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PRESENTING MUTUAL LIFE INSURERS' U.S. GAAP RESULTS

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ABSTRACT

A mutual life insurer's U.S. GAAP report does not show the amount of the company's surplus on a GAAP basis. Instead, it shows an amount representing the surplus minus some or all of the portion of that surplus that the company expects to return to the current participating policyholders. This paper documents the foregoing assertion. It then describes how the principally affected statement items were captioned in the 1996 U.S. GAAP reports of a sample of mutual life insurers and what supplementary information was provided. Finally, it suggests how such reports could caption the items more appropriately.

1. INTRODUCTION

In 1995, the Financial Accounting Standards Board (FASB) and the American Institute of Certified Public Accountants (AICPA) promulgated rules which mutual life insurers must follow if they wish to prepare financial reports in conformity with generally accepted accounting principles (GAAP) in the U.S. The first calendar year for which the new rules were in effect was 1996.

A certain basic feature of the rules, and hence of the reports prepared under them, may not be apparent to many observers. In my view, the recipients of information contained in the reports should be given the best possible chance to understand the information correctly. To ascertain how well the mutual insurers had done in indicating the true nature of the information in their reports, I undertook a survey of 1996 U.S.

GAAP reports of mutual life insurers. This paper describes the basic feature of the GAAP rules that is my concern, what I found in the survey of GAAP reports, and how I suggest improving the reporting.

2. THE TRUE NATURE OF A MUTUAL LIFE INSURER'S U.S. GAAP REPORT

2.1 Nature and Operation of Mutual Life Insurers

A mutual life insurer has no stockholders. The company returns to some or all its participating policyholders, on a continuing basis, money that it does not reasonably need for policyholder protection or other purposes. Such returns are called "dividends."

A participating policy issued by a mutual life company contains various provisions regarding dividends. Typical of one such provision is the following sentence from a policy issued by The Mutual Life Insurance Company of New York in 1981: "While this Policy is in force, the share, if any, of the divisible surplus accruing on this Policy shall be determined by the Company and allotted as a dividend at the end of each policy year." It may be noted that this sentence indirectly defines "surplus" as the account from which dividends are deducted and "divisible surplus" as the amount of surplus that the company has determined it can return to policyholders in a given period.

Surplus derives from an excess of assets over obligations, as measured by whatever accounting principles are being used (internally or externally; I shall assume for this paper that state laws do not prohibit the disclosure of "surplus" as measured by means of accounting principles other than statutory).

The following discussion of mutual-life-insurer operations draws to some extent on the report of the Society of Actuaries (SOA) Task Force on Mutual Life Insurance Company Conversion (SOA, 1988).

Each new policyholder in an established mutual life company benefits from an accumulation of surplus contributed, primarily or entirely, by current and prior policyholders. Additional surplus typically arises from the transactions under the new policies. The largest amount of new surplus arises from participating policies for which the company charges premium rates significantly higher than what management thinks it will need to provide the benefits guaranteed in the policies. Typically, under such policies the company pays smaller dividends during the early policy years than it could afford to pay if it could be confident that things will go as well as its best estimate of future experience.

The policy year in which surplus begins to arise from new policies depends on the policy provisions, on actual events, and on the choice of accounting principles and actuarial assumptions. Some participating policies carry premiums that are relatively low in relation to the guaranteed benefits and are not expected to generate much surplus or receive much in dividends. Nonparticipating contracts, too (such as immediate annuities) are expected to generate a modicum of surplus, but will not receive dividends.

As time passes, if a relatively large amount of surplus has arisen under a particular block of participating policies, the company can begin to return to the remaining policyholders in the block a substantial portion of that amount (SOA, 1988, 362). That is because the company becomes increasingly confident that it can estimate reasonably closely the amount of money it will need to provide the promised benefits under the remaining policies in the block.

If the company wishes to protect against adversity, be able to respond to changing market conditions, and perhaps grow, it must maintain and perhaps increase its total amount of surplus on an ongoing basis. Since some blocks of policies may cause the company to lose money, others must make "permanent" contributions to surplus (SOA, 1988, 359). Accordingly, the company seeks to return to the typical block of policyholders something less than the amount of surplus, if any, that the block generates.

As I explain below, what a mutual life insurer's GAAP balance sheet shows instead of surplus is, in close or rough approximation, the surplus minus some or all of the portion of surplus that the company expects to return to its current policyholders. If what is shown excludes the entire amount of surplus that the company expects to return to the current policyholders, it is consistent in that respect with the following statement by a committee appointed by the SOA Task Force on Mutual Life Insurance Company Conversion: "Future dividends on participating policies are properly treated as obligations for management accounting purposes" (Life Insurance Company Financial Reporting Section Council, 1987, 2).

