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MUTUAL COMPANY GAAP

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- o What are the objectives of mutual company GAAP?
- o What are the common features seen today?
- o What are the similarities and dissimilarities to stock company GAAP?
- o What have been the experiences of mutual companies using modified GAAP for internal management reports?
- o Should there be a recommended model for all mutual companies? For what purpose?
- o How will a company's methodology relate to or influence deferred acquisition costs under Alternative Minimum Tax (AMT)?

MR. EDWARD L. ROBBINS: Primarily, mutual company GAAP is a very interesting subject right now because of AMT. I would imagine you are interested in that particular subject as it relates to mutual company GAAP. There is another panel discussion at this meeting dealing with AMT, and I think the panelists will probably be touching upon mutual company GAAP and its relationship to AMT in that session.

At any rate, I thought I would spend a few minutes on the subject of AMT early on just to dispense with the subject, and please feel free to ask questions during the discussion period on AMT if you are interested.

First, I will introduce our panel. We have an outstanding panel for this particular subject. Cal Jared, Vice President and Corporate Actuary of the Equitable will speak from the large eastern mutual company perspective. The Equitable has been on GAAP since late in 1984. It was one of the first large mutual companies to go on GAAP, so it has been field testing it for quite a while, over five years. Since Cal joined the Equitable, he has been intimately involved with the GAAP reporting process, and I am sure he has plenty of good war stories for you.

Next is Kriss Cloninger, a principal of KPMG Peat Marwick. Kriss is extremely well-qualified to address this subject from the consulting side. He started using the GAAP process soon after the original stock life company audit guide came out. He has played a key role in several mutual company GAAP conversions, and he will be emphasizing the mutual company GAAP area from the medium-sized and smaller company perspectives.

Bob LaLonde, a marketing actuary for PolySystems, will be our anchorman. As the chief marketing representative of one of the leading actuarial software firms, he will address the mechanics of implementation from the perspective of an organization that has

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sions by now. I promised I would say a few words about the AMT. I would like to show just a few of the rudimentary mathematics of AMT (Chart 1).

CHART 1

Some Alternative Minimum Tax Mathematics

Definitions:

R = Regular Taxable Income (RTI)

A = Additions to R to get adjusted current earnings (ACE)

Crossover Point:

$$.34 * R = .2(R + .75 * A)$$

Solving, A/R = 14/15, or 93.3%

Your regular tax is 34% of your regular taxable income, if you are in the regular tax status. The right side of that equation is what we call tentative minimum tax, and when the tentative minimum tax exceeds the regular tax, that positive excess equals the AMT. I am ignoring a lot of things, like loss carry-forwards, just to keep the presentation simple. So you are talking about the tentative minimum tax being 20% of regular taxable income plus 75% of 20% of add-backs. What we are saying is that as soon as the ratio of add-backs to regular taxable income becomes 93% or so, you are in the AMT. What are the add-backs? There are several. Number one, the small company deduction is an add-back. The company share of tax-exempts and dividends received deductions are add-backs. For most large companies, by far the predominant add-back is the increase in deferred acquisition cost (DAC). So what are we saying? We are saying that, as soon as you become a rapidly growing company and your taxable income shrinks (just as your statutory income shrinks) and your DAC increase grows, you are there.

One of our client company actuaries asked me the following question (Chart 2). He said tentative life insurance company taxable income, or tentative LICTI (it is a large company), looks something like statutory income. The company has very little in the way of tax-exempts and dividends received, and is not a very rapidly growing company. Let's just assume that LICTI is statutory income. What is our so-called "tax rate"?

CHART 2

Ratio of tax to LICTI while in AMT

$$\text{Ratio} = .2 + (R + .75 * A) / R = .2 + .15 * (A/R)$$

<u>(A/R)</u>	<u>"Tax Rate"</u>
< .933	34.0%
1.000	35.0
1.100	36.5
Etc.	

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By tax rate, I mean, if you take a look at page four of the summary of operations, and you take the federal income tax incurred and divide it by your statutory income before income tax, what kind of tax rate am I looking at? This is something typical boards of directors look at. When that becomes 70%, they get rather concerned. Anyway, what this chart shows is that as long as the ratio of add-backs to regular taxable income is less than or equal to 93.3%, your so-called tax rate is at 34%, and for each 10% that the add-back ratio grows, you are adding 1.5% to your effective tax rate, defined that way.

I want to talk about what AMT and minimum tax credit are (Chart 3). Basically, every time you are in an AMT situation, meaning your tentative minimum tax is in excess of your regular tax, that positive excess is put into a bucket called minimum tax credit. That minimum tax credit is subject to a perpetual carry forward, and in the year you are eventually back in regular tax, that bucket can be drawn out of, to fill up the excess of regular tax over tentative minimum tax at such time. This basically relegates the AMT tax to being a timing difference as long as you eventually get back into regular tax. Anyway, what does this slide mean? It is the formula for tentative minimum tax. If you took regular tax away from that, you would end up with AMT. So you will see that in the AMT formula, adding a dollar on the right gives you a 20 cent marginal increment to your actual cash pay out. Meanwhile your minimum tax credit, the excess, is reduced by 14%. What I am going to say has nothing to do with FAS 96, but now you have current taxes and deferred taxes, with a completely different meaning from the FAS 96 version of current taxes and deferred taxes. It means when you have a dollar of additional regular taxable income, you pay 20 cents now and you pay 14 cents when you revert back to regular tax.

CHART 3

Incremental effect of \$1.00 change in RTI while in AMT

	<u>Without Change</u>	<u>With Change</u>	<u>Increment</u>
<i>TMT</i>	$.2*(R+.75*A)$	$.2*(R+1+.75*A)$	$.20$
<i>MTC</i>	$.2*(R+.75*A) - .34*R$	$.2*(R+1+.75*A) - .34*(R+1)$	$-.14$

So, for example, if you are exploring differences in tax reserve patterns, you can use those marginal rates and time value the difference and get a dollar effect of those differences between alternatives. This is probably the most important slide (Chart 4) for discussion, and it is what happens with a dollar change in the add-back, for example, a dollar difference between DAC increase alternatives, DAC meaning deferred acquisition costs under GAAP or tax basis GAAP. You have a 15 cent increment, in other words an increase in DAC has a marginal AMT tax rate of 15 cents, and meanwhile you are adding 15 cents to your minimum tax credit bucket to eventually be used when you are back into regular tax.

The upshot of it all is that the DAC that you calculate for mutual company GAAP, although it may not be the same as what you are talking about for AMT, will probably have a very real effect on real dollar taxes.

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CHART 4

Incremental effect of \$1.00 change in *A* while in AMT

	<u>Without Change</u>	<u>With Change</u>	<u>Increment</u>
AMT	$.2*(R+.75*A)$	$.2*(R+.75*(A+1))$.15
MTC	$.2*(R+.75*A)-.34*R$	$.2*(R+.75*(A+1))- .34*R$.15

I want to take a show of hands of two questions right now. How many nonmutual company representatives do we have in the room? Okay, let's round it to seven (out of 56), a good actuarial average. The next question is how many mutual company people feel that they are at least quite close to stock life company GAAP at the moment? One, two? As I indicated, Cal Jared will be our first speaker.

MR. CALVERT A. JARED, II: I am not surprised that only a couple of people raised their hands saying that they were on stock company GAAP. There is no one single definition of mutual company GAAP, and I guess the major differences all go back to the mutual philosophy of providing low cost to policyholders through the dividends, while also being able to grow the business and grow surplus. The objectives of mutual company GAAP or internal financials typically are being able to assist management in decisions. You want the financials to be able to adapt to changes in assumptions, in experience, in the marketplace, but you also want them to be consistent with pricing and dividend philosophy. There are a couple of major differences between stock company type GAAP and mutual company GAAP. Mutual companies are more concerned with alternate uses of capital than earnings. I guess that the phrase, just to remind you, that we are talking about is measuring profitability, not creating profitability. I am not sure how many war stories I am going to tell you, although I may have a couple later on, but I would like to think that I am going to give a frame of reference for the rest of the speakers. So I have categorized mutual company GAAP into about seven different categories, and anybody else out here could probably narrow that down to five or fewer, or 20 or more, depending on how you wanted to categorize things.

The first one I called stock GAAP, which is either FAS 60 or FAS 97, depending on whether you have converted or not. FAS 60 basically was a level percentage of premium type approach. Obviously the accountants like stock GAAP, since it provides some consistency of reporting to whomever your audience is. However, there are a few drawbacks to it. The first one is that it is mandated by the Financial Accounting Standards Board, which means that FASB can come and change all the rules, as it did when it brought in FAS 97. It is also not necessarily consistent with pricing and dividend philosophy, and again that is important to the mutuals. Someone said that instead of there being two of us on stock GAAP, there are really one and a half. I took that to mean that there are a number of modifications that people make to "stock GAAP." One of them is capitalizing all of your acquisition expenses, rather than just the ones that "are deferrable" under the definitions of FAS 60 and FAS 97. Also, a lot of mutuals, about 50% of the ones that I surveyed, are deferring or smoothing realized gains and losses, which is not stock GAAP either. Also, a number of companies like to establish some

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additional contingency reserves just to be conservative. A number of companies don't follow the lock-in principle, and also a number of companies don't add any explicit margin for adverse deviation. But stock GAAP is the first of the seven categories that I will describe.

The second one I would call full release from risk, which is basically prospective deposit. Some people would call it, at least on annuity type products, break-even interest rate, where you load up your assumptions until your valuation premium equals your gross premium. You may or may not then split this net liability into a benefit reserve and DAC.

The third approach I would call a composite type method, which is basically a combination of the stock GAAP type approach or percent of premium and full release from risk. The ratio of which ones you choose is up to your own thinking.

The fourth one I would call source of earnings (SOE), which is what Equitable has been using, and we think that it is consistent with FAS 60. But you will note that I gave it a separate category, rather than making it just stock GAAP. Basically, you take the traditional type products and net level statutory reserve (or maybe the account value for some of the more recent products) as your benefit reserve, amortize the DAC against your available margins, and we will come back to some of those later.

The fifth category is the level return on equity (ROE), which is the preferred or recommended method in the January 1987 report of the Financial Reporting Section of the Society, when it published the accounting principles for management financial statements and mutual life insurance companies. Keep in mind that, although it is called the level return on equity method, the ROE is only level if your actual experience equals your expected experience, which, of course, means that this method never produces a level ROE. Basically, you use pricing assumptions, and you project your statutory reserves and cash values. Then you look at what the required assets are to support that business. This means that you take your actual assets plus some risk surplus (however you have defined that). That allows you to determine what your required capital flows are on the business, and, therefore, you can then calculate a net liability that will produce this level ROE. You can split that net liability among benefit reserve, DAC, deferred tax, etc. It should be noted that, in the first year, under this method, the net liability may very well be negative, in order to produce some earnings. The disadvantages of this (there are a number of advantages) are that it is very sensitive to your definition of risk surplus. Unfortunately, this is not one of the methods that accountants are known to recognize, in terms of giving you any kind of opinion. It also relies heavily on projections into the future for results.

The sixth category I would label, for want of a better term, those methods that are based on profit charges, specific surplus contribution type charges, maybe in dividend formulas. Probably the best example of that kind is something that a number of mutuals call dividend fund, where it is my understanding that the benefit reserve is equal to the accumulated fund after you have taken out dividends and profit charges. In this event, if your actual experience equals your expected, your profit will turn out to be your profit charge. Another variation, I believe, on that theme, is where you have the benefit

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reserve equal to the statutory reserve. Then you take the DAC and amortize it against your margins after dividends and profit charges. This sounds quite a bit like the SOE method.

