
2002 Valuation Actuary Symposium

September 19–20, 2002

Lake Buena Vista, Florida

Session 14OF

GAAP Issues

Panelists: Scott Wright
Robert Flannery
John Esch

Summary: This open forum addresses current issues of interest to actuaries in the application of U.S. GAAP. Topics discussed include demutualization issues, draft standards of practice regarding nontraditional long-duration contracts, guaranteed minimum death benefits/living benefits, sales inducements, separate accounts, business combinations and FAS 141/142 and policy conversions and exchanges. Experts in the application of U.S. GAAP to life insurance companies lead discussion on the theoretical and practical aspects of these topics and other emerging issues.

MR. SCOTT WRIGHT: We have three presentations and then we'll take questions from the audience. I am with KPMG. I'll be speaking on nontraditional long-duration products, and the newly exposed SOP that came out. Bob Flannery is from USAA. He'll be speaking about deferred acquisition cost (DAC) on internal replacements and the work that's going on as far as that committee is concerned. Then John Esch from Deloitte & Touche in Minneapolis will be talking about some purchase GAAP issues.

There's a new draft Statement of Position by the AICPA on nontraditional long-duration products. That draft SOP discusses three, main, technical areas—separate accounts, the valuation of liabilities under *FAS 97*, and sales inducements, again, mainly for *FAS 97* contracts.

Obviously, with any new regulation, there are some additional disclosures that are discussed, as well as transition rules and the effective date. This draft SOP was exposed in July of 2002. Comments are due by the end of October.

The draft SOP discusses separate accounts, and it defines the accounting for separate accounts similarly to how we see them today, although there are some changes. First, the separate accounts are valued at fair value. The liability is equal to the fair value of the assets backing it. However, there are some rules about which assets you can include, mainly those that are contractual liabilities. The draft SOP discusses four main criteria that a separate account must meet to qualify for separate account treatment, so you do have to meet all four of these. The separate account has to be legally recognized. In the United States, there's specific separate accounting that we see, but that could be an issue for other countries that don't necessarily have the same concepts that we do.

Separate account assets are legally insulated from the general account liabilities so that any type of claim on the general account liabilities can't come after the separate account assets. The separate account investments are directed by the contractholder, and the investment performance passed onto that contractholder, less any fees and assessments. So, the accounting implications that we see in the new draft SOP is that market-value adjusted (MVAs) annuities, GICs, and equity-indexed annuities fail the definition of separate accounts. You would not be able to consider those as separate accounts today.

The reserves for minimum guaranteed benefits are held in the general account, not in the separate account. Seed money that you put into the separate account must be reclassified under—and put into the general account. That poses some logistical problems for many companies. There are rules about transferring funds into the separate account, but that needs to be done at fair value, and the gains and losses are taken into the general account at the time of the transfer.

The next topic that the draft SOP discusses is the valuation of liabilities. Under *FAS 97*, we've become very much familiar with the accretion model. The account balance is equal to deposits, net of withdrawals, plus credited interest, less fees and charges. When *FAS 97* came out, that was

all well and good, and most people could easily identify these amounts. However, when we started talking about new income benefits and two-tiered annuities, that became a little confusing. So the draft SOP clarifies that the credited amounts that we're talking about are credited interest that is available in cash or its equivalent at the time that the contract surrenders or matures. Of course, the account balance is before surrender charges as well. The net result of this for two-tiered annuities and any type of annuities with multiple account values is you're going to take the highest account value that's available in cash or cash equivalents. Of course, there is no reduction for surrender charges or MVA charges. So there is no addition or reduction for MVA charges to your liability.

One of the themes that you see in the draft SOP is that the accumulation phase is very much separate from the annuitization phase in that any annuitization benefits are considered to not be part of the accumulation contract and not valued. This, again, is a very contentious issue for most people. There's also a provision in the draft SOP for which I'm kind of hard-pressed to find an example. A group contract is where you might be able to find this. It should be a contract where your credited interest is referenced to a pool of assets, and yet that contract isn't accounted for under *FAS 133*. The interest credited there and the account balance are going to be based off of the fair value of those assets, even if the assets backing that are not at fair value.

You've probably heard already several times today that there's no liability for annuitization features considered in this draft SOP. The accumulation phase and the payout phase are considered separate contracts, and the reasoning behind that is that the committee didn't want to record potential impacts for future potential events. They feel that that's consistent with current practice in the SEC interpretation as far as accumulation benefits are concerned. My big problem with it is that it could quite possibly overstate income during the accumulation phase, and you could very easily see a loss when a policyholder decides to annuitize.