2.2 GAAP Treatment of Certain Long-term Participating Life Policies

Let us begin with the types of policy that got the most attention and debate while GAAP for mutual life insurers was being developed. These types of policy are defined by the FASB as participating life insurance contracts that meet both the following conditions:

a. The contracts are long-duration participating contracts that are expected to pay dividends to policyholders based on actual experience of the insurer.

b. Annual policyholder dividends are paid in a manner that identifies divisible surplus and distributes that surplus in approximately the same proportion as the contracts are considered to have contributed to divisible surplus (commonly referred to in actuarial literature as the contribution principle). (1995, par. 5)

The AICPA uses the same definition (1995, par. 5). Such policies account for a significant portion of the assets and dividends of many mutual life companies. I shall refer to them below as "long-duration contribution-principle participating life policies."

Under mutual-life-company GAAP there is to be held for such policies a "liability for future policy benefits" equal to the sum of:

a. The net level premium reserve for death and endowment policy benefits.

b. The liability for terminal dividends.

c. Any probable loss (premium deficiency) as described in paragraphs 35 to 37 of FASB Statement No. 60. (AICPA, 1995, par. 15)

The AICPA defines terminal dividends as "Dividends to policyholders calculated and paid upon termination of a contract, such as on death, surrender, or maturity" (1995, Glossary). Under GAAP they are to be accrued in the "liability for future policy benefits" if the following conditions are both met:

a. Payment of the dividend is probable.

b. The amount can be reasonably estimated. (AICPA, 1995, par. 17)

The AICPA notes that the two conditions ordinarily will be met (1995, par. 17). Terminal dividends, therefore, are normally accrued as part of the GAAP "liability for future policy benefits."

The next question is how annual dividends are treated. The answer to that question is not obvious on the surface. It lies in the rules set forth for the GAAP "net level premium reserve for death and endowment policy benefits": "The net level premium reserve should be calculated based on the dividend fund interest rate, if determinable, and mortality rates guaranteed in calculating the cash surrender values described in the contract" (AICPA, 1995, par. 16). If the dividend fund interest rate is not determinable, the rate used to calculate the guaranteed cash or other nonforfeiture values is to be used (AICPA, 1995, par. 16).

As described by Cody (1981, 318), a dividend fund is akin to an asset-share objective. For each policy, an account can be maintained that ascribes to the policy its share of actual premium and investment income, benefit costs, expenses, contributions to surplus, and dividends. The amount that management desires that account to attain at each policy duration is determined prior to issue. Actual dividends are determined as the amounts that can be paid, in the light of actual experience and in accordance with the contribution principle, while maintaining the dividend fund from year to year.

In order to be reasonably sure that a block of policies will be self-supporting, the company sets the dividend-fund amounts at conservative levels. According to Kabele (1995, 348), possible levels include those obtained when statutory-type mortality and interest rates are used to calculate a statutory-type net level reserve, from which some or all the unamortized acquisition costs are then deducted. The "dividend fund interest rate" would be the interest rate used in calculating such a reserve. Kabele points out that the AICPA's specifications for the "net level premium reserve for death and endowment policy benefits" produce, in combination with the deferral and amortization of acquisition costs also called for, something that could serve as a dividend fund (1995, 349).

At any time it is possible to derive the dividends which can be paid to a policy throughout its remaining lifetime, while maintaining the dividend fund at each duration, if future experience duplicates current best-estimate. Since those dividends will be deducted from the dividend fund just as benefits and expenses are deducted, the dividend fund makes provision for, or accrues, dividends as well as benefits. When viewed from the time of policy issue, the dividend fund accrues both benefits and dividends entirely on the basis of best-estimate assumptions.

It may seem contradictory to refer thus to best-estimate assumptions if the dividend fund amount is based on conservative assumptions. Such a dividend fund amount is, however, determined without making any provision in the calculation for dividends. If it did make provision for the dividends that best-estimate experience will produce, calculation by use of conservative assumptions would not produce meaningful results.

U.S. GAAP for mutual companies' long-duration contribution-principle participating life policies (being discussed here) is based on best-estimate assumptions, as is evidenced by the following statement: "Because the liability for future policy benefits defined in this SOP generally follows the FASB Statement No. 97 model, AcSEC concluded that provision for adverse deviation should not be made" (AICPA, 1995, par. 52). Accordingly, the GAAP liability item must accomplish its accruals on the basis of best-estimate assumptions. As explained above, it does that, for insurers following the contribution principle, if it and the unamortized acquisition expense item together are considered to accrue dividends in the process.

The foregoing can be summarized simply, perhaps, by noting that there is a choice of ways to arrive at a policy liability that accrues dividends as well as benefits in a financial report that takes a best-estimate perspective: (1) use best-estimate assumptions and include anticipated future dividends explicitly in the calculation or (2) use significantly conservative assumptions and leave dividends out of the calculation. For long-duration contribution-principle participating life policies, mutual-company GAAP does the latter (except for the explicit treatment of terminal dividends).