And then the seventh category, as I label it, the one that seems to be getting a lot of press these days and may be the most in vogue (at least to talk about, because I am not sure how many people are actually doing it at this point), is the value added approach, also known as actuarial appraisal or net worth accounting. Basically, you are calculating the present value of after-tax earnings on three things: your in-force business, your capital, and new business. The first question that would come up in doing that is, what is the discount rate? The good news is that you could vary the discount rate for different blocks of business, different types of products, based on the risks inherent in the business. Of course, that also turns out to be a disadvantage because the discount rate is so subjective. In any event, this method is oriented towards the future, whereas GAAP sometimes is more prone to look at what has happened in the past. It allows you to change assumptions. A good benefit of this is also that you can use statutory reserves, so you don't need to calculate some other new reserve. Disadvantages? Again, the fact that you can change assumptions is seen by some to be a disadvantage. The accountants don't recognize this as a valid GAAP method, and then there is the whole question of forecasting new business, and how subjective that is.

Well, those are the seven categories that I have described. In regard to stock GAAP, I had called about 10 of the larger East Coast mutuals, and as I indicated before, in terms of GAAP financials, they are all over the map. There is very little consistency. However, there was one consistent theme and that was that virtually no one had implemented FAS 97. We have just finished it, and we are refining it. We have not yet tried to go through and unlock and update on a quarterly or annual basis. But I want to give you a feel for some of the key components since, presumably, not too many of you in this room have converted to FAS 97, though, you may have to at least think about performing some DAC calculations on FAS 97, in connection with the AMT that Ed described. The first thing that you need to do is define what goes into the four product category buckets. These are universal life, investment, limited pay and traditional type contracts. Obviously, the interest-sensitive type products that you are all familiar with would fall in the universal life type category. You may find that if you are selling some participating whole life contracts that are in essence acting like universal-life type contracts, the accountants may insist that you treat those as universal life, rather than traditional type products. In the investment category, there are single premium deferred annuities (SPDAs) in the accumulation phase and some annuities in the pay-out phase (if there is no significant mortality element in them). Also, the bulk of your pension type products may very well fall in the investment category. For limited pay, most of your income paying annuities would obviously fall in the limited pay category. For at least the equitable, we have moved away from a lot of limited pay type contracts unless they were universal life or investment types. Therefore, we are not selling a lot of the traditional type limited pay. We were able to demonstrate that, except in a couple of minor instances, the front-ending of profits (which is prohibited under FAS 97) in the limited pay line was not material, so we didn't have to deal with any deferred profit liability.

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Probably the biggest change in implementing FAS 97, other than the amount of work you have to go through to come up with these new amortization schedules (which then may not change your actual amortization greatly), is writing off replacement DACs. For a number of the larger companies, which have had a fair amount of internal replacement activity of converting traditional products to interest-sensitive type products, that is not an insignificant amount of write-off. Also, FAS 97, as interpreted by the proposed question and answer booklet from the AICPA (which may or may not ever come out as a practice bulletin), indicates that the loss recognition principle is not applicable to investment contracts. That may be a difference for some companies. FAS 97 is fairly similar to SOE, and we have always been on the SOE for our FAS 60 type products and continue to do that for the traditional products for which FAS 97 didn't mandate any changes. However, there are some differences between FAS 97 type SOE, which is called the estimated gross profit calculation, and the old FAS 60 SOE, at least the way we have done it. First of all, under FAS 97, there is no lock-in and there is no adverse deviation. When you amortize DAC, you use the credited rate, rather than the earned rate. From a theoretical point of view, anyway, you are supposed to use the flow of funds in the accounts rather than cash flows. In other words, you are dealing with account values and what is happening going in and out of accounts, rather than the cash that is actually moving around those account values.

There are also some changes in what expenses are capitalizable under FAS 97. In theory, you are supposed to amortize your DAC over the life of the business. I would just point out that FAS 60 always had that same requirement. But from what I have seen of stock companies, as well as ourselves, most companies are still cutting short the number of years over which they are amortizing their DAC, rather than trying to amortize it over the entire life of the business. Instead they are amortizing it until some large portion of the business has run off. Obviously, the reporting format has changed dramatically, so that the first time you try to analyze what is happening with FAS 97 type financials, you are liable to get some strange results and a lot of strange questions, until you begin to reorient yourself in terms of what to look for.

In regard to AMT and the companies that I called, there was another consensus. It was that everybody was studying it, yet nobody had quite figured out exactly what they were going to do to calculate DAC for the AMT requirement. Even those who are already on stock GAAP, or something close to it, need to do a fair amount of work, because there are three issues that seem to override the normal type actuarial calculations. The first one is the fact that the tax reserve is a commissioners reserve valuation method (CRVM) reserve, whereas the GAAP reserve is typically a net level type reserve, even if they are not on the same assumptions. That means that somehow you have to bring the DAC that you are using for tax purposes into sync with the tax reserve. Second, there are some companies that have not been capitalizing actual expenses, if you will, but are capitalizing some sort of estimated expenses, and that may or may not create a difference in calculating DAC for tax purposes. There are some words surrounding the AMT that indicate that the way you calculate DAC is to use the FASB pronouncements that were in effect at the time the contract was issued. If you want to take a strict interpretation of that, it would suggest that you can at least start off making a case (maybe an aggressive case) for using FAS 60 type DAC calculations for some product, and FAS 97 for the exact same product, depending on which year it was issued.

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Other than that, I don't have any consensus on AMT. However, I do have some consensus. You will be happy to know that the bulk of the people are using DAC factors for both traditional and nontraditional. However, most of the companies that I know that have converted to FAS 97 are either moving away from factors or are weaning themselves from them. This is because they are going to have problems if they have to unlock frequently and are using factors. Most companies are also doing five-year projections and using their internal financials in their planning process. They are publishing quarterly results. If their accountants are involved at all, they are more likely to be used in a consulting and assisting role, rather than in an auditing and review type role.

Now with that, until the question and answer period, I will leave you with two words of advice regarding GAAP financials and DAC. Good luck!

MR. KRISS CLONINGER, III: My charge is to discuss mutual company GAAP from the viewpoint of the medium-sized mutual. Let me summarize my presentation by saying that on a scale of 10, what the mid-size mutuals are doing ranges from zero to nine. There is a concentration of rankings around seven, and another concentration around zero. What do we mean by mutual company GAAP? We don't mean statutory, even though the typical CPA audit report might state that the mutual life insurance company financials are prepared in conformance with statutory accounting practices, which are considered to be generally accepted accounting principles for mutual life companies. What we do mean by mutual company GAAP is a type of management basis financial statement. I say a type of management basis financial because companies have tended to adopt adjustments to their statutory financials that they believe most accurately reflect the economic results they are realizing on their blocks of business.

Each of the companies I have worked with has a slightly different view of the way its products work or the way each manages its products compared to other companies. Consequently, the companies tend to adopt an approach to management basis accounting that conforms to that view. That tailoring leads to a situation where there is a wide diversity of practice, even though there is a high degree of commonality in the objectives of companies that have done this. Some would say that a wide diversity of practice also prevails in the stock companies. I agree that there is a range of accounting practices used by stock companies, but I don't believe that the range is nearly as wide as the range we are seeing in the mutuals now.

Let's look at the objectives mutuals typically have when they decide to develop management basis financials. I think the main objective is to develop a financial model that produces profitability and ROE measures that are meaningful to the managers who use this financial information. Companies want their managers to understand how the product lines work from a financial perspective, and then to utilize this information to make timely decisions, based on relevant financial information. Many stock companies use their GAAP financial statements as the vehicle to develop long- and short-term profit plans. They then develop strategies that can drive the organization toward the achievement of that profit plan. The mutuals that have developed management basis financials tend to have similar goals. They want a financial model they can use to set financial objectives that management can buy into and work toward. They want a model that correlates well with the actual economics of the business. They want a model that

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shows good results when they successfully implement the strategies that have been developed to achieve the plan.

Well, what type of model tends to correlate well with the economics of the types of business written by most mid-size mutuals? The accounting model defined by FAS 60 did not make much sense for traditional participating products. That is probably why the FASB chose to specifically exclude mutual life companies from the requirements of FAS 60. Under FAS 60, profit recognition is highly correlated with premium recognition. So when I heard one mutual company CEO say "the premium is largely irrelevant," I knew we would be in big trouble as consultants if we recommended strict application of FAS 60. In a mutual company, profit or ROE is more appropriately recognized as after-dividend margins are earned, or as planned contributions to surplus are realized. This pattern of profit recognition can be achieved under several accounting models, but the model I have seen used most frequently by the mid-size mutuals is the retrospective deposit type of accounting model. One characteristic of the retrospective deposit model is that earnings tend to emerge as margins are earned. Acquisition costs are capitalized and amortized in proportion to the gross margins that emerge from the contract. Profits, or net margins, can then emerge as a level percent of the gross margins. This result tends to make sense to the mutual companies that think that profits are actually after-dividend margins or contributions to surplus that should be recognized when they are realized. The retrospective deposit model works well for all products with policy account values. The policy account values are held as benefit reserves. Gross margins are measured by comparing actual investment income, claims and maintenance expenses with amounts charged or credited to the policy account values. Contingent surrender charges are typically included in the gross margins. Acquisition costs are then amortized with interest at the assumed earned rate. If you do all that, your pretax earnings emerge as a level percent of gross margins, assuming your projection assumptions are realized.

Retrospective deposit type methodology has been adapted to the traditional participating life insurance. The policy reserve is typically defined on one of several bases. One choice is the dividend basis reserve; the reserve used in the dividend model. Another is the statutory reserve. The one I have seen most often is the level reserve based on policy guarantees. Amounts charged or credited to the policyholders are defined with reference to that reserve and the gross premium, and gross margins are measured by comparing actual investment income, claims and maintenance expenses with those amounts charged or credited to the policyholders. Expected dividends are then deducted from these gross margins to obtain the net revenue stream that will be used to recover deferrable costs. If that type of model is used, it is then possible for management to state that it uses a common accounting model for all its lines of business. As you have interest-sensitive and traditional participating business under this approach, you can say that you use a net margin basis for accounting for all of your products. Thus, earnings are measured on a comparable basis for all lines of business, and that has some appeal.

What types of costs have companies capitalized? I think the tendency has been to capitalize most of the costs that are deemed to be acquisition costs in the pricing process. This has commonly been the practice, regardless of whether those costs vary with or are directly related to the production of new business, as FAS 60 requires. Some companies have deferred costs that are a level percentage of premium but are not a

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level percentage of the stream of gross profits. Costs of these types include the level renewal commissions and premium taxes that have to be paid when the company receives the premium. Such costs are not capitalized and amortized in the same period under the retrospective deposit model, as they are in the FAS 60 model.

Just as the stocks did, the mid-size mutuals tended to carry forward any unamortized net acquisition costs associated with internal replacements (that is, policies where a universal life type product replaced one of the traditional products). Typically, this cost has to be estimated, using techniques similar to those used by stock companies. While FAS 97 prevented this practice for stock companies, most of the mutuals I have worked with have also restated their management basis financials to eliminate this asset. It actually ends up improving future earnings because you relieve yourself of the need to amortize that carry-forward cost.

