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TASK FORCE ON MUTUAL LIFE CONVERSION

The Society of Actuaries Task Force on Mutual Life Insurance Company Conversion has recently submitted its final report. Appointed in July 1984 with Harry Garber as Chairperson, this Task Force has met monthly, and has established committees that have had additional meetings. The purposes of this Task Force are "to examine the actuarial issues involved in converting a mutual life insurance company to the stock form of ownership and to produce a record of examination." The recently completed report is the record called for by the Task Force's charge.

The report itself includes 28 typewritten pages, attached to which are six appendices adding another 100 pages. One must be impressed by the amount of good thought and constructive effort that this voluminous report represents.

By way of background, it may be noted that when the Task Force was formed, some three years ago, it appeared that several of the large multi-line mutual life companies had become interested in the possibility of conversion to the stock form. The driving force behind that interest was the feeling that a mutual life company might be at a disadvantage in accumulating sufficient capital to permit it to enter, to expand, and to compete in its selected markets, and to maintain, securely, its ability to meet its obligations to policyholders.

During the life of the Task Force the Union Mutual conversion took place. Many of the concepts reflected in that conversion have been helpful to the Task Force in the development of its report. That the interest in mutual life conversion has to some degree died down does not detract from this important document. Many of the actuarial principles

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BOOK REVIEW

B. Michael Pritchett, *Financing Growth: A Financial History of American Life Insurance Through 1900,* pp. 90, S.S. Huebner Foundation for Insurance Education, Wharton School, University of Pennsylvania.

Reviewed by Anthony B. Richter

Life insurance companies, some with hundreds of officers, have come a long way since the early days of the industry when a typical new company would have only three: President, Cashier and Actuary. Those early days are examined in some detail in *Financing Growth* by B. Michael Pritchett of Brigham Young University, an examination of the investment role played by life insurance companies prior to 1900.

By necessity, the book is in some respects a history of the early days of the industry itself, and a colorful history it was. The first company to issue policies was a branch of an English company with the incredible name of The Corporation for the Relief of Poor and Distressed Presbyterian Ministers and of the Poor and Distressed Widows and Children of Presbyterian Ministers. It issued its first policy on May 22, 1761 and, under the name of the Presbyterian Ministers Fund, is still operating from its office in Rittenhouse Square in Philadelphia.

Although several other companies entered the business in the following decades, the industry did not begin to flourish until the "mutual era", which began with New England Mutual (1835) and which soon included The Mutual Life Insurance Company of New York, New York Life, Connecticut Mutual, Penn Mutual and Mutual Benefit.

Active person-to-person solicitation began with the mutual companies.

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LIFE INSURANCE RESERVES AND THE AICPA EXPOSURE DRAFT ON AUDITING ACCOUNTING ESTIMATES

By Jonathan S. Carr

Auditing accounting estimates is the main job of an actuary taking part in the audit of a life insurance company. Accounting estimates are also the prime concern of a company's valuation actuary. Why? Because life insurance benefit reserves and Deferred Acquisition Expense (DAC) are "accounting estimates" under the definition given in the exposure draft of a proposed Statement on Auditing Standards issued by the AICPA's Auditing Standards Board entitled "Auditing Accounting Estimates."

According to the draft, an accounting estimate "is an approximation of a financial statement element, item, or account in the absence of an exact measurement." The absence of an exact measurement arises from two sources:

"a. Exact measurement of some amounts or the valuation of some accounts is uncertain pending the outcome of future events.

"b. Relevant data concerning events that have already occurred cannot be accumulated on a timely, cost-effective basis."

Not many accounting estimates are more "uncertain pending the outcome of future events" than benefit reserves and DAC, which depend crucially on projected interest, withdrawal, and mortality. Also point (b) above applies to benefit reserves and DAC; in-force models are an example of an approximation of "events that have already occurred."

The draft should not have a major impact on current practice for internal control for and auditing of accounting

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Life Insurance Reserves

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estimates, since its recommended procedures should already be part of any good internal control structure and audit. The motivation for issuing the draft seems to be to make auditing standards consistent with the AICPA's recently issued standards for financial forecasts and projections. Still, it is interesting to review the draft's structured approach to accounting estimates as it applies to benefit reserves and DAC.