The foregoing relates to the "liability for future policy benefits." Other features of U.S. GAAP for long-duration contribution-principle participating life policies are consistent with the above-described nature of the liability. For example, dividends paid are treated as expenses (AICPA, 1995, par. 14). That treatment would be inconsistent with a liability that did not make provision for the payment of dividends. Also, stock life insurers that issue participating policies are permitted to use the mutual-company GAAP rules for policies that have the characteristics of long-duration contribution-principle participating life policies (FASB, 1995, par. 6). Since stock life companies' liabilities must accrue policyholder dividends in order to be able to determine stockholders' equity, stock companies' use of a liability such as is specified for mutual companies is appropriate.

All indications are, therefore, that the U.S. GAAP "liability for future policy benefits" under a mutual company's long-duration contribution-principle participating life policies makes provision for future dividends as well as benefits. It must be noted, however, that the company's reported GAAP liability may differ from management's own dividend fund (or asset-share objective or the like). Hence the GAAP liability may be only a rough approximation to the liability that would make provision for the dividends that the company expects to pay if actual future experience duplicates best estimate.

2.3 GAAP Treatment of Other Policies and Contracts

The foregoing discussion pertains only to long-duration contribution-principle participating life policies. There follows a discussion of the other principal types of policy or contract involved.

Let us begin with universal life-type contracts, because of their implications for deferred annuities. The universal life-type contracts involved can be participating or, if issued by a stock life insurer whose results are consolidated with those of the mutual insurer, nonparticipating. If dividends under a participating universal life-type contract are expected to be negligible, then the product need not, presumably, be classed as a long-duration contribution-principle participating life policy for GAAP purposes.

The U.S. GAAP "liability for policy benefits" for a universal life-type contract is, essentially, its account balance or, in the absence of a stated account balance, its cash surrender value (FASB, 1987, par. 17). The account balance is, together with future premiums, the source of both future benefits and future dividends, if any. Therefore, in a financial report that takes a best-estimate perspective, the account balance makes provision for future dividends.

We have now the question of whether U.S. GAAP reports take a best-estimate perspective with respect to universal life-type contracts. That they do is indicated by the following statement, relating to the "liability for policy benefits": "Provisions for adverse deviation shall not be made" (FASB, 1987, par. 18). Further indication is given by the following statement, which relates to the amortization of deferred acquisition costs under universal life-type contracts: "*Estimated gross profit*, as the term is used in paragraph 22, shall include estimates of the following elements, each of which shall be determined based on the best estimate of that individual element over the life of the book of contracts without provision for adverse deviation..." (FASB, 1987, par. 23). Presumably, the foregoing two statements are what the AICPA was referring to in the sentence about provision for adverse deviation that is quoted above in connection with long-duration contribution-principle participating life policies. From them we may, likewise, conclude that GAAP reports take a best-estimate perspective with regard to universal life-type contracts. Therefore, the GAAP liabilities shown for those contracts make provision for future dividends.

Let us now turn to deferred annuities. For deferred annuities in their accumulation period, the U.S. GAAP liability is likewise, essentially, the account balance (FASB, 1987, par. 15). If GAAP reports take a best-estimate perspective with regard to deferred annuities in their accumulation period, then the liability for those annuities makes provision for future dividends.

The document that specifies the GAAP liability for deferred annuities in their accumulation period does not state what perspective is involved for them (FASB, 1987, par. 15). It is, however, the same document that specifies the liability for universal life-type contracts, discussed above. As indicated above, that document takes the same general approach, the "deposit" approach, to the valuation of both universal life-type contracts and deferred annuities in their accumulation period. The following remarks from that document, furthermore, indicate that the perspective with regard to deferred annuities is in at least one respect not what one might consider conservative:

> Several respondents suggested that the presence of an annuity purchase option constitutes a mortality risk....The Board concluded that...[a] mortality risk does not arise until the purchase provision is executed and the obligation to make life-contingent payments is present in an annuity contract (FASB, 1987, par. 40).

On the foregoing bases, my best guess is that the perspective taken for deferred annuities in their accumulation period is best-estimate. Accordingly, I judge that the GAAP liability for those contracts makes provision for future dividends.

Let us now turn to deferred annuities (other than variable annuities) in their payout period. For such contracts a "liability for policy benefits" is to be established on the basis of assumptions that include provision for the risk of adverse deviation (FASB, 1987, par. 16 and FASB, 1982, par. 21). The principally applicable document, originally written to apply only to stock life companies, also states:

> If limitations exist on the amount of net income from participating insurance

contracts of life insurance enterprises that may be distributed to stockholders, the policyholders' share of net income on those contracts that cannot be distributed to stockholders shall be excluded from stockholders' equity by a charge to operations and a credit to a liability relating to participating policyholders' funds in a manner similar to the accounting for net income applicable to minority interests. Dividends declared or paid to participating policyholders shall reduce that liability...

For life insurance enterprises for which there are no net income restrictions and that use life insurance dividend scales unrelated to actual net income, policyholder dividends (based on dividends anticipated or intended in determining gross premiums or as shown in published dividend illustrations at the date insurance contracts are made) shall be accrued over the premium-paying periods of the contracts (FASB, 1982, pars. 42-3).