If we talk about annuitization features, such as market-value adjusted annuities, they do not meet the criteria for separate accounts. They must be accounted for under normal *FAS 97* accounting. The MVA cannot be taken into account when determining what the *FAS 97* liability is. There is either an increase or a decrease to that liability. In most typical two-tiered annuity products,

you're going to see the lower of the two tiers being used as the reserve with no additional liability credited for the second tier.

Guaranteed minimum income benefits are a very contentious issue. If the guaranteed minimum income benefit can be net settled, then you account for that under *FAS 133* as an embedded derivative. In the general case, if it's not net settled, then there's no liability that you can set up under *FAS 97* and under this draft SOP. Again, this is a change in a lot of people's views of what they think a liability should be for these contracts.

The draft SOP also discusses, in detail, mortality and morbidity guarantees and reserves that you could possibly hold for that. First, they talk about whether the contract is an insurance contract or an investment contract. There's a significance test on the mortality or morbidity element in which you compare the excess of the present value of the benefits that you expect for that benefit. All forms of revenue—not just those for the benefit but all the assessments for the contract. In doing this, you're asked to look at reasonably possible outcomes. This significance test is done once at contract inception. However, when the SOP is adopted within the company, then you need to perform the test at the date of adoption for all contracts that are in force.

Contracts that fall under the insurance category with significant mortality or morbidity risk need to have that benefit reserved for in the case where the benefit is not proportional to the charges that you charge. This pertains to typical guaranteed minimum death benefits under variable annuities where you're charging a percentage of the assets for the benefit, but the actual benefit fluctuates with the market. There's no real link between the two items. I think there's an example of level cost of insurance (COI) products for universal life in Canada. I think Canadian products would fall under that.

The reserve that they ask you to calculate in the draft SOP is kind of a mixture between *FAS 60* and *FAS 97* concepts. It's a retrospective accumulation of the assessments that you charge times a benefit ratio; then, from that balance, you would subtract off all the benefits and the expenses that you pay for this guaranteed minimum death benefit. Of course, the reserve is accrued at interest, which I assume would be the credited rate, although I don't think it's explicitly

stipulated in the SOP. The benefit ratio would be the present value of your benefits and expenses that you expect to pay divided by the present value of the assessments that you are going to receive under the contract. So, the reserve itself looks like a *FAS 60* type of reserve; it is just a retrospective look at the reserve. However, as actual experience emerges, you're going to replace your estimate of what the benefits and expenses were with what actually happened. If you unlock the benefit ratio, the reserve kind of falls under the unlocking type concepts in *FAS 97* as well.

There are some typical rules that you would find. You can't hold a negative reserve, so the reserve has to be greater than zero. The reserve should be based on a range of reasonably possible scenarios. Stochastic valuation is implied very strongly there. You have to look at your actual experience and regularly reevaluate your future expected experience. I have one other note as far as the DAC is concerned for this type of business. Holding a reserve and changing how you account for the benefit is going to affect your estimated gross profit (EGP) stream, which should change your DAC amortization.

The last major topic on the draft SOP is sales inducements. These are your higher credited rates in your first year or possibly persistency bonuses in year 10 and year 20. To get the special treatment for sales inducements, you have to show that two criteria are met: (1) that the incremental amounts are credited as compared to contracts without this benefit; and (2) that the higher credited rate would be lower in the future. You just have a heaped credited rate in the first year or in some future year. Day one bonuses, persistency bonuses, and enhance credited rates fall into this category.

There are two different sides to the sales inducement. There's the liability side. If you have a sales inducement that occurs in the future, then you need to account for that now, and the accounting is that the liability should accrue over the period in which it's earned. If you have a sales inducement that occurs in year 10, then you need to start setting up a liability now. That liability would be over EGPs. Then there's the other side. If you have sales inducements in the first year, then that sales inducement needs to be amortized over the life of the contract because that's an expense that the insurance company has at the beginning, and that's very similar to a

deferred acquisition cost. As a matter of fact, it's so similar to a deferred acquisition cost that it's going to be amortized in the same way. However, it's going to be called something different. There is going to be a new line on your income statement called deferred sales inducement.

Another contentious issue that pops up in the SOP is the fact that for future sales inducements (ones that don't necessarily occur at issue), you cannot recognize lapses in determining the amount that you need to hold for your liability and the amount that you end up capitalizing at issue. The amortization of that liability is done over a stream that does include lapses. That seems a little inconsistent.

FROM THE FLOOR: How would you contrast this to an annuitization bonus?

MR. WRIGHT: They see the accumulation in the annuitization phase as two, very distinct contracts. So anything that happens at annuitization would be taken care of in that second contract. The first contract is the accumulation contract. These amounts are going into the accumulation. I see your point. You can have two, very similar benefits accounted for very differently, but I think the SOP is pretty clear that if it's an annuitization type benefit, then that is taken care of later.

FROM THE FLOOR: How do you recognize lapses?

