S O C I E T Y   O F   A C T U A R I E S

PROFESSIONAL ACTUARIAL SPECIALTY GUIDE

U.S. GAAP—FINANCIAL REPORTING

Overview

Generally accepted accounting principles (GAAP) apply to external financial reporting of business enterprises. The principles that constitute GAAP vary from product class to product class and according to the purchase status of the business.

At one time, the generally accepted basis of accounting for life insurance companies was statutory accounting (that is, those practices prescribed or permitted by insurance regulatory authorities), which emphasizes the balance sheet and the ability of insurers to meet their obligations to policyholders.

However, by the early 1970s, the needs of investors and other users of financial statements, with respect to evaluating the earnings performance of stock life insurance companies, led to the formation and application of a set of principles for GAAP accounting and reporting that focused on the matching of costs (benefits and expenses) with revenues over time. These principles were published in *Audits of Stock Life Insurance Companies (Audit Guide)* issued by the American Institute of Certified Public Accountants (AICPA) in 1972 and later codified in *Statement of Financial Accounting Standards (SFAS) No. 60* issued by the Financial Accounting Standards Board (FASB).

In 1987, the issuance of *SFAS 97* clarified the accounting and revised the reporting for products such as universal life to accommodate their dynamic characteristics, investment contracts to account for them as financial instruments, and limited-payment contracts to spread reported income over the product's full term rather than the premium-paying period.

Life insurers were required to restate prior financial statements when the provisions of *SFAS 97* were adopted. Because the accounting and reporting for these products vary from GAAP for traditional products in several significant respects, the appropriate classification of products is a key first step in ensuring proper GAAP treatment.

The principles of accounting for universal-life-type contracts under *SFAS 97* include a retrospective deposit method of determining the basic liability for policy benefits, deferral and amortization of deferrable policy acquisition costs and unearned revenues based on estimated gross profits (that is, margins, rather than premiums), and retrospective adjustment (unlocking) of such amortization schedules when estimates of gross profits change. *SFAS 97* defines revenues for such contracts as policy charges (rather than premiums) and includes only benefits in excess of policyholder balances as expenses.

Mutual and fraternal life insurers, originally exempt from *SFAS 60* and *SFAS 97*, were able to represent statutory financial statements as being in conformity with GAAP until FASB *Interpretation 40* eliminated that practice for statements issued for reporting years 1996 or later. *SFAS 120* and AICPA *Statement of Position (SOP) 95-1* now define the application of GAAP to these companies, should they choose to issue financial statements described as prepared in conformity with GAAP. This guidance defines the appropriate methodology for traditional participating products typically sold by mutual insurers. Key elements of this methodology are the use of premiums as revenue and the amortization of deferrable policy acquisition costs in relation to gross profit margins.

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Product accounting and reporting for other products sold by mutual and fraternal insurers that are similar to those sold by stock companies are defined by *SFAS 60* and *SFAS 97*.

For all product lines, a different set of accounting principles, purchase accounting (PGAAP), applies when the insurance company has been acquired by another company.

In addition to the accounting and reporting for their products, insurance companies also must deal with GAAP guidance for their investments, taxes, and general business activities, such as accruing for pensions, postretirement and postemployment benefits, and contingencies.

The Role of the Actuary

The actuary is involved with financial reporting for life insurance companies through experience and training in estimating the financial effects of life and other contingencies utilizing the time value of money. Those responsible for the calculation of GAAP actuarial values such as traditional product benefit reserves, deferred policy acquisition costs, or deferred taxes should possess a knowledge of the authoritative guidance and accepted interpretations of such guidance that apply to their work. In addition, a firm grounding in GAAP will be useful to actuaries involved in financial reporting for mergers and acquisitions, demutualizations, source-of-earnings analysis, management-basis financial reporting, the use of GAAP in price testing, or setting return on equity (ROE) targets.

Many areas of GAAP involve professional judgment, and qualified actuaries may reach differing conclusions. In the area of GAAP reserve calculations, there are many acceptable variations in use within the insurance industry. Assumptions and methods should be selected and applied with integrity, informed judgment, and perspective in relation to the purpose for which the results are intended. The practicing actuary should be familiar with authoritative accounting and actuarial standards, as well as prevailing accounting practices in areas not specifically addressed by an SFAS and other pertinent accounting and actuarial literature.