While amortization can theoretically be over the entire life of the contract, it is common practice to use a shorter period. This period might be the same period that is used to amortize costs in the dividend formula. Or it might be a limited period, such as 20 or 30 years, after which an immaterial amount of the business originally issued is expected to remain in-force. Or it could be a period after which the amount of future gross profits is expected to be immaterial.

A minute ago, I alluded to the adoption of FAS 97. The mid-size mutuals I have worked with developed these management basis financials before FAS 97 was adopted, and a couple of them have made some changes to reflect the requirements of FAS 97. However, the changes were generally minor in nature since they were already using a retrospective type of accounting model. The biggest balance sheet change was to write off those deferred costs associated with internal replacement transactions. Some companies have actually implemented the minor changes to the amounts deferred, to exclude the so-called recurring acquisition costs that FAS 97 says you cannot capitalize. The costs of that nature are generally deemed to be the level commissions and the premium taxes.

The more significant changes for FAS 97 have come in the area of what I called dynamic DAC, where FAS 97 provides that the stream of gross profits you used to amortize DAC should reflect actual emerging experience and your current best estimates of your future gross profits. You then do a recomputation (from issue) of the unamortized DAC and utilize that in your financials. While some of the mid-size companies had previously unlocked assumptions periodically, when dividend bases or experience assumptions changed significantly, most did not unlock assumptions very often. Now, FAS 97 once again requires the periodic reevaluation of estimated future gross profits, and I think companies are tending to follow this methodology.

What else did FAS 97 change? One requirement was that realized capital gains and losses be shown "above the line," that is, as a part of revenue and operating income. Many stock companies objected to this, on the grounds that comparisons of operating income are distorted by including realized gains and losses in those amounts. Nevertheless, they had to make the change. Several mutual companies had also concluded that the recognition of realized capital gains and losses in operating income in the year they

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were incurred also distorted period to period comparisons of income statements. They intended to spread realized capital gains and losses over some period, such as five years. I am seeing that fairly often. Some companies also spread unrealized gains and losses. Most will credit or debit policyholder liabilities with any gains or losses that will inure to the benefit or detriment of the policyholder. This practice is necessary to reflect the actual economics of the product. Since realized and unrealized gains and losses are not directly associated with specific contracts, companies tend to charge or credit these capital gains and losses to the surplus line of business in their internal financial statements. Most of the mid-sized mutuals are using these management basis numbers to monitor product and management performance and analyze profits by line of business. Some have started to base incentive compensation on the results reflected in the management basis financials. I think that companies usually take three or more years to get comfortable with the numbers before they seriously attempt to establish incentive compensation based on these numbers.

Well, what about a common model? Why aren't companies all over the lot in what they are doing? Personally, I think the time has come for the mutual life companies to accept the inevitable, and reconcile themselves to the concept that statutory is not GAAP for mutuals. The IRS is forcing the issue. That is what we are hearing about AMT. For 1990, we are going to have to include the change in DAC in the AMT base, and the people I have talked to consider it a slam dunk that the change in DAC will be included in the regular taxable income base in the near future. If it is inevitable that DAC is going to have to be computed, and the Congress is saying that DAC should be computed in conformity with GAAP, then I think we would be well-advised to reach mutual agreement on what constitutes GAAP for mutuals. I think it is time to accept the inevitable and to get on with the task.

MR. ROBERT J. LALONDE: We will have a little change of gears here. There are so many things to talk about when it comes to converting a company to a GAAP basis that we could spend days and days on it. Why would a mutual company want to look at financial statements on a GAAP basis? I think there are a number of reasons, some of which have already been identified. The basic question is, are we doing okay? How do we measure ourselves, in the face of the common complaint that nobody can figure out financial statements prepared in accordance with statutory accounting principles? Even actuaries, who are supposed to understand all this stuff, have a heck of a time trying to explain to management and the board of directors that we are doing okay, even though we are losing money since we are growing. Of course, another situation that we are faced with is federal income tax (FIT) consequences. There is also peer comparison, specifically how do we compare ourselves to other companies? We really cannot do that very well with statutory accounting, but I think, even though it is not perfect, GAAP still gives us a little more ability to compare ourselves with other companies. You can get the board of directors on your side by converting to something that is more common to their enterprises. Measuring ROE is useful and important. After all, that is how we measure how we are doing, even in the investment area. We are making nine percent or something like that. Is our operation earning the kind of growth it needs to? There is a theorem that says that for a mutual company to grow, if it is growing at 10%, it has to earn 10% ROE. So it gives you an opportunity to look at that. Another application is motivating management through compensation programs. GAAP is a more acceptable

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approach here than statutory. Somebody has to convert a losing situation to a winning situation. Another reason to go to GAAP is to satisfy the requirements of a lender or perhaps to satisfy the requirements of Standard & Poors, since it wants to see how you really compare.

What are the GAAP steps that you need to follow to get the ball rolling? Well, you have already started by attending a conference on GAAP methodology. You may also want to look at some literature and the study notes. Once you have decided what you want to do, you need to start building a plan. How are we going to do this? What is involved? There are lots of options that you may not be aware of, and I am going to discuss some of them and give you lots of things to think about.

When we get going we have to assemble the historical expense data. That is going to be really interesting for some mutual companies that have been around for many, many years, going back into records and getting commissions on those policies that are still in force. We all have those old blocks of American experience policies that are sitting out there that we have to do something with. We need to build some workable models so that we can analyze various options. When you bring in the consultants to help you out, they are going to give you lots of options to look at, and so you want to get a feel for how the different options and models will affect your operations. And, of course, you will be examining the alternative accounting methods. There is no one method, as we already identified. And last, what I think you need to start thinking about is how you are going to evaluate your GAAP (or whatever) accounting method. It has to be good because, if you are going to have compensation based on it, you don't want to be doing it on the back of an envelope, so to speak. You must have accuracy. The work that you do has to have credibility and be accepted; otherwise, you will be fighting battles. You have to have a process set up so that you can make sense out of it.

Here is a simple little equation that perhaps will help you understand the various options. Any kind of accounting model starts off with net income, and it is basically cash in minus cash out, and then there is a change in accruals. So on a statutory basis, the change in accruals represents how we compute reserves, conservative assumptions, and that we don't use any lapse assumptions. Now, if we want to go to an ROE basis, we might set up our formula so that the accruals give us the result of, for example, producing a level ROE. If we are doing a percentage of premium computation, then the way we compute the reserves and the DAC amortization process will be such that the net income will be a certain percentage of premium. It is really simple. All you have to do is work on the accrual part, but still, there are a lot of options there for you.

Some of this has been discussed already, but we will spend a little bit of time on profit emergence options. What has been covered by FAS 60 is basically the level percentage of premium approach. We hope that if our actual experience is what we had assumed, then we will get a profit that emerges, say 5% of premium. In a participating policy, I don't know. Maybe you want to have a 10% or a 1% of premium approach, or something like that. A release from risk is also inherent in FAS 60 because FAS 60 states that you need to load up your assumptions to take care of adverse deviation, so there is always a tug-of-war as to how conservative you want to be. You can be conservative to the point of being over-conservative. For example, instead of using an 8% interest rate,

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you might use a 6% interest rate. If you are going to use pricing as 60% of a mortality table for GAAP, you might use 80% of a mortality table, and that is sort of inherent in a release of risk type of concept.

FAS 97 switches the emphasis to the quantification of margins. In other words, let's figure out what our margins are from mortality, from interest, from expenses, and let's work with that concept. I think, in some respects, an ROE method can also be viewed as an identification of margins in figuring out what we are earning on the equity that we have tied up in the business that we are pursuing. This election of different kinds of methods can yield some of the inconsistencies with pricing previously mentioned. Not all of the acquisition costs are deferrable under generally accepted accounting principles. Only those that vary with the amount of business produced, like commissions. But some of the marketing expenses which we might ordinarily include in our pricing of a product are not deferrable, for example, the fixed overhead associated with agents, etc. We would probably want to recover advertising costs in an acquisition mode for pricing, but under GAAP they would not be a deferrable expense. And sometimes the amortization period that we use for GAAP would be different from what we might use for profit evaluation. The way we measure profits could be different if we try to get an asset share that exceeded a reserve at some point in time. That is kind of hard to translate into some kind of generally accepted accounting principle. How do you get profits to emerge so that they accumulate to 110% of the cash value? That means there will be some timing differences between the methods. So you have some inconsistencies that you are going to have to ponder and address and figure out how to deal with. Eventually, pricing has to recover all of your costs. GAAP or whatever you want to use will just affect the timing of how you are going to bring those into your financial statements.

There are some mechanical differences between a statutory and GAAP valuation. In a statutory valuation, you normally look at a reserve factor for every age, plan and year of issue, whereas in a GAAP valuation, you have to take a wider scope. You think about building models, and you have, maybe, a reserve factor that you apply to every fifth age or to every tenth age. For example, you collect the in-force data between the ages of 15 and 20 and you put that in a cell and assign it to cell age 17 and you have a reserve factor for age 17. Sometimes, you don't GAAP all of the plans. You only GAAP the major plans, and then you have a magnet plan to which you assign all of your other plans for purposes of coming up with GAAP results.

There are a lot of approximations in the process that have been accepted as being appropriate. One of the processes that you will have to go through is to convince everybody that the modelling process is accurate and realistic. It will be interesting to see whether the IRS will allow modelling of financial results as an acceptable way of computing DAC balances. So we may have to rethink that a little bit. The reason we went to modelling for GAAP is because there are so many factors involved. There is not just a net level premium or a level premium as in statutory, where you have a level premium or some kind of net premium that you are going to use to get to deferred premiums and a single reserve factor which is your statutory reserve. When you get to factors for GAAP, you have a reserve factor for the benefits, reserve factors for maintenance expenses, and reserve factors for deferrable expenses, and you could break those down further. So we went to models because we have so many GAAP factors to keep

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track of that we had to condense the mechanical side of the valuation down so that we could handle it.

Let me show you what I mean by some of the variances of factors here. This is a representation (Chart 5). Here is age 45 and we have benefit premiums identified for the death benefit for the prospective need of paying cash values, for endowments and for dividends. If you wanted to put the dividends into the net premium, then, of course, there would be a place to put that.

CHART 5

Report 213: GAAP Initial Benefit Premiums Per Unit

Executive Whole Life Preferred Risk						
Plan Codes:	Statutory	1981	GAAP	1982		
Mode Codes:	1					
Payments/Years:	1					
Tables:	Mortality *65-70 combined lives (interpolated)*					
	Withdrawal *71-72 LIMRA lapse rates (permanent)					
Withdrawal distribution level distribution						
	Benefit Premiums					
Age	D.B.	C.V.	End.	Div.	Total	
45	7.194	4.212	0.000	0.000	11.406	

You have a total GAAP net premium of \$11.41. So we carry forward that \$11.41, and that is for benefits (Chart 6). Then we have a net premium for acquisition costs of \$3.55. Nonacquisition costs are things like premium taxes and for items needed to administer these policies. We have not even gotten into overhead. That is outside of this, but we have a total of \$17.70 as the total GAAP premium, and the gross premium is \$22.45 giving us a GAAP margin of 21%. I am not saying that this is illustrative of all stock companies. It just happens to be what the numbers are for this particular example.

Now we had the discussion about the retrospective deposit method which generally involves finding that set of assumptions that raises our net premium so that it equals the gross premium. Somehow we have to find a set of assumptions to either raise the benefits and all those other things so that it is some conservative set of assumptions.