MR. WRIGHT: I guess my statement is about lapses in general. If you are looking at a benefit that happens in 10 years (say it is a persistency bonus), then you have to assume that the policy is going to persist to year 10 and to calculate what that amount is. When you're reserving for that amount, you assume that the policy persists, as well as that amount is also going to be spread over the life of the contract under a deferred sales inducement. The amount that you capitalize is also going to be determined in the same way that there are zero lapses and that the policy exists. However, when you go to calculate the amortization of that amount, you are doing that over EGPs, which do include lapses as a component. So, there's a disconnect between what you're capitalizing and how you're amortizing it. Many people think that that's an issue that needs to be addressed within the SOP.

I think it relates more to the amount that you capitalize. You can make it work, but it just doesn't make sense at the end. I think the results don't make sense anyway.

There are several new disclosures required. Separate accounts have to have some wording around them as far as the nature of the separate account, the timing, and the extent of the guarantees that are in the separate account. Seed money that is within the separate account needs to be specifically disclosed as well. There are also sales inducements, the nature and cost capitalized, the amounts amortized, and the unamortized balance. I think you see disclosures that are very similar to DAC disclosures under *FAS 97*. Then, additional liabilities, methods and assumptions for calculating liabilities that are above the account balance are similar disclosures to what you see on a lot of our reserves.

Essentially, the effective date is for reporting periods beginning in 2004. The technical date is for fiscal years beginning after December 15. Early adoption is going to be encouraged. If this becomes final early enough, you are allowed to adopt it for 2003. Most of the changes that you see are going to result in cumulative effects that are going to go through income in the year that you adopt the change. Again, the public exposure period ends on October 31, 2002. We're all asked to send in our comments—not only critiques of the methods in the SOP but also solutions to the problems. That was made very clear at the beginning of the draft SOP. I thought that was kind of fun.

Regarding the additional liabilities that you set up, the significance test for the *FAS 97* contracts takes place at the adoption date for in-force policies only that one time. You don't have to redo that every year. When you do the significance test for the mortality or morbidity, then you use actual experience that has emerged since the inception of the contract, and then there is best-estimate future expectations. Again, the change in the liabilities that you create as of the adoption of the SOP goes in cumulative effective through income, and that cumulative effect would modify your EGPs as well.

Sales inducements. The big thing about sale inducements is if you were already deferring sales inducements, then you can continue to hold that balance that you have. However, in the future,

you're going to have to amortize it according to the principles in the draft SOP; however, I think most people probably were already doing that. You cannot go back and capitalize sales inducements that you weren't accounting for as deferred up until now, so this one is a prospective transition.

At KPMG, our New York office put together a roundtable where we invited several different companies to come in and give some opinions as to what they thought of the draft SOP. They kind of just batted it around for a little while to see what they thought. We ended up putting together some key issues from that discussion that we plan to submit to the AICPA. I think most people thought the mortality and morbidity significance test was too prescriptive to actually have the test described within the SOP as the ratio between the benefits and the assessments. Most people liked the minimum guaranteed death benefit liability because of the way it was using assessments.

I think one main comment that came out, though, was that the draft SOP said that you were going to use the revenues or the assessments when you calculated the minimum guaranteed death benefit liability and the significance test. However, they talked about also including the spread, which, in my mind, says you're going to take out the credited rate. I wasn't necessarily sure, and I think there is a little bit of haze around what they meant by putting in the credited rate. Most people were just adamantly opposed to the exclusion of annuitization features—the guaranteed minimum income benefits and the two-tiered annuities. They just felt that it was wrong to not hold a reserve for those. Again, we're preparing written responses to the Accounting Standards Executive Committee (AcSEC) based on that roundtable. Now we're going to let Bob Flannery take the stage and talk about DAC on internal replacements.

MR. ROBERT J. FLANNERY: I was invited to speak by our auditors who happen to be with KPMG. I'm going to give you a company perspective, and the main conclusion I would draw for you at the end is continue to work closely with your auditors because there are a lot of things about the SOP that are qualitative rather than quantitative. That has been an evolution in what I've seen on the SOP itself.

I'll talk a little bit about the timeline, current literature, the schematic of the Statement of Position, which continues to evolve, a definition of an internal replacement, tests to see whether any internal replacement is substantially different or not, how you'd account for one that is substantially different and for one that is not, and the transition.

There has been a lot going on over the last several years, at least in early 2001. My own recollection is we've been talking about this for a very long time. In that sense, it reminds me a lot of Guideline XXX where you think adoption is just at the edge of your high beams. As you keep driving, the adoption keeps moving. I recently got an e-mail that is showing the most current draft of the proposed Statement of Position. I think there's probably even some renumbering of paragraphs.