Actuaries who become deeply involved in GAAP issues inevitably will be drawn into a broader familiarity with relevant accounting guidance and tax law. The Professional Actuarial Specialty Guides (PASGs) titled “U.S. Taxation—Life Insurance,” “U.S. Statutory Financial Reporting and the Valuation Actuary,” “Mergers and Acquisitions—Life Insurance,” and other topics may assist the actuary in exploring the available literature.

Introductory Material

The material in this section provides an introduction to the evolution of GAAP for life insurance companies.

MacKay, Ian, and Korbly, Ben. “Financial Reporting: The Standards Setters,” *The Actuarial Update* (March 1991), p. 1.

This article provides background on the process by which GAAP is established and applies to life insurers, focusing on the roles of standard-setting bodies such as FASB, the SEC, and the AICPA and its Accounting Standards Executive Committee (AcSEC).

Level: Basic Pages: 3

Stein, Robert W. “Interrelationships of Various Life Insurance Company Valuations,” Chapter IV in *The Valuation Actuary Handbook*, Itasca, Ill.: Society of Actuaries, June 1987, p. IV-1.

This paper compares and contrasts the purposes and audiences for GAAP, statutory, and other valuation bases, focusing on their complementary nature.

Level: Basic Pages: 23

Horn, Richard G. “Life Insurance Earnings and the Release from Risk Policy Reserve System,” *Transactions of the Society of Actuaries XXIII* (1971): p. 391.

This paper clarifies the operation of the policy reserve system for traditional insurance products as the timing mechanism that determines the incidence of earnings through “provisions for adverse deviation” and “release from risk,” which are inherent in GAAP for traditional products. The paper also describes how source-of-earnings analyses allocate differences between actual and expected results to component influences, such as deviations from assumed persistency, mortality, investment income, and expenses.

Level: Intermediate Pages: 9

Authoritative Accounting Standards

In this section we review the range of authoritative accounting guidance on the application of GAAP to life insurance companies. The AICPA has resolved that its members shall not express an opinion that financial statements are presented in conformity with GAAP if such statements contain any departure from an accounting principle promulgated in FASB *SFAS*s, together with those *Accounting Research Bulletins* and *Accounting Principles Board Opinions (APB)* that are not superseded by the action of the FASB. Other pronouncements by accounting bodies, such as the AICPA *Practice Bulletins*, provide guidance on specific issues that practitioners are encouraged to follow to enhance the quality and comparability of financial statements.

The AICPA publishes an annual series, *Current Text—Accounting Standards*, which presents accounting standards organized by accounting issue in *Volume 1—General Standards* and the applicable standards for the life insurance industry in *Volume 2—Industry Standards*. The AICPA's *Original Pronouncements Accounting Standards* presents the original text in chronological order. Subscription service also is available. AICPA publications are available from the AICPA order department. Copies of issued and proposed SFASs may be obtained from the FASB order department.

Accounting Guidance Specific to the Life Insurance Industry

The following guidance is specific to the life insurance industry, addressing issues such as the definitions of revenues, expenses, and policyholder liabilities, the determination of deferrable costs and revenues, bases for amortizing deferrable costs and revenues, definitions of loss recognition and recoverability, and accounting treatment of reinsurance contracts.

AICPA. "Accounting for Certain Insurance Activities of Mutual Life Insurance Enterprises," *SOP 95-1*, January 18, 1995.

This statement defines GAAP for participating life contracts that pay dividends to policyholders based on actual experience and distributed in proportion to their contribution to divisible surplus. The reporting guidance follows *SFAS 60* by requiring reporting of premiums as revenues and reporting of reserve increases in the income statement. However, the accounting guidance looks to *SFAS 97* UL-type principles to require the computation of a "proxy account balance" as the policyholder liability and the amortization of DAC in relation to gross margins, with retrospective unlocking.

Level: Intermediate | Pages: 33

AICPA. *Audits of Stock Life Insurance Companies*, with conforming changes as of May 1, 1994.

This audit guide, first issued in 1972 prior to the creation of the FASB, contained the original definition of GAAP for stock life insurers. While its guidance does not address universal life and investment contracts, it provides an authoritative exposition of GAAP for traditional products. A revised audit guide, addressing mutual and fraternal as well as stock life insurance companies, is currently in preparation.

Level: Intermediate | Pages: 198

AICPA. "Application of FASB *Statement No. 97*, 'Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments,' to Insurance Enterprises," *Practice Bulletin 8*, November 1990.