Then, since we have used such conservative assumptions, when the business plays out, there is a release of risk from that which then flows into our financial statements.

I have four different kinds of reserve factors for each duration. I have an initial reserve factor, a final reserve factor, a terminal reserve factor, and an average reserve factor. There are seven different ways you can calculate average reserve factors within the GAAP functioning. So when you start looking at all the options, there are some mechanical implications that you need to consider (Chart 7).

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CHART 6

Report 216: GAAP Premium Analysis Per Benefit Unit

Executive Whole Life Preferred Risk				
Plan Codes:	Statutory	1981	GAAP	1982
Mode Codes:	1			
Payments/Years:	1			

Tables: Mortality *65-70 combined lives (interpolated)*
 Withdrawal *71-72 LIMRA lapse rates (permanent)
 Withdrawal distribution level distribution

Policy			GAAP Premiums			Gross	% GAAP	
Age	Year	Benefits	Acquis.	Non-Acq.	Total	Premium	Margin	Size
45	1	11.406	3.549	2.744	17.699	22.450	21.161	100.00

You wouldn't store all these factors. You would say, well, I just want to use average factors. Then the system would pick off the average factors, and that is what you would use as a regular type of system. You might want to explore which one of those formulas you want to use. So that is why you need to have that little model to help you examine your options, because you get a little different results here.

Chart 7 shows what a DAC factor might look like. It has a minus sign in front of it, meaning that it is an asset. This is unlike statutory reserves, where we have an expense allowance that is buried inside the statutory reserve and we don't ever see it. We gross things up on GAAP. The liability side has the gross reserve, and then the asset side has the DAC. It would be perfectly acceptable to net it in there, but generally, for reporting purposes, the regulators consider that a geography problem. So we put it on the asset side. But DAC has the same kinds of options as well. The one on top happens to be for underwriting. Let's take the column for commissions. You can see what is happening with this DAC number now. Just look at the averages. You have a minus \$16.40 and then you have a minus \$17.78, and you have a minus \$18.53. The minuses are getting bigger. Now this is an asset and the asset is getting bigger. Why is that? Well, because we are capitalizing renewal commissions in this process as well, to the extent that the renewal commissions have been heaped up. And sometimes the formulas just work out that this factor just keeps on going up. When you apply the factor to the in-force data, though, the actual size of the DAC tends to get smaller over time, since you are applying this factor to the number of policies in-force. As a result, when you compute this, you are taking the amount of DAC and dividing it by the expected number of policies in-force, and to the extent that there are differences between what actually happened and what you thought would happen, it is going to affect your results. One of the most difficult things of doing GAAP, after you get it going, is trying to explain what is actually going on with the factor system, and you can spend an incredible amount of time trying to figure it out.

Here are some more transparencies that show what you might want to go through to figure out the benefit components on a year by year basis (Charts 8-10): the discount

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CHART 7

Report 219

Executive Whole Life Preferred Risk

Plan Codes: Statutory 1981 GAAP 1982

Mode Codes: 1

Payments/Years: 1

Tables: Mortality *65-70 combined lives (interpolated)*
 Withdrawal *71-72 LIMRA lapse rates (permanent)

Withdrawal distribution level distribution

Reserve factor basis is unit

Year	Type	Age 45		
		GAAP Acquisition Underwriting	Reserves Commissions	GAAP Benefit Reserves
1	I	-1.09	-14.57	11.40
1	F	-1.19	-15.90	11.13
1	T	-1.37	-18.23	12.76
1	A	-1.23	-16.40	12.08
2	I	-1.21	-16.52	24.16
2	F	-1.32	-18.04	24.55
2	T	-1.39	-19.03	24.63
2	A	-1.30	-17.78	24.40
3	I	-1.24	-17.33	36.04
3	F	-1.35	-18.93	36.98
3	T	-1.41	-19.74	36.60
3	A	-1.32	-18.53	36.32
4	I	-1.25	-18.03	48.00
4	F	-1.37	-19.70	49.63
4	T	-1.42	-20.49	48.82
4	A	-1.34	-19.26	48.41
5	I	-1.27	-18.78	60.22
5	F	-1.38	-20.53	62.73
5	T	-1.44	-21.33	61.46
5	A	-1.35	-20.06	60.85
6	I	-1.28	-19.63	72.87
6	F	-1.39	-21.37	75.68
6	T	-1.44	-22.04	74.32
6	A	-1.36	-20.83	73.59
7	I	-1.28	-20.33	85.73
7	F	-1.39	-22.15	89.01
7	T	-1.43	-22.76	87.52
7	A	-1.36	-21.54	86.62
8	I	-1.28	-21.05	98.92
8	F	-1.39	-22.95	102.97
8	T	-1.42	-23.51	101.38
8	A	-1.35	-22.28	100.16

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CHART 8

REPORT 223: GAAP ANALYSIS - BENEFIT COMPONENTS

EXECUTIVE WHOLE LIFE PREFERRED RISK

STATUTORY CODE: 1981 FEE/UNIT 25.00 SIZE 100.00 AGE 45
 GAAP CODE: 1982 MAXIMUM 25.00 PREMIUM 22.20 MODE 1

MORTALITY *65-70 COMBINED LIVES (INTERPOLATED)* AT -20. 0. 0.
 LAPSE TABLE IS 100.00 % OF * 71-72 LIMRA LAPSE RATES (PERMANENT)
 WITHDRAWAL DISTRIBUTION IS LEVEL DISTRIBUTION

POL YR	ANNUITY FACTOR	DISCOUNT FACTOR	COST AS OF BEG. OF YEAR		FOR		GAAP TERMINAL RESERVES	GAAP NET PREMIUMS
			D.B.	C.V.	END.	DIVD.		
1	7.94742	1.00000	1.210	0.000	0.000	0.000	12.76	11.4058
2	8.69524	0.79899	1.685	1.095	0.000	0.000	24.63	11.4058
3	8.86348	0.69368	2.191	1.726	0.000	0.000	36.59	11.4058
4	8.95811	0.60892	2.594	2.447	0.000	0.000	48.82	11.4058
5	9.04333	0.53585	2.848	3.276	0.000	0.000	61.46	11.4058
6	9.13785	0.47166	3.366	3.312	0.000	0.000	74.32	11.4058
7	9.13747	0.42006	4.035	3.517	0.000	0.000	87.52	11.4058
8	9.11056	0.37520	4.466	3.668	0.000	0.000	101.38	11.4058
9	9.05660	0.33600	4.859	3.949	0.000	0.000	115.97	11.4058
10	8.98532	0.30128	5.331	4.416	0.000	0.000	131.22	11.4058
11	8.90840	0.27006	5.947	4.872	0.000	0.000	146.41	11.4058
12	8.78478	0.24312	6.782	5.416	0.000	0.000	161.93	11.4058
13	8.65678	0.21863	7.889	5.879	0.000	0.000	177.61	11.4058
14	8.52256	0.19642	9.001	6.399	0.000	0.000	193.50	11.4058
15	8.38379	0.17624	10.199	7.838	0.000	0.000	209.16	11.4058
16	8.26483	0.15745	12.195	8.366	0.000	0.000	224.34	11.4058
17	8.14874	0.14037	13.343	8.899	0.000	0.000	239.77	11.4058
18	8.02822	0.12500	14.599	9.430	0.000	0.000	255.43	11.4058
19	7.90332	0.11116	15.985	9.936	0.000	0.000	271.31	11.4058
20	7.77424	0.09870	17.511	10.439	0.000	0.000	287.37	11.4058
25	7.07206	0.05303	27.079	12.542	0.000	0.000	370.69	11.4058
30	6.26874	0.02683	42.008	14.253	0.000	0.000	459.42	11.4058
35	5.42292	0.01230	65.073	15.523	0.000	0.000	547.30	11.4058
40	4.59406	0.00484	99.640	16.202	0.000	0.000	628.85	11.4058
45	3.88565	0.00152	143.651	16.411	0.000	0.000	696.23	11.4058
50	3.08178	0.00037	184.111	16.623	0.000	0.000	782.44	11.4058
55	1.00000	0.00007	962.963	0.000	0.000	0.000	1000.00	11.4058

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CHART 9

REPORT 224: GAAP ANALYSIS - ACQUISITION COMPONENTS

EXECUTIVE WHOLE LIFE PREFERRED RISK

STATUTORY CODE: 1981 FEE/UNIT 25.00 SIZE 100.00 AGE 45
 GAAP CODE: 1982 MAXIMUM 25.00 PREMIUM 22.20 MODE 1

MORTALITY *65-70 COMBINED LIVES (INTERPOLATED)* AT -20. 0. 0.
 LAPSE TABLE IS 100.00 % OF * 71-72 LIMRA LAPSE RATES (PERMANENT)
 WITHDRAWAL DISTRIBUTION IS LEVEL DISTRIBUTION

CATEGORY: COMMISSIONS			BASIS: UNIT				
POL YR	ANNUITY FACTOR	DISCOUNT FACTOR	COST AS BEGIN. OF YEAR	INITIAL FUND ADJUST.	FINAL FUND ADJUST.	GAAP TERMINAL RESERVES	GAAP NET PREMIUMS
1	7.94742	1.00000	17.96000	-14.5681	0.0000	-18.23	3.3919
2	8.69524	0.79899	1.68375	1.7082	0.0000	-19.03	3.3919
3	8.86348	0.69368	1.68375	1.7082	0.0000	-19.74	3.3919
4	8.95811	0.60892	1.68375	1.7082	0.0000	-20.49	3.3919
5	9.04333	0.53585	1.68375	1.7082	0.0000	-21.33	3.3919
6	9.13785	0.47166	1.68375	1.7082	0.0000	-22.04	3.3919
7	9.13747	0.42006	1.68375	1.7082	0.0000	-22.76	3.3919
8	9.11056	0.37520	1.68375	1.7082	0.0000	-23.51	3.3919
9	9.05660	0.33600	1.68375	1.7082	0.0000	-24.31	3.3919
10	8.98532	0.30128	1.68375	1.7082	0.0000	-25.22	3.3919
11	8.90840	0.27006	0.56125	2.8307	0.0000	-24.87	3.3919
12	8.78478	0.24312	0.56125	2.8307	0.0000	-24.50	3.3919
13	8.65678	0.21863	0.56125	2.8307	0.0000	-24.12	3.3919
14	8.52256	0.19642	0.56125	2.8307	0.0000	-23.73	3.3919
15	8.38379	0.17624	0.56125	2.8307	0.0000	-23.40	3.3919
16	8.26483	0.15745	0.56125	2.8307	0.0000	-23.07	3.3919
17	8.14874	0.14037	0.56125	2.8307	0.0000	-22.73	3.3919
18	8.02822	0.12500	0.56125	2.8307	0.0000	-22.37	3.3919
19	7.90332	0.11116	0.56125	2.8307	0.0000	-22.01	3.3919
20	7.77424	0.09870	0.56125	2.8307	0.0000	-21.63	3.3919
25	7.07206	0.05303	0.56125	2.8307	0.0000	-19.59	3.3919
30	6.26874	0.02683	0.56125	2.8307	0.0000	-17.27	3.3919
35	5.42292	0.01230	0.56125	2.8307	0.0000	-14.87	3.3919
40	4.59406	0.00484	0.56125	2.8307	0.0000	-12.57	3.3919
45	3.88565	0.00152	0.56125	2.8307	0.0000	-10.63	3.3919
50	3.08178	0.00037	0.56125	2.8307	0.0000	-8.07	3.3919
55	1.00000	0.00007	0.56125	2.8307	0.0000	0.00	3.3919

