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Mutual company GAAP: Doubly different

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Many of us are used to thinking of the difference between statutory accounting principles (SAP) and generally accepted accounting principles (GAAP), in terms of the degree of conservatism employed. In particular, we think of the mortality and interest assumptions chosen under the two approaches as producing larger SAP reserves than GAAP reserves for the same policy liabilities. The treatment of acquisition expenses may give rise to additional conservatism in SAP reports compared to GAAP. Other differences between SAP and GAAP exist, of course, such as in the valuation of assets.

Now we have GAAP for mutual life insurance companies, as prescribed by the Financial Accounting Standards Board (FASB) and the American Institute of Certified Public Accountants (AICPA). The new mutual company GAAP reports will differ from mutual company SAP reports not only in their degree of conservatism but also in presenting different items of information.

Nature of the GAAP bottom line

Where mutual company SAP balance sheets show the company's surplus, GAAP balance sheets will show something different that many actuaries consider useful for management purposes. It can be described by quoting from the 1986 report of a committee of the Society of Actuaries Task Force on Mutual Life Insurance Company conversion:

> The most useful form of mutual life insurance company financial statement for management purposes is the one that best reflects...realistic operating results. ...Future dividends on participating policies are properly treated as obligations for management accounting purposes. ...

With this approach, the FASB-AICPA mutual company reports will treat future dividends as obligations, that is, accrue them in a liability item.

This may not be immediately apparent, because the FASB-AICPA documents call for the policy liability to be calculated without reference to future annual dividends. The treatment is to be achieved, however, by employing conservative mortality and interest assumptions. The result will be something akin to what some actuaries call "asset shares" or "dividend funds." It will be somewhat as if GAAP-type mortality and interest assumptions were used and future dividends were built into the calculation. As the AICPA document says:

> This estimate of the liability is consistent with the view that the mutual life insurance enterprise is liable for the guaranteed provisions of the policies it sells and for paying dividends related to favorable experience.

The AICPA document calls for dividends to be treated as expenses when paid and for "terminal" dividends expected to be paid in the future to be explicitly accrued as part of the "liability for future policy benefits."

The above relates to "traditional" policies. For universal life policies, the prescribed treatment is similar to that under stock-company GAAP. Policy dividends are, however, likely to be negligible or nonexistent in the case of universal life policies issued by mutual companies.

Clearly, the "bottom line" item obtained when liabilities determined as above are subtracted from assets will not be a mutual company's surplus. Dividends, as described in actuarial literature and in mutual company participating policies, are not expenses; they are distributions of surplus. If they can be said to accrue, they accrue in surplus. If the bottom line were to show the surplus, future dividends could not be accrued in a liability.

Labeling the GAAP bottom line

The FASB and AICPA documents do not say how the bottom line of the balance sheet should be labeled, but "Surplus" would be an inaccurate caption. Since a portion of surplus representing the accrual of future dividends will be excluded from the bottom line, a more accurate name would be, "Surplus Not Dedicated to Existing Policyholders."

Accountants may prefer to use the phrase, "Policyholders' Equity," instead of referring to the company's surplus. However, the policyholders to whom the mutual-company GAAP bottom line will be attributable do not include the company's existing policyholders. All the existing policyholders' interests will be reflected in the liabilities. Yet in a mutual company, it seems reasonable to attribute any excess of assets over liabilities to participating policyholders of the company. Since under FASB-AICPA GAAP the bottom line will be attributable to neither existing policyholders nor past policyholders, it seems reasonable to attribute it to future policyholders.

The stockholders of a stock company (e.g., General Motors) expect dividends to be paid out of stockholders' equity. Similarly, the participating policyholders of a mutual life insurance company might reasonably expect policy dividends to be paid out of the bottom-line amount if it were captioned, "Policyholders' Equity." As explained earlier, however, management will not expect to pay dividends to existing policyholders out of the GAAP bottom-line amount. Accordingly, "Future Policyholders' Equity" would be a misleading caption.

Similar considerations apply when labeling other related items in mutual-company GAAP reports.

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