Clearly, for stock life companies the total U.S. GAAP liability makes provision for future dividends to policyholders--at least, in the case of certain participating "insurance" or "life insurance" contracts. Whether the U.S. GAAP rules call for such provision in the case of mutual companies' deferred annuities in payout seems unclear. Consistency with the treatment of mutual insurers' long-duration contribution-principle participating life policies would dictate including such provision. It would seem that mutual insurers should be permitted to include such provision if they so desire. The provision could be made, presumably, by using either best-estimate assumptions with provision for adverse deviation and explicitly including expected dividends, or by using statutory-type assumptions with dividends left out of the calculation.

With respect to long-duration participating life policies that do not have the contribution-principle characteristic and are not universal life-type policies, the requirements for mutual insurers are similar to those described above for deferred annuities in payout. My conclusion with respect to them is the same.

With respect to all participating products not thus far discussed, it appears to me that a mutual company should be permitted to include provision for future dividends in its GAAP liability if it so desires.

Nonparticipating products need not be considered here. Their contribution to the residual balance-sheet amount is not influenced by the question of how to treat future dividends to policyholders.

2.4 Implications for the Residual Item in the Balance Sheet

As explained above, a mutual life insurer's report that follows the U.S. GAAP rules will include provision for future dividends in some portions of the policy and contract liabilities, while the picture with respect to other portions is unclear. To the extent that such provision is included, the residual item in the balance sheet falls short of the amount of the company's surplus (as measured on a GAAP basis). If this point is not immediately clear, Section 4 of this paper may help make it clearer.

In preparing its report, the company can caption the affected statement items in such a way as to communicate, with the help of supplementary information in the notes to the statements, the true nature of the report. I undertook a survey of mutual life insurers' 1996 U.S. GAAP reports to see how effectively they communicated their true nature. Section 3 of the paper describes the survey and what I found, while Section 4 comments on what I found and suggests a better approach to presenting the information.

3. SURVEY OF MUTUAL-LIFE-INSURER U.S. GAAP REPORTS

3.1 Scope and Nature of Survey

In May 1997 I wrote to about 4 dozen companies that I was reasonably sure were operating in the U. S. as mutual life insurance companies. I also wrote to a few fraternal organizations whose U.S. life-insurance operations I believed were subject to the mutual-life-insurer GAAP rules and to a few companies about which I was uncertain as to whether they were mutual life companies.

In my letters I asked each insurer: to send me its GAAP report if it had prepared one; if it had not prepared a GAAP report, to tell me whether, and if so approximately when, it planned to do so; and if it had prepared any items for external communication that referred to GAAP reports or to any GAAP numbers, to send me a copy of each type of such item.

About 6 weeks later I made telephone follow-ups to about 20 of the approximately 30 organizations that had not yet responded. I ultimately received written or oral responses from 30 organizations that were mutual life companies or fraternals. Of those, 11 organizations sent me copies of their 1996 GAAP reports (a condensed report in one case).

Most of the other 19 organizations informed me that they had not yet prepared GAAP statements. Many of those indicated that they were planning to prepare GAAP statements fairly soon, such as within the next year. A few organizations stated that they had prepared GAAP statements, but had not yet released them to the public. Since my survey sampling procedure was not rigorous, and since the purpose of the survey was not primarily to ascertain companies' future plans, I will not give any more precise information here except with respect to the GAAP reports I received.

Most of the GAAP reports I received were contained in an annual report resembling the reports that major stock corporations send annually to their shareholders. Two organizations sent me one or more related items in addition to their GAAP report. In view of my findings with regard to the GAAP reports themselves, there will be no need to comment on the additional items.

3.2 Captions of Key Statement Items in the Reports Received

The 11 GAAP reports I received were each accompanied by an unqualified opinion as to their conformity with GAAP (indirectly in the case of the condensed report). Five different accounting firms were represented among the 11 opinions.

Let us look first at the residual item in the balance sheet: the number obtained when the liabilities and a minority interest, if present, are subtracted from the assets. In describing how that item was captioned, I shall use the term "policyholders," regardless of whether the report used that term or a similar term such as "policyowners."

The residual item typically consisted of two or more items that were then totaled. The total was labeled "Total equity" in 6 reports, "Total policyholders' equity" in 1 report, and "Total policyholders' surplus" in 4 reports.

Among the minor components of the residual item, "Net unrealized investment gains," or the like, appeared in all 11 reports. "Foreign currency," or the like, appeared in 3 reports.

The major component of the residual item was captioned variously in the reports. It was captioned "Retained earnings" in 4 of the 6 reports in which the residual item was captioned "Total equity" and also in the report in which the residual item was captioned "Total policyholders' equity." In one of the 2 other reports using the caption "Total equity", the major component was captioned "Policyholders' equity," and in the other it was captioned "Surplus."

In the 4 reports using the caption "Total policyholders' surplus," the major component was captioned in the following 4 different ways: "Accumulated surplus," "Policyholders' surplus," "Unassigned surplus," and "Unassigned funds."