You should be able to find the current draft of the FASB Website or the AICPA Website. Any of the major search engines would point you there if you were to type in FASB or Emerging Issues Task Force. That's how I've often found some literature on it. There are some changes in the draft. Based on that, I don't know that you'll have AcSEC approval in late 2002, but that is the current expectation. There is the FASB public exposure period, and the final SOP in the second quarter of 2003. Of course, all of these dates are subject to change, though I hope with notice. As Scott mentioned, right now the expected adoption date would be for fiscal years after December 15, 2003. As always, early adoption is encouraged.

In the current literature, the official title of the draft Statement of Position is the Accounting by Insurance Enterprises for Deferred Acquisition Costs on Internal Replacements Other Than Those Specifically Described in *FAS 97*. I dare you to say that without taking a breath. Those of you who have *FAS 97* memorized probably remember Paragraph 26 with great affection. It was talking about when you would surrender a traditional life insurance contract and replace it with a universal life type contract. What that paragraph said is, any unamortized acquisition cost associated with the prior or the replaced contract, or any difference between the cash surrender value in the previously recorded liability shall not be deferred in connection with a replacement.

You get some further guidance in subsequent paragraphs 70 through 72. *FAS 76* talked about the extinguishment of debt. The Emerging Issues Task Force 96-19 interpreted *FAS 96* in such a way that you could have had a prior debt. You do a debt exchange, which does not contain any substantive modifications. In the document, it was called substantially different. When that happened, the result was you had the prior debt with its unamortized amount, new fees for the exchange of debt, and the conclusion that those should be amortized over the life of the new debt. An exchange or a modification in terms that is not substantially different doesn't result in an extinguishment, in this case, of the prior debt, and that means that the new debt is a continuation of the old. Of course, we're going to draw an insurance analogy.

The Statement of Positions schematic. Is the SOP even applicable for your situation? Here you would review any contract modification being proposed. This is substantive. It doesn't matter about the form of the modification, but is there a change in substance? You'd evaluate that based on Paragraph 17 of the SOP. I'm not sure that it's still Paragraph 17, so please read it. On one side, you would look to see whether you have one of those two criteria satisfied? If so, you don't have to do any further evaluation for implementation of the SOP.

If neither of those criteria is satisfied, then you go down the right side of the schematic and look at the substance of the modification under Paragraph 8. If all of the criteria of Paragraph 8 are satisfied, and we'll get to those in just a minute, then you have an internal replacement, but it's one that is not substantially different. You account for the DAC on the original contract and with this modification as a continuation of the original contract. If you have at least one of the criteria not satisfied, then you have an exchange that is substantially different. It counts basically like an extinguishment, and you have to account for this as a new contract, not a continuation.

What does the draft of the SOP say? This is where we're referencing what was at least numbered as Paragraph 17. You're looking for a modification in substantive terms, product benefits or features that occur by amendment to the contract, a rider to the contract, or election of a feature within an existing contract, or by the exchange of one contract for another. Then you look to see whether those changes are made in accordance with existing contract provisions, as

referenced by Paragraph 17, and whether they would not require evaluation under the criteria of Paragraph 8.

Under Paragraph 17 no further evaluation of a utilization of the SOP is required if either of these two conditions exist. There is a change in cost-of-insurance charges, crediting rates, or similar provisions within ranges outlined in the contract without any changes in benefits. Let's say that you are currently paying a cost of insurance (COI) charge of 20 cents per thousand per month. It changes to 22 or 23 cents under operation of the contract. That would not be an internal replacement. What about election of a rider or a feature present in the original contract that doesn't change the primary nature of the contract or the contract's amortization method or revenue classification? In that case, you don't have to do an evaluation for an internal replacement.

The key is in Paragraph 8. The attachments to the document read like a mantra. When you're trying to determine whether or not an internal replacement is substantially different, there are four things you'll want to continually look for. (1) Does the modification result in a change in the inherent nature of the contract? I'll give you some specific examples in a minute. (2) Do you have to make an additional deposit or a premium on the original benefit or is one not required to effect the transaction? If, on the other hand, you do have to make a change in premium, but it's commensurate with a change in the benefits, then that's deemed not to violate this provision. (3) Is there no net decrease in the balance available to the contractholder when you'd made this modification? As a quick example of that, let's say you have a single premium deferred annuity. You're in the surrender charge period, and to go from that contract to a new contract, you'd only transfer the value after the application of the surrender charge. That's a reduction in the balance available, so that would violate, number 3. (4) The modification does not result in a change to either the amortization method or the revenue classification of the contract. You can probably think of some examples readily, but we'll have some in a minute.

