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U.S. GAAP Seminar in Hong Kong—an Encore

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In October 2006, the International and Financial Reporting Sections collaborated to produce a three day seminar in Hong Kong on GAAP accounting. Response was phenomenal and potential registrants had to be turned away. Your section leadership, concerned about this, scheduled a repeat performance for Aug. 7-9, 2007. Again, the response was stunning, as over 130 people registered and attended.

The faculty comprised Charles Carroll of Ernst & Young, Tom Herget of PolySystems, Bill Horbatt of Actuarial Consortium, Michael Lockerman of PricewaterhouseCoopers, Simon Walpole of Deloitte and Jonathan Zhao of Ernst & Young. This seminar, held in the Kowloon part of Hong Kong, was coordinated by the Hong Kong staff office. Pat Kum and assistants Sarah Hui and Christina Lai were very helpful and ran a well-organized meeting.

The topics addressed were background of GAAP, principles of GAAP, expenses, product classification, non-par products (life and health), par products, fund-based products, payout annuities, investment contracts, investment accounting, shadow accounts, internal replacements, purchase accounting, reinsurance accounting, SoP 03-1, SoP 05-1 and a lively panel on emerging issues.

The faculty would like to share several Frequently Asked Questions (and answers!) with the readership.

One question that was on participants' minds was the treatment of reinstatements of traditional life insurance products. In much of Asia, companies are legally required to reinstate lapsed policies for two, three or even five years after the lapse occurred. These reinstatements may require little to no underwriting. Provided back premiums are paid with interest, companies must reinstate the lapsed contract.

In these cases, policyholders are (thankfully) not allowed to pay back premiums posthumously and companies have no requirement to pay death benefits once the policy has been lapsed for longer than its grace period. These contracts typically have a contractual grace period of 30 to 60 days and internal company guidelines dictate that benefits should be paid if death occurs 15 to 30 days after this contractual grace period.

The panel agreed that *Section 6300.29: Contract Reinstatements in Applying SOP 05-1* provided an answer. Provided the lapsed policy reached a point beyond where the internal company guidelines required a claim be paid, the policy should be considered extinguished and any reinstatement should be considered a separate contract. The panel also agreed that the calculation of this "new" policy may be very difficult with most companies' current systems and suggested participants perform an analysis based on materiality.

There were also some questions on accounting for sales inducements. Participants were particularly interested in recurring persistency bonuses, such as a bonus that is credited every five years, which qualify as sales inducements in accordance with SOP 03-1.

Although the SOP may not be explicit in this guidance, the panel believed that it would be appropriate to accrue a liability for these bonuses simultaneously. For example, the bonus credited at the end of year five would be accrued over the first five years and the bonus for year 10 would be accrued over the first 10 years. Although somewhat conservative, paragraph 36 of the SOP states that persistency may not be considered in this accumulation. As a result, most companies use an interest method to accumulate the amounts.

However, paragraph 37 states the company should simultaneously accrue a sales inducement asset for these liability accruals that would be amortized with expected gross profits. Including these sales inducement assets and liabilities would result in a more level recognition of income, but due to the conservatism in the liability accumulation, income would be somewhat deferred to later periods.

Another question was, "what is the difference between recoverability and loss recognition?"

Both terms deal with the analysis of profitability for a block of business. Recoverability refers to business issued within the current fiscal year. It answers the question, are costs that are deferred recoverable? Loss recognition refers to products issued over a multi-year period. It answers the question, is the liability I have established sufficient to mature the block of business?

The guidance for recoverability and loss recognition may be found in Paragraphs 32-37 of SFAS60.

For recoverability, the actuary must establish that costs deferred are recoverable from margins in the product. The study is performed regularly, on a quarterly or annual basis.

For FAS60 recoverability studies, for products with net to gross premium ratios over 100 percent, the provisions for adverse deviations (margins) are reduced until the net to gross premium ratio is 100 percent. If the margins are still over 100 percent, there is likely a problem with the original assumptions or with communications between the pricing and valuation areas.

For performing these tests, the contracts should be grouped consistently with the enterprise's manner of acquiring, servicing and measuring profitability.

For FAS60 loss recognition (also called premium deficiency) studies, the actuary's best estimate is used for all future assumptions. This gross premium reserve becomes the minimum floor for the net liability (reported GAAP benefit reserve less reported DAC).

It is generally easier to perform FAS97 recoverability and loss recognition studies. Since all future assumptions are based on current best estimates, the actuary need only to replace the contract rate (used to discount the cash flows) with the current earned rate(s).

Loss recognition is not performed for FAS91 products.

Moving on to the next topic, the discussion of the requirements of SFAS 113 on the accounting for reinsurance raised a question regarding when it is and is not appropriate to net reinsurance amounts against direct amounts. In most cases SFAS 113 calls for reporting reinsurance balances separate from direct rather than netting. For example, the cost of reinsurance (defined as the premiums paid, less allowances, less claims reimbursed) should be

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accrued separately over direct premiums or direct EGPs depending on whether the underlying policies are covered by FAS 60 or FAS 97. Netting reinsurance costs in the EGP calculation is not appropriate. One area where netting is allowed is in the calculation of deferred acquisition costs. If there are high front-end reinsurance allowances payable, these may be netted against direct deferrable acquisition costs in calculating the deferred acquisition cost asset.

The reception at the end of day one was well-attended and the faculty and participants got to know each other. Many attendees lived in Hong Kong and had to return to the office to work the night shift. But those that didn't were able to cover for them at the hors d'oeuvres table and wine bar.

The faculty that didn't live in Hong Kong had some travel tales to tell. Tom Herget had been in mainland China for 12 days and had to have a cheeseburger immediately upon his arrival. This time, Bill Horbatt's luggage arrived. Charles Carroll reported no unusual travel issues. But, Michael Lockerman was very fortunate to make it.

Some questions directed at Michael were, "Have you been near a chicken farm or processing plant? Have you been in any jungles?" and "Can you take a deep breath for me?"

These were not questions from participants at the seminar, but from a physician at the Hong Kong airport. Although he had flu-like symptoms, Michael's desire to teach U.S. GAAP overwhelmed his regard for his own health (as well as, apparently, the health of the fellow passengers on his flight from Bangkok) and he arrived at the airport with a fever of 102. In a region where SARS and Avian Flu have been significant occurrences and dengue fever is having a recent resurgence, airports are ready and the heat camera easily identified Michael's red face in a sea of blue-green smiles.

He was approached by masked, gloved men who quickly escorted him to a secure part of the airport where he waited for masked, gloved physicians to examine him. After an hour examination, the doctors concluded he either had a simple flu (low mortality rate) or dengue fever (not contagious) and set him free.

At the end of the meeting, the faculty awarded a prize for best participation. Suchin Pongpuengpitack of AIA Thailand was awarded third place and Allen Chi Tat Lowe of Prudential UK was runner-up. But outdistancing the entire class was first-place winner Ching Gabrielle Chan of Alico Taiwan, who won a very attractive GAAP textbook work shirt.

The U.S. GAAP seminar continues to fulfill a need. The faculty plans more road trips, a fiesta in Mexico City and a return to the Pacific Rim, either Tokyo or Seoul. We hope to see you there. ☐