Now let us look at other statement items.

There was nothing in any of the liability-item captions to indicate that any of them included provision for future dividends, other than dividends payable. On the other hand, "future policy benefits" were commonly mentioned among the liabilities.

In the statement of operations (or "income" or "earnings"), 10 reports used the caption "Net income" and 1 the caption "Net earnings." In each case the income or earnings figure was combined with net unrealized investment gains and foreign-currency or minority-interest items, as applicable, to produce the year's change in the residual balance-sheet amount.

The statement of operations in each report except the condensed report contained a separate item for policyholder dividends. In most cases, that item was located under the heading "Benefits and expenses," or the like. When it was located under a heading such as "Benefits and other deductions," at least one item with a caption including the word "expenses" was also located under the same heading.

None of the reports included an item referring to policyholder dividends in the statement of (changes in) equity (or surplus).

3.3 Supplementary Information Provided in the Reports Received

There follows a summary of the relevant information given for each of several product types, as best I can determine, in the notes to the financial statements.

<u>Long-Duration Contribution-Principle Participating Life Policies</u>

Here is what each of the 11 reports indicated with regard to the policy liability:

Net level premium reserves for death and endowment policy benefits, based on the nonforfeiture interest rate, ranging from [specific range of rates given], and mortality rates guaranteed in calculating the cash surrender values described in the contracts, plus the liability for terminal dividends.

. Net level premium method based on the guaranteed cash value basis for mortality and interest. Mortality rates similar to those used for statutory valuation purposes. Interest rates generally range from [specific rates given].

. Net level premium method and the guaranteed mortality and dividend fund interest. The mortality and interest assumptions are equivalent to statutory assumptions. Interest assumptions ranged from [specific rates given].

. Net level premium method, using interest rates and mortality tables used to calculate guaranteed cash surrender values.

. Net level reserves using same interest and mortality assumptions as used to compute the cash values.

. Net level premium reserve for death benefits, using dividend fund interest rates and mortality rates guaranteed in calculating cash surrender values. ...Dividends to policyholders based on estimates of the amounts to be paid for the period are reported separately as expenses.

. Net level premium reserve for death and endowment policy benefits, based on dividend fund interest rate and mortality rates guaranteed in calculating the cash surrender values described in the contract.

. Net level premium method and assumptions as to interest (dividend fund interest rate) and mortality (those guaranteed in the calculation of cash surrender values shown in the contract). [Note: this report contained some specific interest-rate information that I was unable to match up conclusively with the foregoing information.]

. [Discussed together with all other products except "nontraditional life products and deferred annuities."] Reserves calculated using net level premium method based upon assumptions regarding investment yield, mortality, morbidity, and withdrawal rates determined at the date of issue, commensurate with the company's experience.

[Mention of provision for adverse deviations from those assumptions "in certain cases."]

. [In the condensed report, no supplementary information pertaining to these matters given.]

. [In a full report, no supplementary information pertaining to these matters given.]

Universal Life-type Contracts

The reports described the liability in terms of the account value, in some cases stating that it was before deduction of surrender charges. A few reports gave a brief explanation of how the account values are derived.

Deferred Annuities in the Accumulation Period and Other Investment Contracts

The reports described the liability in terms of the account balance. A few of the reports did not identify deferred annuities separately from other investment contracts in giving the description.

Deferred Annuities in the Payout Period

Only two reports described the liabilities specifically with respect to deferred annuities in payout. One of those reports described the liability as the present value of expected future payments and gave a range of interest rates used. The other report merely gave the range of interest assumptions used. Neither report mentioned a provision for future dividends.

Other Products

For products other than those discussed above, the descriptions were generally in terms of a net level reserve using assumptions (in some cases described as being based on experience or on projected experience and in some cases described as being made at issue) as to such things as mortality, interest, and withdrawal, with provision for adverse deviation. No mention was made of a provision for future dividends.

Reconciliation to Statutory Results

Each report included a note concerning the differences between GAAP and statutory results. Following is a summary of each report's note.

. Reconciliations of statutory balance-sheet and operations-statement residual items to GAAP. Each reconciliation contained an item adjusting for future policy benefits. Accompanying text mentioned that statutory and GAAP life insurance reserves are based on different assumptions.

. Reconciliations of statutory balance-sheet and operations-statement residual items to GAAP. Each reconciliation contained an item adjusting for future policy benefits and an item captioned "Policyholder dividends." One-sentence qualitative elaboration on the reconciliations.

. Reconciliations of statutory balance-sheet and operations-statement residual items to GAAP. Each reconciliation contained an item adjusting for future policy benefits. Accompanying text mentioned, among ways in which statutory accounting differs from GAAP, that reserves for life and disability policies and contracts are based on statutory requirements.

. Reconciliations of statutory balance-sheet and operations-statement residual items to GAAP. Each reconciliation contained an item adjusting for insurance reserves and an item adjusting for dividend liabilities. No qualitative elaboration.

