection of comments from people who had been accounting for internal replacements prospectively. My impression is that the companies for whom it was material were using that approach. I also think that there are going to be some approximate procedures. You're not going to see companies doing this on a policy-by-policy basis. They're going to have to make certain assumptions about the DAC that's being carried over and, like anything else, have an approach and have support for those assumptions. But I think that, as the person said before me, there are a number of practical issues, and I hope that reasonable approaches will be developed to handle them.

**MR. MAHAN:** They have stated that the reason they were giving an extra year for the required implementation date was to allow these issues to be vetted and the companies to work it through.

**VINCENT Y. Y. TSANG:** Let's say a company has only 10 policies replaced. The cost of doing it is far heavier than the transfer over. Is this SOP requiring that a company must carry the DAC over or is that just an option?

**MR. WHITE:** I am searching to make sure that the new draft still has this item about it not being applied to immaterial items. I recall that language was in there. If you've got a situation where it's clearly an immaterial component, I can't imagine that the companies or the auditors would insist on going through the SOP by rote. Because you have the ability to unlock, and you have the ability to look to how you can develop methods of allocating between policies that are replaced as part of an exchange program and those that aren't, I think it'll be a situation where you just take care in the assumptions. You look at different approaches and come up with something that works with the method you have. I can't envision companies that

do a grouped method moving to seriatim because of the SOP. There are going to be practical approaches that people come up with just to make it work out.

**MR. MAHAN:** I don't know this for a fact, but I'm under the impression that, after going many years with no guidance, the reason they finally addressed what would be appropriate facts and circumstances is that the industry was going through major replacement programs of annuities, especially. Unfortunately, in addressing huge replacement programs where you could be in a position to really respond in detail, it's bringing in the little stuff. Hence, it brings in a question such as you asked, about incidental replacement that happens every day that we normally don't even monitor or aren't even aware of in many cases.

**MR. WHITE:** I think this may be under the radar a little bit, as people's focus has been on the SOX issues lately. There really were surprisingly few comment letters that were written, and a number of the comment letters essentially argued that this shouldn't be done at all, which didn't provide a lot of useful input.

**MR. MAHAN:** I had a client whom I asked, as we were going through SOX, based on where this internal replacement is going, how do you see yourself responding to that? He said, well, we see a few issues there, and under the new rules we think we're going have to make some changes, but we're OK under the old rules. And I asked, what are the old rules? He thought for a second, and he said, well, actually there aren't any old rules. I thought here we are, going through 404, saying what they're doing is right. They're claiming they're OK on the old rules, and then when I ask them what the old rules are, they say there aren't any. It was an awkward position to be in, but I think maybe some remediation can be brought in.

**FROM THE FLOOR:** Let's do a question on 404. PCAOB came out last week with some new information. Any thoughts on what that might imply?

**MR. MAHAN:** People were looking for more specifics and they didn't get them. The SEC had a big share forum, and I think a lot of what the PCAOB did was, to some degree, linked to what they heard at the share forum: too many processes, not enough risk assessment. They heard about communication issues and the embedded controls. Some of the concepts I talked about today came from what the PCAOB said, and the SEC had a release as well. One of the things I learned was that the issues the whole company is dealing with are just as applicable to all the actuarial areas as they are to the rest of the company.

What they write should be read by the actuaries as applicable to them and as informative to them as something that's as head-on as actuarial issues of SOP. I would encourage all of you to get your hands on PCAOB's recent guidance. The other thing they emphasized was that this issue of too mechanized, too check-the-box, too ground-up, and that it needs to be management's assessment reflecting their facts and circumstances, not one size fits all. I hate to hear this "facts and circumstances" because that's how we got into trouble on internal replacements.

Nevertheless, they're trying to avoid a check-the-box environment. Their answer to avoiding that is for you to look at the assertions you're making on your financial statements and the risk that they could be materially misstated, and you respond that way. That was the biggest message they gave.