This practice bulletin provides guidance in the form of questions and answers for certain controversial *SFAS 97* implementation issues, including the applicability of unlocking and loss recognition on investment contracts, the inclusion of capital gains and loss and certain expenses in estimated gross profits used as the basis of amortization of deferred costs and unearned revenue for universal-life-type contracts, and the applicability of *SFAS 97's* prohibition of rolling over deferred cost balances on internal replacements.

Level: Intermediate | Pages: 8

FASB. "Accounting and Reporting by Insurance Enterprises," *SFAS 60,* June 1982. Also included in the AICPA's *Accounting Standards—Volume 1* and as an appendix to the fourth edition of the *Audit Guide*.

SFAS 60 codified the principles from the 1972 *Audit Guide* and represents the currently applicable authoritative guidance for accounting and reporting for traditional life, accident, and health insurance.

Level: Intermediate Pages: 40

FASB. "Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments," *SFAS 97,* December 1987. Also included in the AICPA's *Accounting Standards—Volume 2.*

This FASB statement, issued in 1987, establishes standards of accounting and reporting for universal life and similar contracts, and addresses the accounting for limited-payment insurance contracts and investment contracts. In addition, the statement revised reporting for realized capital gains and losses by requiring them to be reported as components on net income, and ended the practice by some companies of continuing the deferral of acquisition costs when traditional life contracts were replaced internally by universal life-type contracts. The statement's guidance, which is quite brief, is supplemented by appendixes providing background information and the basis for the FASB's conclusions as well as an illustration of accounting for capitalized acquisition costs.

Level: Intermediate Pages: 32

FASB. "Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts," *SFAS 120,* January 1995.

This FASB statement extends the requirements of *SFAS 60, SFAS 97,* and *SFAS 113* to mutual and fraternal insurers and refers to AICPA *SOP 95-1* for the accounting and reporting for the participating life contracts of those insurers. It also permits stock life insurers to apply the provisions of *SOP 95-1* to participating life contracts with dividends based on the contribution principle. This latter provision will likely benefit mutuals who demutualize in the future, as the accounting for their participating business would not have to change.

Level: Intermediate Pages: 15

FASB. "Applicability of Generally Accepted Accounting Principles to Mutual Life Insurance and Other Enterprises," *Interpretation No. 40,* April 1993.

This milestone pronouncement by the FASB ended the long-standing practice of describing the statutory-basis financial statements of mutual and fraternal insurers as being in conformity with "generally accepted accounting principles," effective for fiscal years beginning after December 15, 1994 (later amended to December 15, 1995).

Level: Intermediate Pages: 9

FASB. "Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts," *SFAS 113,* December 1992. Also included in the AICPA's *Accounting Standards—Volume 2.*

This FASB statement, effective in 1993, provides guidance for gross reporting of reinsurance ceded, definition of transfer of insurance risk, and recognition of income for prospective and retrospective provisions of reinsurance contracts.

Level: Advanced Pages: 46

Accounting Guidance Regarding Deferred Taxes

Deferred taxes are the accrual, without interest, of the tax effects of the timing differences between the tax and GAAP bases of assets and liabilities. Recent history has seen a transition from an approach based on accruing income statement tax differences to various versions of a liability method, in which deferred taxes are based on the current tax effect of cumulative "temporary differences" in the balance sheet.

FASB. "Accounting for Income Taxes," *SFAS 109,* February 1992.

SFAS 109, issued in 1992 and effective for reporting in 1993, supersedes prior guidance regarding income tax accounting in *APB 11* (an income method) and *SFAS 96* (a rather complex liability method). *SFAS 109* recognizes an asset or liability for the expected future tax consequences of temporary differences, and represents a significant simplification of the liability method introduced in *SFAS 96,* especially regarding the recognition and measurement of deferred tax assets.

Level: Advanced Pages: 128

Accounting Guidance Regarding Purchase Accounting

The purchase method of accounting requires the updating of asset, liability, and amortization assumptions to current values and the replacing of deferred acquisition costs with the value of the business acquired when one enterprise is purchased by another.