. (2 reports) Reconciliations of statutory balance-sheet and operations-statement residual items to GAAP items. Each reconciliation included an item adjusting for "policy" or "insurance and annuity" reserves. No qualitative elaboration.

. (2 reports) Reconciliations of statutory balance-sheet and operations-statement residual items to GAAP. Each reconciliation contained an item adjusting for future benefits. No qualitative elaboration.

. Summary statutory numbers given, but no reconciliation to GAAP numbers. Accompanying explanation indicating, among other things, that GAAP liabilities are based on "reasonably conservative" estimates of expected mortality, etc., rather than using "statutory" rates for mortality and interest.

. Statutory balance-sheet and operations-statement residual items given, but no reconciliation to GAAP numbers. Statement that the statutory liability for future policy benefits was computed using required valuation standards.

. Statutory balance-sheet residual item given, but no reconciliation. No qualitative elaboration.

There was no mention of dividends other than the two instances cited above.

4. COMMENTS AND SUGGESTIONS

4.1 Initial Basis of Discussion

As mentioned in Section 3.2, every GAAP report I received included policyholder dividends with benefits and expenses in its statement of operations; no report mentioned dividends in its statement of (changes in) equity (or surplus). Under accrual accounting, those facts imply that every participating policy or contract liability made provision not only for future benefits, but also for future dividends, if material. The statements and notes do not indicate, however, whether such provision was in fact made for any products.

As explained in Section 2.3, the GAAP rules for mutual insurers cause the liabilities for some products to make provision for future dividends and should, I believe, be interpreted as permitting mutual insurers to make such provision in the case of all other participating products. It seems desirable, for the sake of consistency, to treat all products the same way with regard to dividends. Since uniform treatment also makes the discussion easier, I shall first discuss a hypothetical report in which the liabilities for all participating products make provision for future dividends except as immateriality may permit otherwise.

Regardless of how the residual balance-sheet item is captioned, the liability item for policies and contracts should indicate that it is the liability for both future benefits and future dividends. The caption for the liability item for dividends payable would include the word "payable." Let us turn now to the choice of caption for the residual item.

4.2 Use of the Term "Equity"

Seven of the 11 reports used the term "equity" in captioning the residual balance-sheet item.

Some members of the public may interpret "equity" as meaning "surplus." That interpretation would be misleading, as I will discuss further in Section 4.3. It seems likely that other persons will interpret "equity" by analogy to their understanding of stockholders' equity.

Persons who know much about stockholders' equity know that it is where stockholders' dividends come from. At the end of each fiscal year, net income is carried ("closed") to retained earnings, a component of stockholders' equity. Dividend payments reduce stockholders' equity, not net income.

It seems likely that some persons seeing a reference to a mutual insurer's "equity" will conclude that it is where policyholder dividends come from, just as stockholder dividends come from stockholders' equity. Persons who are current participating policyholders may assume that the "equity" is where dividends paid to *them* come from. As explained in Section 2, however, the residual balance-sheet item in U.S. GAAP is where dividends to current policyholders do *not* come from (under the assumption, made for purposes of this discussion, that a liability for future dividends has been established for each participating product if material). Where the dividends do come from is similar to where benefits come from; it is from a portion of premium receipts and investment earnings plus, in some policy years, the liability for future dividends that is implicit in the policy liabilities.

Of course, under normal conditions the amount of dividends eventually paid to this year's current participating policyholders will exceed the amount of the current liability for future dividends. That will happen as a result of future premium receipts and investment earnings. Likewise, however, stockholders have a reasonable expectation that the dividends paid within their lifetimes will exceed the current amount of stockholders' equity. The point is that stockholders' equity is the source of dividends, while a mutual insurer's residual U.S. GAAP balance-sheet amount is not. Accordingly, I find "equity" to be a misleading term for the latter.

One may argue that, nevertheless, "equity" would fit the FASB's definition of that term. To be sure, the FASB has stated, "In a business enterprise, the equity is the ownership interest....[It] is the same as net assets, the difference between the enterprise's assets and its liabilities" (FASB, 1985, par. 60). At first glance, that definition would seem to fit the U.S. mutual-company GAAP situation. The FASB has, however, defined "liabilities" as follows: "Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to *other* entities in the future as a result of past transactions or events" (FASB, 1985, par. 35, emphasis mine).

A footnote to the foregoing definition of "liabilities" explains that obligations need not be hard and fast, legal obligations in order to be liabilities. The point here is not to quarrel with the treatment of future dividends as liabilities and their resultant exclusion from the residual balance-sheet item. The point is that if future dividends to current policyholders are a liability as defined by the FASB, they are a liability from the perspective of some entity *other* than the current policyholders.

Who might that other entity--the "owner(s)" of the "equity"--be? There are no stockholders. Past policyholders are out of the picture. Accordingly, the "owners" of the "equity" must be the future participating policyholders. Hence, if the residual item is "equity", it is "future policyholders' equity."

It would seem strange, of course, to consider future policyholders to be owners of the insurer, as would be implied by the FASB definition of "equity." Accordingly, the term "equity" seems ill-suited for use in a mutual insurer's report.