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CHART 10

REPORT 225: GAAP ANALYSIS - NON-ACQUISITION COMPONENTS

EXECUTIVE WHOLE LIFE PREFERRED RISK

STATUTORY CODE: 1981 FEE/UNIT 25.00 SIZE 100.00 AGE 45
 GAAP CODE: 1982 MAXIMUM 25.00 PREMIUM 22.20 MODE 1

MORTALITY *65-70 COMBINED LIVES (INTERPOLATED)* AT -20. 0. 0.
 LAPSE TABLE IS 100.00 % OF * 71-72 LIMRA LAPSE RATES (PERMANENT)
 WITHDRAWAL DISTRIBUTION IS LEVEL DISTRIBUTION

CATEGORY:		OVERHEAD		BASIS: UNIT			
POL	ANNUITY	DISCOUNT	COST AS	INITIAL	FINAL	GAAP	GAAP
YR	FACTOR	FACTOR	BEGIN.	FUND	FUND	TERMINAL	NET
			OF YEAR	ADJUST.	ADJUST.	RESERVES	PREMIUMS
1	7.94742	1.00000	2.57523	0.1992	0.0320	0.21	2.7442
2	8.69524	0.79899	2.57383	0.1842	0.0137	0.44	2.7442
3	8.86348	0.69368	2.58791	0.1685	0.0113	0.68	2.7442
4	8.95811	0.60892	2.60465	0.1519	0.0111	0.93	2.7442
5	9.04333	0.53585	2.62273	0.1345	0.0115	1.19	2.7442
6	9.13785	0.47166	2.63999	0.1163	0.0097	1.46	2.7442
7	9.13747	0.42006	2.65933	0.0972	0.0090	1.73	2.7442
8	9.11056	0.37520	2.67952	0.0771	0.0084	2.00	2.7442
9	9.05660	0.33600	2.70114	0.0560	0.0082	2.28	2.7442
10	8.98532	0.30128	2.72442	0.0338	0.0085	2.57	2.7442
11	8.90840	0.27006	2.74907	0.0105	0.0088	2.85	2.7442
12	8.78478	0.24312	2.77541	-0.0139	0.0094	3.13	2.7442
13	8.65678	0.21863	2.80333	-0.0396	0.0097	3.42	2.7442
14	8.52256	0.19642	2.83285	-0.0665	0.0103	3.71	2.7442
15	8.38379	0.17624	2.86537	-0.0948	0.0123	4.02	2.7442
16	8.26483	0.15745	2.89948	-0.1245	0.0129	4.33	2.7442
17	8.14874	0.14037	2.93406	-0.1557	0.0135	4.65	2.7442
18	8.02822	0.12500	2.97066	-0.1884	0.0142	4.98	2.7442
19	7.90332	0.11116	3.00942	-0.2228	0.0149	5.30	2.7442
20	7.77424	0.09870	3.05051	-0.2589	0.0157	5.64	2.7442
25	7.07206	0.05303	3.29602	-0.4683	0.0200	7.36	2.7442
30	6.26874	0.02683	3.63212	-0.7356	0.0255	9.12	2.7442
35	5.42292	0.01230	4.10551	-1.0768	0.0326	10.94	2.7442
40	4.59406	0.00484	4.79198	-1.5122	0.0416	12.85	2.7442
45	3.88565	0.00152	5.77587	-2.0679	0.0531	15.05	2.7442
50	3.08178	0.00037	7.08016	-2.7772	0.0677	16.57	2.7442
55	1.00000	0.00007	16.49344	-3.6824	0.3364	0.00	2.7442

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factors, the annuity factors, the actual cost for each year, and how the GAAP reserve factors are actually being created from duration to duration. You would want to have something to be able to show other people the process used. In this case, we started off with the net premium of \$22.20 and we keep rolling that forward. I guess the GAAP net premium is \$11.40, and we have interest to add on and death benefits to subtract, etc.

The same kind of process is used for DAC, where we have a cost in the beginning of the year of \$17.96 and we have a net premium of \$3.39. You subtract that and end up with a *negative asset*. It is the same kind of process. The timing here, though, on the expenses is upfront, whereas, we are used to seeing things occurring at the end of years. So you have to reorient your thinking a little bit, in that respect.

This is just another nonacquisition cost; they all look alike from the point of view of representation (Chart 11). We are trying to get the benefit reserve here, and this is what a GAAP valuation looks like, where we have a column called Era 3. When you get into GAAP, you have different eras from when you changed the pricing of rate books, so you have a different set of assumptions every year. The authorities allow you to use a set of GAAP factors for a number of years of issues. If you look down at Era 3, it is a representation of 1972 and before. We have 747 policies with a certain amount of issue. You notice we have a basic gross annualized premium of \$74,347 which compares to a model premium of \$67,046. Thus, one of the issues is, is that a good enough fit? Look at benefit reserves, statutory mean at the central age. First we check out the means. On a statutory basis we have \$729,699 of statutory mean. The actual, which we got from an in-force file of the actual reserves, was \$725,948. That doesn't look too bad as a fit. Then we have the GAAP components, death benefit of \$256,897. That means that since we did a pretty good job of estimating the statutory reserve, our GAAP numbers are probably going to be pretty good. In addition to the \$256,897, we have cash values with a total of \$538,282, and there's a little adjustment to get us down to \$529,286. Then we go through the business of getting the reserves for nonacquisition costs. There is a pretty large number there. That must mean that there are a lot of expenses out there for which we need to reserve. We build a reserve if the amount of expense, maybe inflation, was added here. So if the amount of expense is rising and we are charging a level premium, then we need to be accumulating a reserve to pay for those expenses. That is what that means. And acquisition costs is a negative number. It doesn't look like there is much left over here. You get a number of categories for, say commissions or however you want to break them down. The deficiency reserve doesn't really mean what we think of it as meaning. It just means, since it is a negative number, that the gross premium exceeds the net premium, and so we have what is considered to be sufficiency there.

The next chart is what you might do to get the other side (Chart 12). In statutory, we do due premiums and deferred premiums; you do the same sort of thing over here. So that you can make adjustments to the balance sheet items, you need to adjust the liability side for deferred premiums (if you have that in your reserve formula), and you need to make an adjustment to the asset side for cost of collection of deferred and due premiums. It just depends upon the formulas that you elected when you set it up.

I just wanted to give you a little bit of a feel for what things look like and switch over to FAS 97 which is different, of course, from FAS 60. FAS 97 is effective for reporting

SAMPLE LIFE - COMPANY A - PREM PAY PLANS
RESERVE SUMMARY REPORT FOR, 3/31/1990 VALUATION
REPORT PLAN CODE 1916, COMPANY =

	1972	1973	1971	1970	1969	1968	1967	1966	1965	1962
** GENERAL INFORMATION										
NUMBER OF POLICIES	107	747	98	71	37	21	37	55	18	1
NUMBER OF RIDERS	0	0	0	0	0	0	0	0	0	0
NUMBER OF UNITS	442	2857	299	204	128	88	104	78	44	1
AMOUNT ISSUED	442319	2856749	299494	204209	127500	87500	104000	77500	44000	1000
AMOUNT INFORCE	442319	2856749	299494	204209	127500	87500	104000	77500	44000	1000
AMOUNT FROM TAPE	442319	2856749	299494	204209	127500	87500	104000	77500	44000	1000
GROSS MODAL PREMIUMS	5096	36634	3337	2356	1663	1834	2520	1539	851	2
BASIC GROSS ANNLZD	10718	74347	8220	6208	3760	2419	3547	2486	1340	27
MODEL PREMIUMS	10010	67046	7211	5438	3336	2115	3211	2158	1193	18
SUBSTANDARD EXTRAS	0	0	0	0	0	0	0	0	0	0
** BENEFIT RESERVES **										
STATMEAN(CENTRAL AGE)	125033	729699	91155	73182	43595	31010	46136	34803	20790	440
STATMEAN(ACTUAL AGE)	123983	725943	91663	73198	43453	31876	46969	34760	20836	462
GAAP DEATH BENEFIT	45780	256897	34035	30364	18891	12930	23731	16708	10039	155
CASH VALUES	48376	281386	30083	22795	13794	10057	12532	10360	6129	171
COUP/ENDWMT	0	0	0	0	0	0	0	0	0	0
*SUB TOTAL	94156	538282	64118	53159	32185	22987	36262	27069	16168	326
CATEGORY 4	-1339	-8996	-1188	-861	-478	-327	-455	-335	-200	-4
** TOTAL **	92816	529286	62931	52298	31707	22659	35807	26734	15968	322
** NON ACQUISITION **										
CATEGORY 1	18274	94921	6311	4735	3855	2608	3002	2649	1525	50
CATEGORY 2	0	0	0	0	0	0	0	0	0	0
CATEGORY 3	0	0	0	0	0	0	0	0	0	0
CATEGORY 4	0	0	0	0	0	0	0	0	0	0
CATEGORY 5	2432	8219	386	-380	327	175	-74	-161	-152	-8
** TOTAL **	20706	103140	6697	4355	3682	2778	2927	2489	1373	41
** ACQUISITION **										
CATEGORY 1	-233	-1545	0	0	0	0	0	0	0	0
CATEGORY 2	0	0	0	0	0	0	0	0	0	0
CATEGORY 3	0	0	0	0	0	0	0	0	0	0
CATEGORY 4	0	0	0	0	0	0	0	0	0	0
CATEGORY 5	-8	-43	0	0	0	0	0	0	0	0
** TOTAL **	-241	-1588	0	0	0	0	0	0	0	0
DEFICIENCY RESERVES	-7016	-47053	-6620	-5503	-3334	-1954	-3869	-2184	-1230	-1

CHART 11

MUTUAL COMPANY GAAP

SAMPLE LIFE - COMPANY A - PREM PAY PLANS
PREMIUM SUMMARY REPORT FOR, 3/31/1990 VALUATION

COMPANY TOTALS BY ISSUE YEAR: FOR COMPANY #

	1970	1969	1968	1967	1966	1965	1964	1963	1962	1961
* PREMIUM SUMMARY **										
ANNUALIZED GROSS	8516	4560	2479	3604	2582	1562	704	1370	1229	1018
MODEL GROSS	7859	4084	2170	3266	2194	1367	585	1093	1038	932
GAAP BEN(WITHOUT CAT 4	2085	1144	615	993	645	389	128	280	230	196
GAAP BEN (CAT 4 ONLY)	289	123	67	100	70	45	16	84	32	32
GAAP NON ACQUISITION	3792	1971	1066	1350	1015	696	416	711	763	636
GAAP COMMISSION AGG	0	0	0	0	0	0	0	0	0	0
GAAP OTHER AGG	0	0	0	0	0	0	0	0	0	0
TOTAL GAAP NET	6116	3238	1748	2442	1730	1130	560	1025	1026	864
DEFICIENT PREM	-1473	-896	-422	-824	-465	-236	-25	-67	-13	-68
STAT NET(CENTRAL AGE)	6257	3436	1857	2872	1907	1159	420	862	759	697
** DUE PREMIUMS **										
GROSS	546	72	416	82	6	0	0	17	85	52
BENEFIT (WITHOUT CAT 4	137	17	92	5	1	0	0	3	5	8
BENEFIT (CAT 4 ONLY)	19	2	14	1	0	0	0	0	1	2
NON ACQUISITION	352	36	264	16	1	0	0	13	29	43
COMMISSION	0	0	0	0	0	0	0	0	0	0
OTHER AGG	0	0	0	0	0	0	0	0	0	0
TOTAL GAAP NET	508	55	370	22	3	0	0	16	35	53
STAT NET (CENTRAL AGE)	445	53	306	18	4	0	0	10	21	30
** DEFERRED PREMIUMS *										
GROSS	2553	1374	231	606	568	385	114	394	253	273
BENEFIT (WITHOUT CAT 4	630	327	56	157	113	92	23	89	48	54
BENEFIT (CAT 4 ONLY)	71	37	5	16	11	11	3	9	6	8
NON ACQUISITION	1042	640	78	220	167	167	59	163	130	168
COMMISSION	0	0	0	0	0	0	0	0	0	0
OTHER AGG	0	0	0	0	0	0	0	0	0	0
TOTAL GAAP NET	1742	1004	139	398	291	270	85	261	184	230
STAT NET (CENTRAL AGE)	1852	997	163	460	336	271	71	256	149	182
** ADVANCE PREMIUMS **										
GROSS	11	115	0	0	248	0	0	3	4	0
BENEFIT (WITHOUT CAT 4	3	32	0	0	75	0	0	1	1	0
BENEFIT (CAT 4 ONLY)	0	2	0	0	8	0	0	0	0	0
NON ACQUISITION	2	31	0	0	96	0	0	3	4	0
COMMISSION	0	0	0	0	0	0	0	0	0	0
OTHER AGG	0	0	0	0	0	0	0	0	0	0
TOTAL GAAP NET	5	65	0	0	178	0	0	4	4	0
STAT NET (CENTRAL AGE)	8	91	0	0	214	0	0	2	2	0