Accounting Practice Board Opinion (APB) 16, "Business Combinations," August 1970. Included in the AICPA's *Accounting Standards—Volume 1.*

Under *APB 16's* guidance for purchase accounting, assets and liabilities of the acquired business are revalued at current cost (that is, market value at date of the acquisition of the enterprise). For insurance enterprises, the present value of profits from the existing business is capitalized and amortized over the remaining lifetime of the contracts. The residual between the purchase price and the excess of revalued assets over liabilities is capitalized as goodwill and amortized over a period such as 40 years.

Level: Advanced Pages: 67

FASB Emerging Issues Task Force (EITF). "Accounting for the Present Value of Future Profits Resulting from the Acquisition of a Life Insurance Company," *EITF 92-9,* November 19, 1992.

This guidance clarifies the accounting for the present value of profits (PVP) resulting from the acquisition of a life insurance company occurring after November 19, 1992. It also requires the application of a premium deficiency test to all PVP assets in reporting periods following that date.

Level: Advanced Pages: 2

Accounting Guidance Regarding Invested Assets

FASB. "Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases," *SFAS 91*, December 1986.

Some interpreters have looked to *SFAS 91* for guidance regarding the accounting treatment of acquisition costs for investment contracts, even though *SFAS 91* describes the acquisition of assets such as loans rather than liabilities such as deposits. *SFAS 91* describes the "constant effective yield" or "interest" method of accounting, which provides for the emergence of earnings in relation to the underlying assets.

Level: Advanced Pages: 26

FASB. "Accounting for Certain Investments in Debt and Equity Securities," *SFAS 115,* May 1993.

SFAS 115 effectively ended the long-standing practice of reporting virtually all bonds and other debt securities in good standing at cost or amortized cost. This FASB statement requires debt and certain equity securities to be classified as "held to maturity," as "available for sale," or as "held for trading." Securities in the latter two classifications must be reported at fair market value. As the following reference describes, *SFAS 115* also has a significant impact on the determination of the DAC asset when amortization is based on gross profit margins, which include capital gains and losses.

Level: Advanced Pages: 48

FASB EITF. "Adjustments in Assets and Liabilities for Holding Gains and Losses as Related to the Implementation of FASB *Statement No. 115," Topic No. D-41*, January 29, 1994.

In this discussion, the EITF endorsed the SEC's position that the equity effect of unrealized holding gains and losses on assets classified as "available for sale" should be adjusted for deferred tax effects and for the effect that including such gains and losses in gross profit margins would have had on deferred policy acquisition cost balances had they been reported as realized gains or losses included in gross profit margins used as the basis of amortization. This "shadow DAC" calculation does not affect reported net income but is carried through to the DAC asset reported on the balance sheet.

Level: Advanced Pages: 2

Other Relevant Accounting Guidance

This document is not intended to represent a full course in accounting principles; however, the guidance referenced here often is considered in accounting for the life insurance industry.

FASB. "Accounting for Contingencies," *SFAS 5*, March 1975. Also included in the AICPA's *Accounting Standards—Volume 1.*

This accounting standard defines the conditions under which an accrual for a loss contingency should occur, namely, that the impairment of an asset or incurral of a liability be probable as of the date of the financial statement and that the amount can be reasonably estimated. Recognition of gain contingencies is prohibited as premature recognition of income. *SFAS 5* is not intended to replace the guidance directly applicable to the insurance industry, but often is referred to when asset writedowns, loss recognition, or contingency reserves are considered.

Level: Advanced Pages: 18

Relevant Actuarial Standards

Actuarial Standards of Practice (ASOP) indicate how fundamental concepts and methodological principles should be applied and take into account problems arising from limited information, time constraints, and other practical difficulties, as well as conflicts with regulatory or other restrictions. Copies of ASOPs may be obtained from the Actuarial Standards Board (ASB). The following ASOPs specifically address GAAP issues.

ASB. "Methods and Assumptions for Use in Stock Life Insurance Company Financial Statements Prepared in Accordance with GAAP," *ASOP No. 10*, October 1992.

This standard provides guidance with respect to the determination of policy benefit liabilities and deferred policy acquisition cost assets in accordance with GAAP for stock life insurance companies.

Level: Intermediate Pages: 10

ASB. "The Treatment of Reinsurance Transactions in Life and Health Insurance Company Financial Statements," *ASOP No. 11*, July 1989; reprinted 1990.

This standard provides guidance for valuation of financial statement items for reinsurance ceded and assumed.