After Paragraph 8, you'd have some clarification of some of these. How would you evaluate those four things? What does Paragraph 9 say is the most important thing you'd look for in the combination of mortality and/or morbidity risk and the investment crediting arrangement. Those

are the things that define the inherent risk of the contract. If there's a significant change in those, then you'd have a contract and an internal replacement that is materially different. There are some quick examples. If you've had a term insurance contract, and you change to a whole life contract, either PAR or non-PAR, that would represent a significant change in the inherent risk. As such, you'd have an internal replacement that is substantially different.

If you have a variable annuity with a nominal death benefit, and I know sometimes nominal is in the eye of the beholder, that is something. If you have any doubts, check with your auditor, but if you can agree that you've gone from a contract that has either no death benefit or an insignificant one, to one that has a significant guaranteed death benefit, that would also represent a significant change in the inherent risk, and it would result in an internal replacement that is not substantially different. If you went from a variable annuity to a general account fixed annuity, that would also be substantially different.

How about some examples that represent no change to the inherent risk? One might go from a general account deferred annuity to an market-value-adjusted annuity (MVA). There is some discussion of this in the attachments—but the thought here is that there is really no significant change in the surrender charge, or it's not material enough to matter. The crediting philosophy is the same, and the other general contract features are the same.

Disability income (DI) with a long-term care (LTC) rider. You'll see the note that assumes that the value of the rider is a minority benefit. You're not changing the essential risk characteristics, (i.e., DI should predominate). If, on the other hand, you had an LTC rider where it became the predominant benefit, then what I said would not apply. Another thing that's no change in the inherent risk is if subsequent to policy issue, you offer the contractholder additional investment options in their variable contracts. So they preserve all of the rights and privileges, and you've given them something.

How do you account for internal replacements that are not substantially different? In a nutshell, they're accounted for as if you have a continuation of the original contract. What that means is if you had any unamortized deferred balances from that contract, you continue to defer those. That

would include your unamortized DAC and some of the things that Scott was talking about like your unearned revenues, and your unamortized deferred sales inducements. So this dovetails with his presentation. You now have this separate bucket for your unamortized deferred sales inducements.

FAS 60 for renewal acquisition costs. When you've gone from your original contract to this additional contract, this exchange that's not substantially different, you will incur some acquisition cost, if nothing else, and some additional issue costs. What you then do is you take a look at those acquisition costs and any front-end fees that you've incurred for that internal replacement activity. You evaluate whether they are eligible for deferral under the *FAS 60* and existing accounting literature. What it says is any additional costs should be treated similarly to those costs associated with renewals. Sales inducements that meet the criteria on the new SOP that Scott mentioned should be accounted for as if explicitly identified in the original contract at inception.

An activity that is not considered a replacement activity might actually be considered not substantially different. You need to be careful of riders not contemplated in the original contract. I very much agree with this. Definitions of not substantially different may be vague and, therefore, easily manipulated. Read the text of the SOP. I presume this is going to be readily available soon, but make sure you find the most current version, and read the example in the text. They're very indicative but not conclusive. I bet all of the creative actuaries in the audience can find at least one or two examples that are not covered in the literature. Again, try to arrive at a position that's reasonable and discuss it with your auditors.

Implementation is a real tough one. I've talked to a lot of our staff back home. There are many systems implementation issues, and that's what the bullet here says. It might constrain your ability to track replacements accurately back to the original contract inception, and you have to do cost benefit analysis. Does it make sense to try to get perfection, or are there some reasonable shortcuts you can take? The SOP has a numerical example. I don't in my presentation. Don't ask me to show you one at the end.

What if you have an internal replacement that is substantially different? This seems simple enough. What you do is you extinguish the old contract, and all of the DAC is written down. Those balances should not be deferred in connection with a replacement contract. Write down the old, and set up the new.

The transition, similar to what Scott said, will be done prospectively in the year of adoption. If there are any prior balances before the year of adoption (and you might be able to adopt early), they should not be adjusted. The three categories we're talking about are your unamortized deferred acquisition costs, your unearned revenues from excess front-end loads, and your unamortized deferred sales inducements. Now I'll turn the presentation over to John.

MR. JOHN O. ESCH: We're going to move into the world of *FAS 141* and *FAS 142*. I'm not going to apologize, but I am going to warn you that the time that we have today and the scope of this will be relatively brief for the topic of purchase GAAP and what *FAS 141* and *FAS 142* covers. *FAS 141* and *FAS 142* were issued in 2001. So that is essentially behind us in terms of an emerging issue. Any of the transition issues are basically dealt with. We've already begun to see some of the effects of these new Statements with first and second quarter 2001 goodwill write-offs.

These two statements supercede previous guidance, particularly Practice Bulletin 16 and 17 that dealt with both of these issues. There still remains some work that has not been answered by these two statements as well, and there's a group ongoing right now called Business Combo 2, or something to that effect, that will be addressing these issues. Part of the reason why these were issued was that FASB did not like the way businesses were going through acquisitions and business combinations. So they set this up. These rules apply not just to life insurers but to all businesses like most FASBs do.