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PANEL DISCUSSION
CHART 12

MUTUAL COMPANY GAAP

periods after the December 15, 1989, but a lot of companies, since their December 31 fell behind that, implemented it for the entire year of 1989. One point that was mentioned was that you don't have to adopt FAS 97 for universal life for 1988 and prior issues because this thing was not effective until 1989. Maybe we can use FAS 60 on universal life type products (whatever that is) and use FAS 97 only for 1989 issues. That is one little technical point that some people have been making. FAS 97 is balance-sheet oriented rather than income statement oriented. We talk a lot about having something that produces a level percentage of earnings, for example, a level ROE, or a level percentage of premium. The accountants these days are saying, "Forget about all that stuff, just give me a nice balance sheet that I can understand, and let things flow as they are actually occurring." What has happened is we have gotten to an analysis of insurance companies like they were banks. When you give a bank a deposit, it doesn't show that as income. The only thing that it shows as income is the interest that it earned on your deposit, and what it shows as expense is the interest that it had to credit on your deposit. So what is happening is we are moving to that kind of accounting. So let's switch the concept. Under bank accounting, I am using this term very loosely, the reserve equals the fund value, for the most part. If you have some wrinkles in your universal life policy, like persistency bonuses, you need to accrue for them and that would be added to your reserve. There are some new DAC amortization concepts, which basically mean that we are going to get away from an unlocked set of assumptions to changing our assumptions periodically. It's like we're going to be doing a change in valuation bases frequently. So that's where we're headed. The amortization is shifted from premiums to spreads (spreads from mortality, interest, expenses and surrenders). Just a small point. The front-end loads are grossed up; that's another *geography* problem where we have to gross everything up. I won't spend too much time on that, but for a product that is back-end loaded, you get a different set of accounting applications from a product that is front-end loaded. You take your front-end loads and you don't show them as income. You set them up as a liability and you earn them over time, bringing them into income.

We have alluded to unlocking, and I said that it is like a continuous change in valuation bases. So you know how that works, you figure out what your opening reserve is under the new set of assumptions, and then you charge that to Exhibit 8a and bring it into surplus. Well, it is sort of like that, except you bring in the whole thing into income now under FAS 97 rules, and unlocking applies to just about everything. It applies to reserves, it applies to DAC, it applies to front-end loads. The reasons? There are a couple. We talk about emerging experience always being different from what we thought. Well, that is what we want to adjust for; to the extent that our earnings are not what we thought they would be, we want to go back and recalculate DAC based on what actually happened. We need to have a way to be able to calculate what actually happened, and then we need to be able to go in and make an adjustment. Unlocking also is another case where we change something about the future. I look at catch-up as what happened in the past, or retrospective adjustment, and unlocking as something like what happens in the future. You want to change an assumption, say you don't think that the spreads are 150 basis points anymore. You think that the spreads are 100 basis points, so you want to get that into a computation. Then you have to go back and recompute your balances all the way from the beginning and bring them up to date, just like you would do with a valuation change.

PANEL DISCUSSION

Here is a catch-up example. Let's say that your actual earnings are \$1 million, but you expected to make a million and a half. That changes your amortization rate from 92-94%, of what? Well, we are applying an amortization rate to the spreads that we figured out. So we have to go back and now apply 94% to the past spreads, and this changes our opening DAC from \$22 million to \$20 million and the catch-up is \$2 million. That means we take a hit to earnings in this period. Let's say you had a write-down on a bond which was \$2 million, for example. You might bring that into your spread, and you would have to go back and recompute. You can see you had less profit than you thought you would, so you have to go back, take that into account and make a recalculation from the beginning. Prospectively, going forward, you might run into a situation where you have set up a reserve for some persistency bonuses of about \$4 million, and you revise your thinking about how many people are going to get it, from 70-75%. You need to basically start over from the beginning and note that you should be accruing 15% instead of 12%, so you go back and compute what your reserve would be and you find that the reserve is \$4.3 million. You have a \$300,000 unlocking adjustment, which is a hit to earnings in the period of time that you do it.

These kinds of things go on a regular basis, and in fact, I will show you some illustrative effects of this on a real going basis. There is an implication here, I believe, as a result of this new way of tracking DAC. We have a new way of looking at profitability. The whole idea of GAAP, I guess, is going to be new, if you have not worked with it, but certainly relative to FAS 60 it will be different. We have to have different ways of capturing data under 97 from under FAS 60, and we have the unlocking feature that has to be contended with on a regular basis. I think you need something that is very organized, not only to do FAS 97, but to do FAS 60. There is a list of several things. First of all you have to develop accurate and historical SOEs. You have to know where your profits are coming from and how they are getting there. You have to be able to project from current in-force data to do the prospective part. You want to be able to provide accurate financial data, because you want to be able to be believed when you are messing with people's compensation and you are the one who is in charge of it. Generally the actuaries are in charge of this. You need to be able to understand what is happening to your business, in order to be able to explain it to somebody. You want to be able to measure these potential write-ups and write-downs, and to be able to examine future income statements. Now let me give you an example of what the reports look like relative to what you see in FAS 60. The remaining charts illustrate a report where we are taking a GAAP plan code and we are projecting GAAP gross profits. On Chart 13 we have the gross revenues on the first few lines: earned interest, COI charges, surrender charges, recurring policy loads to come up with total revenues. And then we have expenses: credited interest, deaths on the net amount at risk, and recurring expenses. Line 3 gives us the GAAP gross profits. We are at a September 30, 1989 valuation date, so we have a projection of GAAP gross profits, gross margins if you will, for this block of business, and this includes 6,800 policies. We have not used a factor approach. We used a model to project what these would be.

That is the first step. Another step is to go back and figure out what you have. So that is not changing, although sometimes when you do undo, redos, or whatever you call it, you get late issues that sometimes change history somewhat. But now we want to quantify what happens. Going to Chart 14, on March 31, 1988 and June 30, 1988, our

MUTUAL COMPANY GAAP

CHART 13

Everlasting Life

GAAP REPORT 101 ANALYSIS OF PROJECTED GAAP GROSS PROFITS

Reporting Plan 1
Gaap Plan Code 10082

	GAAP Gross Profits for 9/30/1989 29 year valuation					
	9/30/1989	12/31/1989	3/31/1990	6/30/1990	9/30/1990	12/31/1990
1) GAAP Gross Revenues						
a) Earned Interest		898,378	893,694	886,581	879,096	870,731
b) COI Charges		681,108	677,914	675,053	672,302	668,214
c) Surrender Charges		0	0	0	0	0
d) Recurring Policy Loads		130,598	134,247	126,454	120,591	119,332
e) Reinsurance and Other		0	0	0	0	0
f) Total: (a)..(e)		1,710,084	1,705,854	1,688,088	1,671,989	1,658,277
2) GAAP Gross Expenses						
a) Credited Interest		693,696	694,518	694,097	692,732	691,303
b) Deaths on Net Risk		516,404	517,062	518,812	520,315	521,072
c) Recurring Expenses		168,900	167,519	161,795	157,106	154,197
d) Reinsurance and Other		0	0	0	0	0
e) Total: (a)..(d)		1,379,000	1,379,099	1,374,704	1,370,153	1,366,572
3) GAAP Gross Profits: (1f)-(2e)		331,084	326,755	313,384	301,837	291,705
4) Breakdown of Gross Profits by Source						
a) Interest Earnings		204,682	199,176	192,484	186,365	179,428
b) Mortality Earnings		164,704	160,851	158,241	151,987	147,142
c) Surrender Charges		0	0	0	0	0
d) Expense Earnings		(38,302)	(33,272)	(35,341)	(36,515)	(34,865)
e) Reinsurance and Other		0	0	0	0	0
f) Total: (a)..(e)		331,084	326,755	313,384	301,837	291,705
---- INFORCE DATA -----						
5) Policies Inforce		6,869	6,568	6,416	6,274	6,137
6) Specified Amount / 1000		534,344	522,806	510,355	497,934	478,552
7) Face Amount / 1000		560,345	550,741	538,291	525,825	504,295
8) Fund Value	35,893,561	35,914,476	35,935,323	35,901,719	35,809,661	35,766,766
9) Cash Value	35,893,561	35,914,476	35,935,323	35,901,719	35,809,661	35,766,766
---- DEFERRED AMOUNTS -----						
10) Deferred Commission Expense		43,859	47,024	42,963	40,077	40,079
11) Deferred Non-Comm Expense		0	0	0	0	0
12) Front End Loads		0	0	0	0	0
13) Special Benefits		0	0	0	0	0
---- RECONCILIATION DATA -----						
14) Premiums Collected		923,352	989,989	904,493	843,730	843,759
15) Funds Released on Surrender		718,187	783,960	762,064	766,708	720,420
16) Funds Released on Death		68,120	68,944	69,976	70,494	71,140