One may object to some of the foregoing reasoning by pointing out that if a mutual insurer is liquidated, the remaining assets will be distributed to the then existing policyholders. That is true, but the GAAP reports in question are on a going-concern basis, not a liquidating basis. On a going-concern basis, all the monetary interests of the current policyholders are reflected in the liabilities for benefits and (under GAAP) future dividends; only the future policyholders have an interest in the residual item.

One may further object by pointing out that it is possible that the mutual insurer will be converted to a stock company, in which case some or all of the residual balance-sheet amount may revert to the then existing participating policyholders in the form of cash or stock. That is also true, but the amount that may be received bears no determinable relation to the residual balance-sheet item, even as of the time of conversion. The SOA Task Force on Mutual Life Insurance Company Conversion concluded that whether or not a conversion is accompanied by a concurrent public offering of stock in the new company, the then existing participating policyholders' equity value in the new company will depend on the market value of the new company (SOA, 1988, 308-9). In discussing principles of legislation and regulation, the Task

Force stated, "We believe that there is no entitlement of policyholders to any specific value and that book value measures of policyholder contributions are not appropriate measures of value in a world in which market-determined values are the ultimate standard" (SOA, 1988, 315).

Granted, when a stock corporation is acquired by another corporation, the price paid to stockholders of the acquired corporation likewise depends on market values, not on book values. Both situations, however, differ from the going-concern situation that the U.S. GAAP reports are designed to describe.

As explained above, the residual balance-sheet item in question cannot satisfy the FASB's definition of "equity" unless it represents the ownership interest of someone other than the present policyholders. It is the future policyholders' equity if the report is viewed in the light of ongoing operation as a mutual insurer. For various reasons, however, mutual life insurers may be reluctant to call the item "Future policyholders' equity."

A mutual life insurer may still be tempted to caption the residual item "Equity," or even "Policyholders' equity," and depend on the mention of future dividends among the liabilities, plus a note to the statements, to explain the true nature of the item. Such an approach seems questionable. The name given to the residual item is likely to be mentioned orally and in print without being directly followed by an explanation of the true nature of the item. Even though an explanation could be found in the financial statements and, presumably, from other sources as well, there would be many instances in which the explanation would be neither requested nor received. It is best to make the caption itself give as fully true a picture as possible.

Section 4.3 will discuss whether it is possible to give a satisfactorily true picture of the residual balance-sheet item in terms using the word "surplus."

4.3 Use of the Term "Surplus"

Here again I shall discuss a hypothetical report in which the liabilities for all participating products make provision for future dividends except as immateriality may permit otherwise.

As explained in Section 2, the residual balance-sheet item represents the surplus minus the portion of surplus that the company expects to return to the current participating policyholders. Accordingly, "Surplus" is an incorrect caption for the item. The caption that is needed is a condensation of the description given in the first sentence of this paragraph.

A term that has been mentioned now and then for more than two decades is "entity surplus." To those who have been in on the discussions, that term indicates "permanent" surplus--or, more rigorously, what is left of the "permanent" contributions of past and current policyholders and any others. To knowledgeable persons, then, the term conveys the desired meaning. It would seem, however, that other persons might quite possibly think that the "entity surplus" was the company's surplus. As discussed above, notes to the statements would be an inadequate aid in that case.

"Future policyholders' share of surplus" would be as accurate as "future policyholders' equity" and would not have the disadvantage of ascribing, technically, ownership to the future policyholders. Nevertheless, there might still be objections to labeling the item by reference to future policyholders.

"Surplus not allocated to current policyholders" might be confused with surplus itself, on the thinking that only the dividends already declared, or the like, have been "allocated" to policyholders. "Net surplus" might be similarly confused.

"Surplus after future dividends" might create the impression that there are two kinds of surplus: surplus before future dividends and surplus after future dividends.

"Surplus less provision for future dividends" would avoid creating that impression and would seem acceptable unless "provision," in U.S. GAAP parlance, can be used only in connection with income items, not with balance-sheet items, or is otherwise inappropriate for the purpose. If "provision" is inappropriate, "liability" or, perhaps, "reserve" could be used instead. In 2 of the 11 reports reviewed for this paper, the term "reserve" appeared in the balance sheet to denote the liability for future benefits (and dividends, where included).

Each of these last three possibilities seems rather cumbersome. To achieve something shorter, it may be necessary to avoid using either "equity" or "surplus" in the caption, as suggested in Section 4.4.

4.4 Use of Neither "Equity" nor "Surplus"

A term used both by actuaries in referring to an item of the nature being discussed here (Life Insurance Company Financial Reporting Section Council, 1987, 2) and by the FASB in defining "equity" (FASB, 1985, par. 60) is "net assets." Despite those uses, "Net assets" would be a misnomer. Items in the liability/equity section of a balance sheet do not represent assets; the FASB has described liabilities and equity as "mutually exclusive *claims to* or *interests in* the enterprise's assets" (FASB, 1985, par. 54, emphasis mine). In addition to being a misnomer, "Net assets" would fail to call attention to the fact that future dividends are treated as liabilities.