Level: Intermediate Pages: 4

Interpretations and Applications of Standards

The core material for this PASG consists of interpretations of the available guidance by professionals or professional service firms in this practice area. While such interpretations are not in themselves authoritative, they often provide a depth of understanding of the application of principles that is not easily gleaned from the original guidance. Further, the widespread adoption of such interpretations in practice may result in *de facto* recognition as being generally accepted.

GAAP for Traditional Products

Traditional life and accident and health insurance products are those with fixed benefits and premiums for which the guidance of *SFAS 60* continues to apply.

Posnak, Robert L. *GAAP: Stock Life Companies.* Dallas, Tex.: Ernst & Young, 1974. Available from Ernst & Young.

This book presents a comprehensive analysis and illustration of GAAP concepts that was invaluable to those charged with the initial implementation of those principles. It is widely regarded as the best reference regarding the application of *SFAS 60*'s guidance, particularly for special lines of business such as health insurance, credit and group insurance, variable products, reinsurance, and special problems such as recoverability and loss recognition, restricted participating business, and business combinations.

Level: Intermediate Pages: 682

Warnock, R. Larry. “GAAP Reserves,” Society of Actuaries Study Note 385-29-94.

This study note addresses the application of the *Audit Guide (SFAS 60)* to actuarial items included in GAAP financial statements. It is limited in scope, because it relates only to nonparticipating and industrial life insurance contracts issued by stock companies. Similarly, accounting concepts are presented only to the extent that an understanding of such concepts is necessary for a complete understanding of the related actuarial concepts. However, it goes into some depth in analyzing acceptable formulas for GAAP reserve calculations, considerations for selection of appropriate actuarial assumptions, concepts of reserve adequacy, and practical problems frequently encountered by the practicing actuary.

Level: Intermediate Pages: 68

Cloninger, Kriss. “GAAP for Nonguaranteed-Premium Life Insurance,” *Transactions of the Society of Actuaries* XXXIII (1981), p. 499.

This article illustrates the process involved in adapting GAAP principles to a new product. The discussion of whether the lock-in principle of GAAP for traditional products should apply to new products with nonguaranteed elements is especially interesting in light of *SFAS 97*'s later unlocking requirement for universal-life-type products.

Level: Advanced Pages: 12

McLaughlin, S. Michael. “GAAP Reserving Practices for A&H Business,” *The Financial Reporter*, Newsletter of the Life Insurance Company Financial Reporting Section of the Society of Actuaries, August 1995, November 1995, March 1996, and July 1996.

This four-part series of articles provides general background on the application of GAAP to life insurance companies in Part 1 and a discussion of the application of *SFAS 60* provisions regarding benefit reserves, claim reserves, DAC, loss recognition, and reinsurance to disability income policies, medical policies, and long-term care coverages in Parts 2, 3, and 4, respectively.

Level: Advanced Pages: 15

GAAP for Universal Life, Limited Payment, and Investment Products

SFAS 97 revised the accounting and reporting for universal-life-type, limited-payment, and investment products. The following references provide an introduction to the application of its guidance to the calculation of actuarial items in GAAP financial statements.

Brumbach, John W., Eckley, Douglas A., Merdian, Craig A., and Raymond, Craig R. *SFAS 97—A White Paper.* Atlanta, Ga.: Tillinghast, 1988, sections I–IV and appendixes. Available from John W. Brumbach, Tillinghast/Towers Perrin. Also published as “Revised GAAP Accounting for Universal Life, Limited Payment, and Investment Contracts,” Society of Actuaries Study Note 443-24-89.

This material begins with a discussion of the revised product classifications introduced by *SFAS 97*, then briefly addresses the revised accounting standards for limited-payment long-duration contracts and for investment contracts. It concludes with an in-depth discussion of the accounting standards applicable to universal-life-type contracts. Numerous examples illustrating various aspects of the accounting methodology for universal-life-type contracts are presented in the appendixes.

Level: Advanced Pages: 165

“*FAS 97*—Where Are We Now?” *Record of the Society of Actuaries*, 15, No. 3A (1989), p. 1145.

The topics related to *SFAS 97* addressed by this panel include an example of the earnings volatility that may result from the “unlocking” of amortization schedules, interpretations of the accounting for annuities as investment contracts, an overview of purchase accounting, advice for dealing with negative gross profit elements in amortization of acquisition costs for universal life-type contracts, and a discussion of the implementation process for a large insurer. The results of a brief survey regarding the implementation effort and financial impact of adopting the new guidance also are provided.