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Everlasting Life

GAAP REPORT 102
ANALYSIS OF PAST GAAP GROSS PROFITS

Reporting Plan 1
Gaap Plan Code 10082

GAAP Gross Profits for 9/30/1989 29 year valuation

	12/31/1987	3/31/1988	6/30/1988	9/30/1988	12/31/1988	3/31/1989	6/30/1989	9/30/1989
1) GAAP Gross Revenues								
a) Earned Interest		857,002	876,126	877,928	884,003	895,637	898,960	898,575
b) COI Charges		683,067	681,752	674,577	669,418	666,527	663,066	662,036
c) Surrender Charges		1,875	1,750	1,450	1,275	1,625	1,225	0
d) Recurring Policy Loads		179,151	184,260	170,129	164,814	175,296	167,340	153,417
e) Reinsurance and Other		0	0	0	0	0	0	0
f) Total: (a)..(e)		1,731,095	1,743,886	1,724,083	1,719,510	1,739,085	1,730,591	1,714,228
2) GAAP Gross Expenses								
a) Credited Interest		581,593	601,879	604,738	602,261	626,394	684,452	660,099
b) Deaths on Net Risk		124,594	240,476	768,531	33,797	334,428	1,064,852	437,804
c) Recurring Expenses		201,690	217,351	179,149	186,492	183,641	197,507	161,461
d) Reinsurance and Other		0	0	0	0	0	0	0
e) Total: (a)..(d)		907,877	1,059,706	1,552,418	822,549	1,144,663	1,946,811	1,259,365
3) GAAP Gross Profits: (1f)-(2e)		823,218	684,183	171,666	896,961	594,422	(216,220)	454,863
4) Breakdown of Gross Profits by Source								
a) Interest Earnings		285,408	274,247	273,190	281,742	269,843	214,508	238,476
b) Mortality Earnings		558,473	441,276	(93,954)	635,622	332,099	(401,786)	224,232
c) Surrender Charges		1,875	1,750	1,450	1,275	1,625	1,225	0
d) Expense Earnings		(22,539)	(33,091)	(9,020)	(21,678)	(8,345)	(30,167)	(7,844)
e) Reinsurance and Other		0	0	0	0	0	0	0
f) Total: (a)..(e)		823,218	684,183	171,666	896,961	594,422	(216,220)	454,863
.... INFORCE DATA								
5) Policies Inforce	7,999	7,841	7,672	7,492	7,314	7,148	6,999	6,869
6) Specified Amount / 1000	589,506	578,767	566,684	551,261	538,584	537,167	535,754	534,344
7) Face Amount / 1000	616,413	606,105	594,395	579,158	566,735	563,335	561,929	560,345
8) Fund Value	33,498,291	34,077,770	34,362,152	34,448,396	34,652,026	35,344,004	35,597,196	35,893,561
9) Cash Value	33,498,291	34,077,770	34,362,152	34,448,396	34,652,026	35,344,004	35,597,196	35,893,561
.... DEFERRED AMOUNTS								
10) Deferred Commission Expense		113,776	106,741	99,125	93,049	118,816	112,983	57,207
11) Deferred Non-Comm Expense		0	0	0	0	0	0	0
12) Front End Loads		0	0	0	0	0	0	0
13) Special Benefits		0	0	0	0	0	0	0
.... RECONCILIATION DATA								
14) Premiums Collected		1,542,600	1,447,206	1,343,954	1,261,304	1,361,589	1,294,748	1,204,291
15) Funds Released on Surrender		455,128	665,825	730,360	513,008	605,868	491,690	309,318
16) Funds Released on Death		0	0	0	0	0	0	0

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CFGAAP Version 2.1

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PANEL DISCUSSION
CHART 14

MUTUAL COMPANY GAAP

GAAP gross margins are \$823,000, and there are some fluctuations. For example, at September 30, 1988, we only had a gross margin of \$171,000, and at June 30, 1989, we had a loss of \$216,000 due to a \$401,000 loss on mortality. We paid more in net amount at risk deaths than what we collected on charges.

We are going to use all that information to come up with an amortization rate that we want to apply to our spreads. Going to Chart 15 we, first of all, identified deferrable expenses in the past and in the future to develop total commissions of 3.8 and we go through other types of expenses. As you can see, they are all past us. We could look at the relative timing of GAAP gross margins on line 4 between interest and mortality. We want to get to a margin down there on line 6b, DAC, 37.99 85%. That means that the amortization rate that we want to use for DAC is about 38% of premiums. How are we going to compute that?

Going to Chart 16 you can see the GAAP gross margins on line 6, \$684,183 in June 30, 1988, \$171,666 in September 30, 1988. Basically, you start with the unamortized DAC at the beginning of the period, you add interest at the credited rate on the DAC, you add in deferred expenses, you subtract out the amortization, and then you adjust for any unlocking. If you look at the unlocking line, you notice how it fluctuates. I want to show that to you because it gives you some idea of the sensitivity of the unlocking to changes in gross profits on a line of business. We see a \$171,000 profit in September 30, but we had an unlocking adjustment that was negative. That means we had to write down DAC, because our profits were less than what we expected. But in the first quarter, that June 30, 1988, we had \$684,000, so we wrote up DAC by \$81,000, because our profits were greater than we expected. In a sense, that is a barometer of our profitability of whether we are tracking against the assumptions. The assumptions that we would use here would be very close to our pricing assumptions. We would be tracking this and this barometer; unlocking would be telling us how well we are doing as we roll along.

What do I like as a model for GAAP, for all companies, not just mutuals? I guess I really kind of like two. One is the SOE and the other is the ROE. But you can take the SOE and use it for ROE. The reason I like the SOE approach is because actual experience is always different from assumed, and if you use any of the other models, the first thing that will happen is you will get variations in your profits that have to be explained. You are continually going back to explain why we had more charge-off on DAC. In the factors you can never see it. It is not easily observable, but under the SOE approach where you have numbers flowing down to you, and you can see that it is because we had a mortality gain, or we had a mortality loss, or it is because we had more interest spread than we thought. It is the kind of thing that is going to win you a lot of points with the accountants, with the financial people, with the chief executive officer, who is trying to understand what is really happening to his business, and with the board, for that matter, because you can explain it to all of them. You have a method of quantifying what is happening, and I believe that this works equally well for participating business, if you run it off an experience fund to show what is happening. I guess the preeminent reason is because, bottom line, it enhances our position as people who understand what is going on. We have a tool with which to explain to management what is going on.

PANEL DISCUSSION

CHART 15

GAAP REPORT 105
GAAP GROSS PROFIT SUMMARY

Present Values at Credited Rate
as of 4/30/1982
for 9/30/1989 valuation

	Past Values	Future Values	Total
1) Deferrable Expenses			
a) First Year Commissions	2,254,728	0	2,254,728
b) Renewal Commissions	1,374,007	259,651	1,633,658
c) Total Commissions: (a) + (b)	3,628,736	259,651	3,888,386
d) Percentage	0	0	0
e) Per Unit	0	0	0
f) Per Policy	853,844	0	853,844
g) Flat Unallocated	0	0	0
h) Reinsurance Expense	0	0	0
j) Discretionary Reduction	0	0	0
k) Total Expenses: (c)..(j)	4,482,580	259,651	4,742,230
2) Front End Loads	0	0	0
3) Special Benefits	0	0	0
4) GAAP Gross Profits			
a) Interest Earnings	3,078,694	2,601,357	5,680,051
b) Mortality Earnings	5,950,940	543,695	6,494,635
c) Expense Earnings	996,320	(707,913)	288,407
d) Surrender Charges	16,968	0	16,968
e) Other	0	0	0
f) Total: (a)..(e)	10,042,922	2,437,139	12,480,061
5) Breakdown of Gross Profits			
a) Positive Gross Profits	11,572,380	2,439,021	14,011,401
b) Negative Gross Profits	(1,529,458)	(1,883)	(1,531,340)
c) Total: (a) + (b)	10,042,922	2,437,139	12,480,061
6) Margins			
a) Gross Profits	80.4717 X	19.5283 X	100.0000 X
b) Deferred Acquisition Costs	35.9179 X	2.0805 X	37.9985 X
c) Front End Loads	0.0000 X	0.0000 X	0.0000 X
d) Special Benefits and Other	0.0000 X	0.0000 X	0.0000 X
e) Net Margins: (a)-(b)+(c)-(d)	44.5538 X	17.4477 X	62.0015 X

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Everlasting Life

GAAP REPORT 107
GAAP AMORTIZATION SCHEDULE AND RECOVERABILITY ANALYSIS

Reporting Plan 1
Gaap Plan Code 10082

GAAP Gross Profits for 9/30/1989 29 year valuation

	3/31/1988	6/30/1988	9/30/1988	12/31/1988	3/31/1989	6/30/1989	9/30/1989	12/31/1989
1) Policies Inforce	7,841	7,672	7,492	7,314	7,148	6,999	6,869	6,718
2) Specified Amount / 1000	578,767	566,684	551,261	538,584	537,167	535,754	534,344	522,806
3) Face Amount / 1000	606,105	594,395	579,158	566,735	563,335	561,929	560,345	550,741
4) Fund Value	34,077,770	34,362,152	34,448,396	34,652,026	35,344,004	35,597,196	35,893,561	35,914,476
5) Cash Value	34,077,770	34,362,152	34,448,396	34,652,026	35,344,004	35,597,196	35,893,561	35,914,476
6) GAAP Gross Profits		684,183	171,666	896,961	594,422	(216,220)	454,663	331,084
7) Deferred Acquisition Cost Asset								
a) Unamortized DAC (BOP)		1,494,742	1,491,221	1,493,638	1,464,468	1,452,105	1,150,713	1,092,626
b) Interest on DAC		30,385	30,025	29,896	27,875	25,577	22,102	20,785
c) Deferred Expenses		106,741	99,125	93,049	118,816	112,983	57,207	43,859
d) Amortization		221,773	67,437	305,913	230,578	269,815	153,971	112,072
e) Unlocking		81,126	(59,297)	153,999	71,723	(170,137)	16,575	0
f) Unamortized DAC (EOP): (a)+(b)+(c)-(d)+(e)	1,494,742	1,491,221	1,493,638	1,464,468	1,452,105	1,150,713	1,092,626	1,045,198
8) Front End Load Liability								
a) Unamortized FEL (BOP)		0	0	0	0	0	0	0
b) Interest on FEL		0	0	0	0	0	0	0
c) Front End Loads		0	0	0	0	0	0	0
d) Amortization-Liab Release		0	0	0	0	0	0	0
e) Unlocking		0	0	0	0	0	0	0
f) Unamortized FEL (EOP): (a)+(b)+(c)-(d)+(e)	0	0	0	0	0	0	0	0
9) Accrued Special Benefits Liability								
a) Accrued Special Bens (BOP)		0	0	0	0	0	0	0
b) Interest on Acc Spec Bens		0	0	0	0	0	0	0
c) Special Benefits		0	0	0	0	0	0	0
d) Amortization-Liab Accrual		0	0	0	0	0	0	0
e) Unlocking		0	0	0	0	0	0	0
f) Accrued Special Bens (EOP): (a)+(b)-(c)+(d)+(e)	0	0	0	0	0	0	0	0
10) Net Assets: (7f)-(8f)-(9f)	1,494,742	1,491,221	1,493,638	1,464,468	1,452,105	1,150,713	1,092,626	1,045,198
11) PV Future Revenue (Earn)	6,252,356	5,723,763	5,699,588	4,942,284	4,471,825	4,813,171	4,476,797	4,255,781
12) PV Future Def Exp (Earn)	961,573	878,766	801,475	728,291	627,262	529,323	485,045	453,045
13) PV Future FEL (Earn)	0	0	0	0	0	0	0	0
14) PV Future Spec Bens (Earn)	0	0	0	0	0	0	0	0
15) Recoverability Test: (11)-(12)+(13)-(14)	5,290,784	4,844,998	4,898,113	4,213,992	3,844,563	4,283,847	3,991,751	3,802,734

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MUTUAL COMPANY GAAP
CHART 16

PANEL DISCUSSION

MR. ROBBINS: Thanks to our panelists. Questions from the audience? I have a couple of additional questions for the panel just to start things off. Cal, I am interested in what the Equitable has done in several areas. What kind of management information are you currently getting from your doing GAAP? I am interested in things like SOE analysis by line of business and how finely you are segmented. You are on 97 right now. I wonder if you are analyzing the sources of the unlocking of the opening adjustment at the beginning of the year as to what is causing it -- retrospectively or prospectively, perhaps. Have you made some progress along those lines?