In somewhat the same vein, "Investment in future business," or the like, would be misleading. The term "investment" would encourage, or at least permit, the inference that the return on the "investment" would redound to the current policyholders. Since the entire monetary interest of the current policyholders is (on a going-concern basis, at least) reflected in the liabilities, that inference would be mistaken.

A caption having neither of the foregoing drawbacks may be "Margin after future dividends." To my knowledge, there is no particular reason for someone to assume that such a label refers to the surplus. A note to the statements could explain the caption's meaning. Unless "margin" has a generally accepted meaning that could make the caption misleading, "Margin after future dividends" might do.

4.5 If Not All Contract Liabilities Include Provision for Future Dividends

The discussion thus far in this section has assumed that all policy and contract liabilities in the report include provision for future dividends. If it is acceptable to leave such a provision out of the liability for one or more products, even if the omission makes a material difference, and if that is done, then the problem of choosing a caption becomes a bit more difficult.

The first thing to note is that the contract-liability items in the balance sheet should be separated, with those that include provision for both benefits and future dividends being so captioned and the others being captioned only as providing for benefits.

None of the captions suggested in Sections 4.2 through 4.4 for the residual balance-sheet item would be appropriate, since provision for future dividends would not have been made across the board. The residual item could be captioned "Surplus less provision (or "reserve" or "liability") for certain future dividends," or "Margin after certain future dividends," but the word "certain" might associate a certainty with future dividends that they do not deserve.

Substituting for "certain future dividends" in the foregoing something like "future dividends as indicated" would overcome the difficulty mentioned, but the label would appear strange in the absence of the report itself.

It might be possible to use "Surplus not included in liabilities." The reader or listener would at least be alerted to the fact that the residual item differed from the surplus. Reference to the report, including the notes to the statements, would identify the difference.

4.6 Other Statement Items and Related Notes

After correct captions for the balance-sheet liability and residual items are chosen, all other statement items should be conformed to them as appropriate.

If all GAAP items are correctly captioned, it should be possible to furnish a reconciliation of statutory results to GAAP if so desired. The mention of future dividends in the captions relating to any affected GAAP contract liability items will render the reconciliation between statutory surplus and the GAAP residual item accurate despite the difference in nature between those two residual items. The absence of a number indicating the amount of the provision for future dividends that has been made, however, will limit the informative capacity of the reconciliation. For example, a more informative reconciliation would show the difference between the GAAP and statutory contract liabilities, each without provision for future dividends, and then, separately, the amount of the GAAP provision (liability) for future dividends.

5. CONCLUDING REMARKS

None of the 11 1996 U.S. GAAP reports indicated their true nature. Those labeling the residual balance-sheet item as "equity" failed to indicate that if the item is indeed someone's "equity," it is the future policyholders' equity. Those reports labeling the residual item as "surplus" were simply incorrect.

If the report is consistent across product lines in its treatment of future dividends, my preferred caption for the residual balance-sheet item is "Surplus less provision for future dividends" or, for something shorter, "Margin after future dividends."

One of the 11 responding organizations sent, in addition to its 1996 report, its report for the first quarter of 1997. While its 1996 report referred to "Total policyholders' surplus," with a major component of "Accumulated surplus," its first-quarter 1997 report referred to "Total surplus," with a major component of "Equity." Although I do not favor any of those captions for mutual-life-company reports under the current U.S. GAAP, I welcome the fact that the organization was willing and able to change the captions it was using.

As of the writing of this paper, the AICPA was preparing for exposure a draft audit guide for insurers. I hope that the final version of that audit guide will contain appropriate guidance for the captioning of key statement items.

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MUTUAL ORGANIZATIONS RESPONDING TO SURVEY INQUIRY

Acacia Mutual Life Insurance Company

Aid Association for Lutherans

American United Life Insurance Company

Berkshire Life Insurance Company

Columbian Mutual Life Insurance Company

Educators Mutual Life Insurance Company

Farmers and Traders Life Insurance Company

General American Life Insurance Company

Guardian Life Insurance Company of America

John Hancock Mutual Life Insurance Company

Lutheran Brotherhood

Metropolitan Life Insurance Company

The Minnesota Mutual Life Insurance Company

Mutual of America Life Insurance Company

Mutual Trust Life Insurance Company

New York Life Insurance Company

Pacific Mutual Life Insurance Company

Pan-American Life Insurance Company

Phoenix Home Life Mutual Insurance Company

Principal Mutual Life Insurance Company

The Prudential Insurance Company of America

Security Mutual Life Insurance Company

Security Mutual Life Insurance Company of New York

Shenandoah Life Insurance Company

Standard Insurance Company

Sun Life Assurance Company of Canada

Teachers Insurance and Annuity Association

Trustmark Insurance Company

The Union Central Life Insurance Company

The Western and Southern Life Insurance Company