Level: Advanced Pages: 18

Note: Many accounting and actuarial firms, as well as industry groups and educational institutions, offer seminars or have published commentaries on life insurance accounting and reporting, including aspects of *SFAS 97*. Such offerings vary considerably in focus and depth, but generally provide consistent interpretations of authoritative guidance. The following publications are representative of those available and may be obtained from the firms indicated.

Arthur Andersen & Co. "Accounting by Insurance Enterprises—An Explanation of FASB *Statement No. 97*," Subject File IN7352, Item 6, 88-4021, Pages: 59. Available from Ed Bader, Arthur Andersen & Co.

Ernst & Whinney. "Accounting for Life Insurance and Annuity Products—Understanding and Implementing FASB *Statement No. 97"* Pages: 100. Available from National Insurance Services, Ernst & Young.

KPMG Peat Marwick. *Principles & Presentation—Insurance*, annual series. Available from Distribution Center, KPMG Peat Marwick.

KPMG Peat Marwick. "*Statement of Financial Accounting Standards No. 97*—An Evolving Perspective," *Insurance Industry Issues and Trends*, April 1988. Pages: 9. Available from Mary Ann Bramer, KPMG Peat Marwick.

GAAP for Mutual and Fraternal Companies

"GAAP for Mutuals," *Record of the Society of Actuaries* 20, No. 2 (1994), p. 65.

The presentations made by this panel address project management and technical issues related to the implementation of GAAP by mutual companies adopting *FAS 60*, *FAS 97*, *FAS 120*, and AICPA *SOP 95-1*.

Level: Advanced Pages: 28

GAAP for Reinsurance Ceded and Assumed

Accounting and reporting for reinsurance under GAAP require a determination of whether risk is transferred under the reinsurance agreement. If risk is not transferred, the agreement is accounted for as a deposit. If risk is transferred, the accounting for ceded contracts is determined by the classification of the reinsurance product, with net deferred acquisition costs amortized in relation to net premiums or estimated gross profit margins, as appropriate. Accounting for reinsurance assumed may not mirror the accounting for the reinsurance ceded, because the accounting is determined by the classification of the reinsurance product and assumptions depend on the experience of the assuming actuary.

Robertson, Richard S. "GAAP Accounting for Reinsurance Ceded," *Transactions of the Society of Actuaries* XXVII (1975), p. 397.

This paper proposed solutions to certain problems in implementing GAAP for reinsurance ceded and identifies where there may be differences of opinion in accounting and reporting for such reinsurance.

Level: Advanced Pages: 17

Robertson, Richard S. "GAAP Accounting for Reinsurance Accepted," *Transactions of the Society of Actuaries* XXVII (1975), p. 375.

GAAP accounting for reinsurance accepted presents a number of practical problems for the assuming company actuary, including treatment of product features not present in direct contracts and lack of access to the detailed policy or experience information of the assuming company.

Level: Advanced Pages: 22

Special Topics

This section addresses topics that are not considered "core material" but that may be encountered in advanced applications of GAAP by actuaries.

Deferred Policy Acquisition Costs

Robbins, Edward L. "Dealing with the New 'Shadow DAC,' " *The Financial Reporter*, Newsletter of the Life Insurance Company Financial Reporting Section of the Society of Actuaries, March 1994, p. 7.

This article describes formulas for the implementation of the "shadow DAC" calculation related to unrealized holding gains and losses arising from assets designated as "available for sale" according to *SFAS 115*. It should be read in conjunction with the related article described just below.

Level: Advanced Pages: 3

Robbins, Edward L. "Implementation Issues of the 'Shadow DAC,' " *The Financial Reporter*, Newsletter of the Life Insurance Company Financial Reporting Section of the Society of Actuaries, March 1995, p. 9.

This article should be read in conjunction with the related article described just above. It notes that the EITF and the SEC have taken the position that DAC offsets are supposed to be taken to unrealized holding *losses* as well as gains.

Level: Advanced Pages: 2

Deferred Taxes

Calculation of the deferred tax item in GAAP financial statements requires a thorough understanding of the applicable tax law and related tax guidance and interpretations as well as the relevant actuarial and accounting guidance and interpretations. The following reference, although addressing the predecessor guidance (*SFAS 96*) to *SFAS 109*, illustrates the process and considerations involved in applying tax and accounting guidance to deferred tax issues.