MR. JARED: I will take the easy one first. We just converted to FAS 97 within the last month. So we have not unlocked or published any financials, other than the conversion financials, internally, which were for 1987, 1988 and 1989. That's an issue that we will have to deal with. I believe that in time we will publish the financials at a very detailed level, but certainly not in the short run. The reason I say in time is, that currently, for our statutory financials, we are showing some SOE type reports at a fairly detailed level. By that, I mean not only in line of business, but also with certain key products within a line of business. We have about 20 categories of financials that we are showing on an SOE earnings basis. We also do that on a GAAP basis currently for FAS 60, and my belief is we intend to do that for FAS 97, but it is in the future. As I say, we have just converted, and the other hidden message in that is we have not developed good internal automated type systems to allow us to publish quarterly financials on an FAS 97 basis in real time and be able to unlock, etc. That is the next effort, to get that capability, so that we can routinely grind out quarterly financials. Then the next step will be to begin to layer in the kinds of management reports we can get from those.

MR. ROBBINS: Anyone else on the panel want to comment?

MR. LALONDE: I have a question. There is nothing in the literature which really defines what is acceptable GAAP for mutual companies. However, if you ask the accounting firms for an opinion on statutory, they will say that it is according to generally accepted accounting principles. If we start to adopt these ways of adjusting for accruals according to real GAAP, what kind of an opinion would we get from an accounting firm about this? Going on to the next step, with respect to AMT, if we ask for literature on AMT as well, do we get into any areas that we need to think about in advance, because we could get locked into something that we can't get out of?

MR. CLONINGER: As I mentioned, the DAC is supposed to be determined using generally accepted accounting principles. The accounting firms also, as I mentioned, had taken a position that statutory is deemed to be GAAP for mutuals. Actually, my firm had a counter position up until the early 1980s. Then we started working with the Equitable to develop GAAP for mutuals, at the same time we said statutory is now GAAP. So we moved off that position and then we started working with Equitable to develop their management basis financial statements. It is my opinion that while it is not generally accepted yet, the FAS 97 accounting models and the concept of retrospective deposit type methodology can be implemented for most types of business written by mutual companies. I think that if an accounting firm were asked to opine on the calculation of deferrable costs for mutuals (if it were required to support a number in the tax return), we would probably do that. We would opine that, if this number is

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calculated in conformity with FAS 97 and it is applicable to stock companies, we would say that is probably applicable for mutuals, too. That is my guess.

MR. ROBBINS: I will respond a little further from the tax point of view. It is fairly clear from just polling our insurance tax people that "statutory equals GAAP" will not fly for tax purposes. You have to at least capitalize DAC in accordance with GAAP. What does that mean? It could mean the following: Your method of capitalization may be more important than the amortization method that you are using. What is the IRS agent going to look at? Your typical agent is not going to be terribly knowledgeable about life insurance, about gross profit streams, etc., but he knows how to tie numbers and reconcile numbers to exhibits 1, 5 and 6, and he can read the Audit Guide and make up his own mind about what is a deferrable expense. So nice tying, ticking, reconciling exhibits, capitalization, will probably be fairly key to having the audit process go smoothly.

In terms of other questions, it is much more clouded exactly what the amortization method for mutuals is. There is a fairly large constituency that basically says that you should use stock company type GAAP amortization methods for AMT, then modified by the Conference Committee Report language. Conference Committee Report language basically says that, to the extent that reserves are relevant in the amortization process, tax rather than GAAP reserves should be used. Then they make another "giveth-and-taketh-away" type sentence at the end that says something to the effect that this is in order to make the book adjustment and the ace adjustment consistent with each other. I don't know anyone who is exactly sure of what that means. We all have our opinions as to what that means. But as far as mutual company GAAP, for tax purposes, it appears to be very close to stock company GAAP for AMT.

MR. YEK SOAN CHENG: The management to whom we report the GAAP results is usually the same management that approves the pricing and dividends for the company. In making the report to management or the analysis to management, what references, if any, were made to the pricing or dividend assumptions? This could be answered by any of the panelists.

MR. ROBBINS: The question, to some extent, deals with how the pricing people and the financial reporting people communicate and report to management and relate the two subjects.

MR. LALONDE: I guess I am not sure exactly how you are reporting to the same people, but I think the people that do the pricing are in charge of the results as well. That is frequently the case, except in companies where they have financial reporting actuaries who are independent of the pricing actuaries. But in order to establish their assumptions, the financial reporting actuaries' starting point has to be pricing. Those are the best estimate assumptions. Pricing generally includes a number of scenarios that are tested, anywhere from worst case scenarios to wonderful scenarios. You have to look at what is the final resting place of all those scenarios in the pricing scheme, and somewhere there will be some kind of best estimate.

PANEL DISCUSSION

Management needs to have a way of knowing what those assumptions really mean in terms of the emergence of margins and the timing of profits. One of the mysteries of our financial products is how those margins actually emerge, and not all nonfinancial people understand that. Not all financial people actually understand that either. I think that you need something which quantifies those margins on a regular basis and compares them to pricing, and best estimate assumptions are used in most FAS 97 systems, where you can compare the actual to the expected results. Did I answer the question?

MR. JARED: I would just add that what you pointed out is one of the drawbacks under FAS 60, and that is, that your assumptions, if you are following stock GAAP type FAS 60 reporting, are loaded for adverse deviation, so that the assumptions and the emergence of profits don't necessarily follow or agree with your dividend or pricing methodology. Under FAS 97, I believe they will be closer, in that at least your starting point would be your pricing or dividend type philosophy. But, over time, since you are plugging your actual experience into your amortization formulas, you would be automatically adjusting what you initially set out to do.

MR. ROBBINS: I know that at least three of our clients have made a very serious attempt to catch-up each year, to throw in their true experience for each year into their assumptions. Basically, what all three of them have done (two of them are mutuals and one is a stock company) is put their pricing assumptions essentially into what they would call their base line assumptions. They have calendar year adjustment factors to true up the aggregate dollar movements of account values and cash flows until it matches the history. By that process, they know what adjustments they actually had to make over time to their pricing unit assumptions. They actually have a history, not only of their SOE relative to the policyholder situation, but also they have their SOE deviations as a percentage of their pricing assumptions, which is interesting and useful management information. It kind of closes the loop between the financial reporting people and the pricing people.

MR. EDWARD L. ASTRACHAN: The federal tax authorities consider our dividends to basically be in two parts. One, more or less, is customer refunds, and one is ownership distribution. For purposes of mutual company GAAP reporting, has there been any thought to doing that separation as well? In measuring profitability after customer rebate or refund portion of dividends, but considering the portion that would represent ownership profit not to be a deduction from mutual GAAP income?

MR. JARED: That is a scary question.

MR. ROBBINS: If I could rephrase the question so I am sure I understand it, the policyholder dividend of a mutual company is divisible into the customer portion and the owner portion. The customer portion should be deductible, the owner portion should not be, in theory, according to the constituency that would say that. This was the theory of the differential earnings amount. It was the theory of several proposals that have come through. I guess I am thinking of the stock information group (SIG) proposal, which was going to limit your dividends to the extent they did not eat into what they called excess investment income. It was somewhat equivalent to the old phase 1 situation under the 1959 Act. There has always been an attempt by the IRS to do that.

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Of course, it is very unclear how to make those portions correct, how to actually divide the dividends into the customer portion and the owner portion. Would anyone else like to respond to that one?

MR. CLONINGER: I guess we thought about that. We thought about it when we were developing a model for Equitable to use, and actually went so far as to say, "Well, if we divided the dividend into the two components, shouldn't we show the ROE portion as a capital transaction, as opposed to an operating transaction?" We decided that was really impractical and that the company did not develop its dividends in a manner that showed the portion of the dividend that represents return of capital and the portion that represents the other favorable operating margins. I think, while you could conceptually make a case for that approach, it is virtually impossible to implement in practice.

MR. ROBBINS: When TEFRA was around for tax years 1982 and 1983, the IRS used a 77.5% factor for deductibility of dividends for mutuals and 85% for stocks, thus, conceptually, relegating 7.5% of the dividend to being the owner portion of a mutual company dividend for policyholders. So this trend of thought had been around a long time, to attempt to subdivide the dividend into those two components.

MR. LALONDE: I have one comment. For those of you who may end up having to be in charge of the financial reporting under GAAP and you want to get more information and expand your knowledge on all the technicalities involved, I can recommend that some of the executive education opportunities out there are good, in terms of explaining how GAAP accounting principles work and all the ins and outs.

MR. ROBBINS: I have a question for the panel. The question is in regard to the inclusion of capital gains in your gross profit stream for FAS 97 purposes. In one respect, there appears to be a constituency requiring it, and yet Paragraph 28 of the FAS 97 statement basically says you cannot defer profits directly or indirectly from realized gains and losses. There appears to be a conflict here. There also appears to be, to some extent, an administrative complexity in allocating capital gains and losses to your gross profit streams by line of business and by issue year. Would the panel like to take that and would the situation be any different for mutuals?

MR. JARED: I guess I will respond, at least partially for the Equitable, as well as for a number of the large mutuals. We have segmented our general account so that we already have a lot of investment income data broken out into the various segments, and also we are using the investment year method for a number of those. The amount of additional allocation that is necessary to move either investment income or gains and losses to appropriate levels for FAS 97 turned out (at least for us and I believe this would be the case for a number of the larger mutuals, and possibly some of the larger stocks) to not be a big deal.

MR. ROBBINS: And that includes allocation by issue year?

MR. JARED: Yes.

MR. ROBBINS: Okay.

PANEL DISCUSSION

MR. CLONINGER: I don't know. I have not seen what the mutuals are doing in that regard, because very few of them have actually implemented FAS 97. The stocks I have worked with have tended to not reflect capital gains and losses in recomputing under FAS 97. Those that do have segmented assets and actually adjust yields to reflect those gains would tend to, perhaps, reduce future investment yield rates because, presumably, the monies would have to be reinvested at a lower rate in order to take a capital gain. So it affects not only the current year but also the future projected gross profits that are in the model.

MR. JARED: We are looking forward to having some substantial capital gains so we can deal with that problem.

MR. CLARK A. RAMSEY: I have one comment on the capital gains comment you just had, Kriss, and that's that capital gains and losses can arise from factors other than changes in interest rates. In your prospective unlocking, usually you need to be aware of whether it is perhaps a change in credit quality that led to a capital gain, in which case it might not have any effect on anticipated streams in the future. Also, I have a question, it's probably best for Cal or Kriss, on the SOE method. I know that in the development of that method, it was thought that the economics behind participating products were similar to universal life type products. I wonder with the advent of FAS 97 with its unlocking and its discounting at the credited rate and its nondeferral of recurring acquisition costs, etc., if some thought has been given to reflecting that in the SOE method, if any changes have been made in SOE to put it on more of a Statement 97 type basis?

MR. JARED: We thought about it and we discussed it with our accountants because we have audited financials, both statutory as well as special-purpose financials, which are prepared in accordance with, in the old days FAS 60 and now FAS 97. But we chose not to make any change to our traditional products on the SOE, primarily because we didn't believe that it would make a large difference, but, in all honesty, we never tested it. We concluded that FAS 97 did not apply to traditional products, and if SOE was an acceptable methodology for GAAP in the past, it was still acceptable for traditional products.