1990 VALUATION ACTUARY
SYMPOSIUM PROCEEDINGS

GAAP -- RECOVERABILITY/LOSS RECOGNITION

John Glass

Recoverability

This issue involves the recoverability of the deferred policy acquisition cost (DPAC) asset from future revenues.

In any given policy year, costs deferred should be determined according to three criteria:

1. Acquisition costs deferred must fit the definition of costs as deferrable (per FAS 60).
2. Acquisition costs deferred must not exceed what is actually expensed under the above definition.
3. Acquisition costs deferred must be recoverable from the revenue stream.

As the book of business ages, the ongoing recoverability question revolves around item (3) above.

For products governed by FAS 97, recoverability of the DPAC asset is addressed periodically through the unlocking process.

For products governed by FAS 60, recoverability of the DPAC asset is addressed through the discipline of the loss recognition process. This process also involves the adequacy of the GAAP benefit reserves.

Loss Recognition

Under FAS 60, a periodic determination must be made of the adequacy of the unitary GAAP reserves (UGRs). The UGRs are defined as the GAAP benefit reserves minus any related GAAP D&U premiums and minus any related DPAC asset.

The UGRs are adequate if they, along with the present value of future GAAP revenues, will provide for all future GAAP benefits and expenses.

If this adequacy test is not satisfactorily met, then the loss recognition rules of FAS 60 come into play. Essentially, the amount by which the UGRs fall short should be recorded as a loss in the current accounting period. Any given component, or all components, of the UGRs may need to be adjusted, depending upon the root cause of the inadequacy.

Summary

Recoverability and loss recognition are key concepts of GAAP accounting. Careful monitoring is appropriate to avoid material undesirable impacts on earnings for the current period. These concepts reflect a generally conservative accounting philosophy, under which (a) anticipated losses are provided for; and (b) anticipated gains are recorded when realized.

ALLOCATION OF MORTALITY, PERSISTENCY, EXPENSE AND INVESTMENT INCOME INCLUDING CAPITAL GAINS AND LOSSES

John T. Zellner

Definition

This is the allocation of actual company experience for a given calendar year to the various product groups and years of issue within product group.

Why Important?

The allocation of actual calendar year experience is important for the proper unlocking of amortization schedules applied to deferred acquisition costs.

It is also important to develop accurate source of earnings reports and accurate overall profits by business segment for given time periods.

Issues

How is investment income allocated when assets are not segmented? Is segmenting necessary?

What are the problems in reflecting capital gains and losses? Does FAS 97 encourage or discourage taking capital gains or losses?

What are the ways to allocate experience? What are the practical ways to allocate actual experience when experience studies are performed at levels where there is product grouping and years of issue are combined?

Must allocated invested assets equal the account value?

TREATMENT OF NONDEFERRABLE COSTS
John T. Zellner

Definition

Nondeferrable costs consist of all expenses other than deferred acquisition costs. This consists of nondeferrable acquisition expense, maintenance expenses, and all others.

Why Important?

Only expenses that are deferred must qualify as GAAP deferrable expenses. A proper classification of expenses is required.

The proper definition of contract administration expenses is required in order to develop appropriate amounts of estimated "GAAP gross profit" to use in the development of amortization scales.

Issues

What expenses are acquisition expenses but are not deferrable?

What are contract administration expenses?

UNLOCKING
John T. Zellner

Definition

Unlocking is the process of changing the deferred acquisition cost amortization schedule to reflect actual to expected differences in prior-period "GAAP Gross Profits" and revisions in future estimated "GAAP Gross Profits" as defined by FAS 97.

Why Important?

The reporting of GAAP income for products subject to FAS 97 requires that total amortization to date shall reflect actual past experience and updated revisions of future expected "GAAP Gross Profits."

Issues

How often is unlocking required? Quarterly? Yearly?

To what degree should there be unlocking? Can there be partial unlocking?

What is unlocking exactly? Should items other than mortality, lapse, expense and interest assumptions be considered in the unlocking process?

What are the problems in using small or simplified models to amortize DAC when unlocking occurs?

How are actual GAAP gross profits reflected when the model is based only on a sample of the inventory? (Model "Gross Profits" are not on the same basis as actual "GAAP Gross Profits.")