Internal Control For Accounting Estimates

The draft identifies five elements of internal control:

a. "Accumulation of sufficient and reliable data on which to base an accounting estimate." This data would include experience studies for mortality, lapse, interest rates, expenses, and other needed inputs for reserve calculation. Also included would be prospective data such as economic forecasts of inflation and interest rates. Ideally, a company would have a documented program of preparing and updating these studies on a regular basis. An important step here is making sure that all necessary items have been considered — for example, extra mortality on term conversions.

b. "Preparation of the accounting estimate by qualified personnel." This would almost certainly require the involvement of actuaries.

c. "Adequate review and approval of the accounting estimates by appropriate levels of authority including: (1) review of sources of relevant factors; (2) review of development of assumptions; (3) review of reasonableness of assumptions and resulting estimates; (4) consideration of the need to use the work of specialists."

The preparation of an actuarial report in compliance with the American Academy of Actuaries' "Interpretative Opinion 3: Professional Communications of Actuaries" would facilitate the review called for here. Nonactuarial management as well needs to understand the financial impact of the methods and assumptions used to calculate reserves. Projections of reserves and financial statements under various assumptions and methods are indispendable to this understanding, and may soon be required by the actuarial profession and the NAIC for statutory reserves.

d. "Comparison of prior accounting estimates with subsequent results to assess the reliability of the process used to develop estimates." This is an excellent procedure which is often applied to claim reserves. The procedure has been somewhat neglected for GAAP benefit reserves and DAC, probably due to the influence of the lock-in principle, which in effect placed the focus for prior years' reserves on loss recognition.

e. "Consideration by management of whether the resulting accounting estimate is consistent with the plans of the entity." For example, DAC for single premium deferred annuities depends on lapse rates which are heavily influenced by management's intentions for credited interest rates.

Auditing Accounting Estimates

The draft defines the auditor's objective as the obtaining of "sufficient competent evidential matter to provide reasonable assurance that:

"a. All necessary accounting estimates have been developed.

"b. The accounting estimates are reasonable in the circumstances.

"c. The accounting estimates are presented in conformity with applicable accounting principles and are properly disclosed."

The draft suggests a number of procedures for evaluating reasonableness (point b. above). The auditor's first consideration is whether management has identified all the key factors and assumptions underlying the estimate, concentrating on those that are material to the estimate, sensitive to variations, deviation from historical patterns, and subjective and susceptible to misstatement and bias. Lapse assumptions in GAAP reserves often satisfy all of these criteria.

Then the auditor may perform the following procedures, among others:

- "Consider whether there are additional key factors or alternative assumptions about the factors." The auditor would be assisted here by any scenario tests and projections performed by the valuation actuary.
- "Evaluate whether the assumptions are consistent with one another, the supporting data, and relevant historical data." Actuaries have always pointed out the need for consistent assumptions — for example, an inflation rate corresponding to high interest rates. Given the rapid change in the insurance marketplace in the past decade, consistency with historical data may not be extremely close.
- "Test the calculations used to translate the assumptions into the accounting estimate." This would usually require the services of an actuary. Some accounting firms have their own in-house actuaries who participate in audits; other firms work with independent consulting actuaries. The draft also recommends, "Consider obtaining the opinion of a specialist regarding certain assumptions." The draft should have included the words "and certain calculations" in that recommendation.
- "Consider whether there are more appropriate ways to translate assumptions into estimates." For example, Ernst & Whinney's book on GAAP for stock life insurance companies contained many pages arguing for the intermediate reserve factor approach in preference to the mean reserve or mid-terminal reserve factor approach, but the intermediate approach never became the industry standard. Sometimes an auditor will make an issue of the mean or mid-terminal approach applied to a new plan when skewness of issues is significant.

Conclusion

The exposure draft on auditing accounting estimates contains suggestions that actuaries may find useful in internal control design and in documentation for themselves, other management, and auditors. A copy of the draft can be obtained from the AICPA Auditing Standards Division at 1211 Avenue of the Americas, New York, N.Y. 10036. ☐