"FAS 96," Record of the Society of Actuaries 15, No. 2 (1989), p. 841.

The record of this panel discussion briefly describes *SFAS 96*'s liability model for deferred taxes, and includes examples of scheduling of temporary differences and calculation of the deferred tax asset/liability at both the company and the product level.

Level: Advanced Pages: 28

Purchase Accounting

The readings listed under the "purchase accounting" heading in PASG *C-1-90*, "Mergers and Acquisitions—Life Insurance," address the purchase accounting principles applicable to business subject to *SFAS 60*. The following references address considerations in applying *SFAS 97* methodology to limited-payment-, investment-, and universal-life-type contracts that are subject to PGAAP.

Tillinghast. "Purchase GAAP Considerations," Section V of *SFAS 97—A White Paper*, 1988, p. 88. Available from John W. Brumbach, Tillinghast/Towers Perrin.

This brief chapter describes the application of three common methods: the defined initial reserve method, the defined valuation premium (or defined gross profit) method, and the return on investment method for determining PGAAP actuarial items under *SFAS 97*.

Level: Advanced Pages: 7

"Purchase GAAP Issues," *Record of the Society of Actuaries* 20, No. 2 (1994), p. 187.

The record of this panel discussion addresses a number of issues related to the implementation of *EITF 92-9*.

Level: Advanced Pages: 28

Recoverability and Loss Recognition

The GAAP concepts of recoverability and loss recognition were designed to avoid the inappropriate deferral of losses to future periods by ensuring that the net GAAP liability is at least as large as a gross premium valuation based on best estimate assumptions. The recoverability principle limits the original amount of deferrable expenses to that which may be recovered from future profits. The loss recognition principle applies subsequent to issue and requires that deferred cost balances be reduced to the amount recoverable from future profits or that an additional reserve be established to cover future losses. Both of these concepts can clearly be traced to the requirements of *SFAS 5*.

"GAAP Recoverability Issues for Interest-Sensitive Products," *Record of the Society of Actuaries* 14, No. 3 (1988), p. 1229.

The record of this panel discussion addresses recoverability and loss recognition issues under *SFAS 97*.

Level: Advanced Pages: 18

Analysis of Source-of-Earnings and Unlocking Effects under *SFAS 97*

Interpreting the financial results for business subject to accounting and reporting under *SFAS 97* may be difficult, especially if amortization schedules have been unlocked. Source-of-earnings analyses comparing actual and expected gains by source may be enhanced by segregating the effects of unlocking from deviations in gross margins.

Darling, Bruce R. "Unlocking *FAS 97*'s Management Potential," *The Financial Reporter*, Newsletter of the Life Insurance Company Financial Reporting Section of the Society of Actuaries, March 1992, p. 15. Also available as Society of Actuaries Study Note 443-72-94.

This article expands on Michael V. Eckman's discussion of the effects of unlocking on financial results, focusing on the effects on financial results of deviations in experience or future estimated gross margins from those originally expected.

Level: Advanced Pages: 4

Eckman, Michael V. "Additional Source-of-Earnings Analysis under *FAS 97* Universal Life Accounting and Some Observations on the Effect of Unlocking Assumptions," *Transactions of the Society of Actuaries* XLII (1990), p. 59.

This paper extends J.H. Tan's analysis to consider the effect of actual experience varying from expected and the effect of those variances on assumptions for the future. Also, the paper illustrates examples of the effect of changing future assumptions (unlocking) on the magnitude and incidence of actual profits. The discussion of the components of the change in reported income due to unlocking is especially valuable to those interested in analyzing the effects of unlocking.

Level: Advanced Pages: 32

Tan, J.H. "Source-of-Earnings Analysis under *FAS 97* Universal Life Accounting," *Transactions of the Society of Actuaries* XLI (1989), p. 443.

This paper defines a procedure for analyzing the sources of profit for a sample universal life product accounted for under *SFAS 97*.

Level: Advanced Pages: 64

"*SFAS 97*," *Record of the Society of Actuaries* 19, No. 2 (1993), p. 1003 and "*FAS 97*," *Record of the Society of Actuaries* 19, No. 3 (1993), p. 1827.

These two panels addressed topics such as practical considerations in establishing UL-type contract and SPDA DAC models and assumptions, interpretation of unlocking effects, and purchase GAAP issues.

Level: Advanced Pages: 22 and 24

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