FAS 141, in particular, describes and discusses business combinations. You can no longer simply add the balance sheets of the two businesses that are being combined. Another key point here is that the acquired assets and liabilities need to be recorded at fair value. You can read the other items on the list there. Some additional provisions of *FAS 141* are an explicit recognition

of more intangible assets. For life insurers, obvious intangibles are value of business acquired (VOBA), and this statement just describes even more.

When we talk about the intangibles being recognized separately, apart from goodwill, they need to meet one of the two criteria—either legal or separable. Are there legal rights or contractual rights to a certain benefit or to a certain aspect of the business? Can that thing be sold or can it be licensed? We'll go through a couple of examples on this.

The majority of intangibles continue to be amortized against earnings. Goodwill will be the result of what is left over after you have met all of these other requirements. Goodwill specifically excludes those things described as intangible assets. One of the most familiar intangible assets is value of business acquired (VOBA). Companies call this by different names. VOBA is one term. Present value of future profits (PVFP) is a second. They're essentially the same thing, which is just a value of that in-force business. Additionally, there's patents, licenses, trademarks, and brand names. Table 1 shows the categorization that you would need to go through in an acquisition. Are each of these things contractual? Separable? Should we recognize it as a separate intangible?

TABLE 1
Intangible Assets—Examples

Intangible Assets	Contractual?	Separable?	Recognize?
In-force policies (VOBA)	Yes	Yes	Yes
State licenses	Yes	Yes	Yes
Agency force	Yes	Yes/No	Yes
Reinsurance treaties (coded)	Yes	No	Yes
Reinsurance treaties (assumed)	Yes	Yes/No	Yes
Product approvals, registrations	Yes	No	Yes
Health provider contracts	Yes	No	Yes
Customer base ("walk-ins")	No	Yes	Yes
Customer lists, databases	No	Yes	Yes
Workforce	No	No	No

FAS 142 really deals with goodwill and other intangible assets and how to account for those. This is a pretty critical element, or at least will be, with regard to any mergers and acquisition (M&A) transaction. I guess another point that I'd like to make about both of these is since these were adopted in 2001, most of us are pretty well aware that, up to this point, there has not been a whole lot of activity in the M&A world. Most of what companies have been dealing with is the implementation and the transition from the old to the new. As you move forward and start acquiring companies, this will become a more significant thing.

Much of what gets covered in *FAS 142* relates to what accountants deal with in terms of allocating various assets to various pieces and reporting units. Then, the other thing is, with the life insurance industry, there is probably less specific value you can place on patents like a pharmaceutical company would have. It still becomes an important aspect of any M&A deal, but, for our industry, it's perhaps less significant.

Another provision of *FAS 142* is that it requires impairment testing. Goodwill is no longer going to be amortized like it used to be over a fixed schedule. Rather, it's just locked and loaded, and you never touch it. With that comes the flip side where you have to do some impairment testing. You could view it as a pay-me-now or a pay-me-later type of analysis. As you're going through any future deals, do we want to have the value of the business or goodwill? If we put more in goodwill, that means we don't have to amortize it, which could really help our earnings. Then we have the additional work down the road. We're trying to be able to value whether that goodwill is going to be impaired or not. Of course, there are always the disclosure requirements.

As I mentioned, the transition rules for this have really come and gone, but I guess it's important to point out that the adoption did require you to actually go back to your prior transactions and take a look at the goodwill that you're currently holding and do some of this impairment testing as well as the allocation of the assets and liabilities and goodwill to the reporting units.

Table 2 summarizes the accounting for intangibles. We can talk about what each of these categories looks like. How do we do the amortization? How do we do the impairment testing? Another consideration is the timing of the test. One of the practical aspects of goodwill, if you

do a rigorous job of your impairment testing at transition or at acquisition, is you should be able to, at least in theory, update that impairment test with relative ease. This does depend on minimal changes in the environment. I've got a note here that says you're required to do your test annually; then, if circumstances warrant, you perhaps would need to do that more frequently than annually. That would be perhaps a significant change in the business or environment.

TABLE 2
Summary of Accounting for Intangible Assets

	Goodwill	Indefinite Useful Life	Finite Useful Life
Characteristic	Intangible not meeting legal, separability criteria	No factor (legal, contractual, economic, other) limits useful life	Expected useful life is limited
Amortization	None	None	Over useful life
Impairment Test Methodology	Two-step test (fair-value based)	One-step test (FV vs. BV)	One-step test (SFAS 121)
Timing of Test	Annually, or more frequently as circumstances indicate	Annually, or more frequently as circumstances indicate	When there is an indication that the asset may be impaired

I'll go through the impairment process in a little more depth. There is the identification of the reporting units, how you go about allocating, especially under a transition, and the specific two-step approach for doing your impairment testing. For the reporting units, goodwill won't be subject to any amortization. You just keep your goodwill level. You do need to make sure that it gets tested for the impairment. Upon adoption, you need to allocate your goodwill to these reporting units. These reporting units are not something we're going to run into in determining on our own, but your accounting people certainly will be well versed in these reporting units. The actuary needs to know what that encompasses.

You're probably familiar with the segment reporting that the SEC requires, and the reporting units are not necessarily the same as that segment reporting but could be a level below that. The impairment test itself is a two-step procedure. The first one is to compare the fair value of the unit with the carrying value. If it's greater, then you're done testing your goodwill. If it's less,

then you actually have to proceed to Step 2. You basically have an impairment in your goodwill. Step 2 helps you figure out what to do with that impairment and how to make that charge. Once you've written off your goodwill, you can't reinstate it. It's essentially a permanent write-down.

Continuing on with Step 2, implied fair value is done essentially as if it was a new acquisition. I know of one case where outside consultants were brought in to do a fair value on a reporting unit. At the initial point, you get your consultants to set you up and you understand what's going on. Then you are able to replicate that in the future with perhaps a little more ease. As I mentioned, once the goodwill is written down, you can't put that back on the books. That's a permanent write-down.

Here's a very simple numerical example. Step 1, we look at the carrying value or the book value of the reporting unit. We've done some fair-value analysis in the background, and we can see here that the fair value is less than the carrying value. So our goodwill is definitely impaired. So we go to Step 2. We take a look at the fair-value calculation. We allocate all of our assets and liabilities and solve for what the implied fair value of the goodwill is. In this case, it's \$25. We were holding \$100 as goodwill. So we take a \$75 charge. We'll continue to hold goodwill at \$25. Next year we'll go through the same test, and hopefully we won't have any more impaired goodwill.

A couple points on this impairment test. First, it can be performed any time during the year, provided you do it at the same time every year. Different reporting units can be tested at different times. Subsequent to the initial determination, the entity might presume current fair value, and this is the practical simplification utilized if all of these criteria are met. The adverse events would be those that you would determine, and the statement is general enough that they would never give you a precise recipe as to what that would be.

As we mentioned, there might be a need to do interim impairment testing. Some examples of situations where it might be needed would be in the following cases:

- Adverse changes in legal factors, regulation, competition, business climate, and personnel
- A more-likely-than-not expectation exists that a reporting unit (or significant portion) will be sold or otherwise disposed of
- A significant asset group is tested under *FAS 121/144*
- A subsidiary recognizes an impairment loss in its stand-alone GAAP financial statements

In summary, the result of these two Statements is really going to be that significant additional judgment is going to be required. Certainly with the business combinations and the acquisitions, you're going to need to separate out intangibles. You'll need to review your goodwill, and figure out the life and the amortization of the intangibles that are amortized. As I mentioned at the beginning, there still continues to be a lot of work that is yet to be decided. The FASB has not yet told companies exactly how to determine VOBA, for example. It's pretty clear how to amortize VOBA, but how to determine the initial VOBA is a little bit up in the air. Valuation items have also been complete. There's still a large gray area out there.

FROM THE FLOOR: Scott's handouts mention the minimum guaranteed death benefit liability equaling the current benefit ratio times the cumulative assessments less excess benefit payments and related expenses. Then it says, "plus accreted interest." Am I to understand that that's the interest rate earned on the account? Is it credited interest?

MR. WRIGHT: The SOP isn't clear on which interest rate to use, but I would assume that it would be the credited rate that you're using to amortize your DAC—there is a similar approach there.

FROM THE FLOOR: On the impairment test for goodwill, does that mean that that's going to increase earnings volatility on the downside for GAAP earnings?

MR. ESCH: I think the simple answer is yes.

The intended consequence may not be to increase volatility but to increase transparency.

Basically, the FASB didn't like the pooling concept.

FROM THE FLOOR: How would you actually value goodwill? My interpretation of goodwill is it's the inherent value of agency forces and things like that.

MR. ESCH: Goodwill is all of those things but those things that were specified. You go through your agency force. You value your patents. Then, goodwill is just the solved-for number. You revalue your assets and your liabilities.

MR. FLANNERY: Think back to a recoverability test for DAC. What John is basically saying is you value your assets, you value your liabilities, and then do have enough of an excess to carry your goodwill? If the answer is yes, you continue no write-down. If, on the other hand, you end up with basically a recoverability problem for goodwill, you write it down to break even.

FROM THE FLOOR: This is on the internal DAC. If we have a UL to UL that qualifies through the schematic, are we preserving all or some of the DAC on that policy?

MR. FLANNERY: The question was on UL to UL. To extend this, it could be SPDA to SPDA or any product like that. In the SOP, there is an explanation that covers that exact thing. The answer would be, yes, you'd preserve all of the DAC, but you'd still need to do your true-up and unlock to make sure that you can sustain the outstanding DAC. Philosophically, the answer is yes.

FROM THE FLOOR: You're referring to a continuation of the policy. Say it was issued in 1990, and it's rolling over here in 2002. You're sticking new estimated gross profits (EGPs) on that 1990 cohort. Is there any hope of moving to a simpler approach and moving the DAC up to 2002.

MR. FLANNERY: I wish the answer were yes. My reading is, no, you're stuck with all of those complexities. In the SOP, there is one example that showed you had an original 20-year amortization schedule. In your case, you're 12 years through that.

FROM THE FLOOR: Right.

MR. FLANNERY: You would presumably continue an amortization only for eight more years. I think everyone in here knows the behavior of people that have done an internal replacement is probably such that the useful life of that would be more than eight. Unless you have a reasonable basis for changing your assumptions, I think you'd be stuck with, at least for that cohort, an eight-year amortization period.

MR. WRIGHT: The task force did consider many different options when they were talking about that, and that was one very specific option that they considered and decided not to go with.

FROM THE FLOOR: And we're stuck with it now.

MR. FLANNERY: First, there's the new release. It's not even out for comment, but the period hasn't expired, and certainly you want to work with your auditors and opine.

FROM THE FLOOR: I had a question for Scott on the nontraditional SOP. It just has to deal with the practical aspects of doing your initial benefit ratio test. You could think of this as having as much detail as reproducing *FAS 97* in parallel. Do you have to go through this on a block-by-block basis? How do you roll up those blocks to determine significance? Could you speak to that?

MR. WRIGHT: I don't think you have to do it on a policy-by-policy basis, but I think you would probably look at it along the lines that you look at it for a DAC amortization. I would find it very difficult to have a 1995 cohort treated differently than a 1996 cohort, even though they're pretty much the same product. I think what's implied is that you'd probably need to do that.

FROM THE FLOOR: It says to take the ratio of the benefits to the total revenues. If you ignore certain things, like trail commissions, you could get a very different answer. Should there be recognition of things along those lines? There are very relevant expense side items. What about reinsurance?

MR. WRIGHT: As far as the expense items, I think the SOP is saying that you do not include those expense items in the calculation. However, they did mention spreads. They open the door for including investment income and then subtract off the credited interest. So, I think that's a little bit unclear right now in the SOP. I think it should be looked at before reinsurance. You wouldn't have reinsurance considerations going into how you evaluate that.

MR. ROD L. BUBKE: I, as well as most people, have interpreted that portion of the SOP to refer to the guaranteed minimum death benefit. Do you think the intent is to use that same methodology to calculate a reserve for a performance-enhanced death benefit or earnings enhanced death benefit?

MR. WRIGHT: I think the way the SOP reads is it would apply to earnings enhancements as well.

FROM THE FLOOR: Although they can both be in the money at the same time but likely aren't, is there any room for offset there?

MR. WRIGHT: I think the SOP specifically says that the reserve can't be less than zero. That would imply that there's no offset to the two benefits, although it does seem very odd because if you take them together, they are very much offsetting benefits.

FROM THE FLOOR: A question on replacements. Do the criteria look at contract language or do you look at seriatim basis or at a policyholder specific situation? An example would be if you have a flexible premium deferred annuity out of surrender charge that rolls to an SPDA with a surrender charge.

MR. FLANNERY: First, the fact that the surrender charge has worn off would automatically give you one of those four criteria I talked about. So, that's not an issue. I think the interpretation would be that the cash flows are significantly different, and so it would probably be deemed as an internal replacement that is substantially different. I don't know that it's that clear. We've had discussions in the past with our auditors about an old IRA going to a new IRA. Under the current law, you have a higher contribution limit than you did on the old, so the cash flows could be different. The best guidance I can give you is go back to your auditors with the facts of the case and make a representation. I suspect that's the type of question that will get addressed to the AICPA and FASB, and they'll clarify the quantitative nature. Lately, the tendency seems to be more toward qualitative and toward the nature of the provisions and the characteristics of the cash flows. Does that help?

MR. STEVEN J. FINN: Can we get back to the issue of goodwill in determining the value? I can share how we approached it. We have goodwill associated with agency force. We took the present value of future profits that were anticipated to come from that agency force and used that to determine what our carrying value of the goodwill was and compare that to the fair value of goodwill. We then compared that to the carrying value of the goodwill and utilized that to determine if we needed to write anything down (which we determined we did not). The auditors were okay with that.