

RECORD, Volume 22, No. 1*

Marco Island Spring Meeting
May 29–31, 1996

Session 7PD

Generally Accepted Accounting Principles (GAAP) for Mutuals—Current Status

Track: Financial Reporting
Key words: Financial Accounting Standards, GAAP

Moderator: EDWARD B. KIFFEL
Panelists: DAVID W. PARSONS
CHARLES A. SINEX
STEPHEN J. STROMMEN
Recorder: MATTHEW GOTTFRIED

Summary: Panelists share experiences and discuss alternative approaches to various implementation issues related to mutual company GAAP conversions. Items discussed include general implementation issues (length of amortization period, classification of contracts, "backcasting" and gathering of historical data, selection of assumptions, and so on), Financial Accounting Standard (FAS) 115 approaches, issues that specifically relate to mutual companies (deferral of policyholder dividends to later policy years, reflection of extraordinary policyholder dividends related to investments in subsidiaries, and so forth), and uses of GAAP financial information gleaned from the conversion process.

Mr. Edward B. Kiffel: We are fortunate to have with us a distinguished panel of actuaries that is experienced in various aspects of GAAP for mutuals. Each of the panelists has a particular area of expertise that he will address in his presentation. For those companies and fraternal organizations that have elected to create GAAP financials in response to the new FASB requirements that were issued in January 1995 and are effective for year-end 1996, they are now entering the homestretch of finalizing approaches and processes and assembling their 1995 and quarterly 1996 financials.

At the same time, they have begun the difficult and delicate task of educating, disseminating, and effectively communicating GAAP basis results to their senior management and board. Issues that are currently being focused on that will be

addressed by our speakers include managing earnings volatility vis-à-vis dividends, capital gains, and losses, dealing with *FAS 115* and its effects on the balance sheet and equity, and making use of GAAP information and the communication of it to senior management.

The first of our speakers is Steve Strommen of Northwestern Mutual, who will talk about managing earnings volatility. Steve is an associate director of financial planning at his company, and as a member of the GAAP project team, he is responsible for determining and testing the best approach to controlling earnings. Steve is also currently serving as chairperson of the Society's Technology Task Force.

Steve will be followed by Dave Parsons of Metropolitan Life, who will discuss *FAS 115* and its effects. Dave is vice president and actuary in the corporate controller's department in charge of financial reporting. He serves as project manager of the GAAP for mutuals project at Met Life, directing and coordinating many of the related investment, accounting, and actuarial efforts.

Our final speaker will be Charles Sinex of Indianapolis Life, who will discuss the use of GAAP information and its communication to various constituents. Charles is a senior assistant actuary in the actuarial department and project leader of his company's GAAP implementation project. His other responsibilities include overseeing reinsurance actuarial issues and leading the experience studies unit. Matthew Gottfried will be our recorder. Matt has recently joined Ernst & Young's actuarial group in New York.

Mr. Stephen J. Strommen: I will cover some aspects of amortizing deferrable acquisition costs (DAC) under GAAP accounting. As you know, there are two ways under which acquisition costs are amortized, either in proportion to premiums or in proportion to gross margins, and I will talk about the gross margins approach. I also will talk about the classification of expenses that are used in determining gross margins.

When I first began working on this as a naive mutual company actuary who had no experience in GAAP, I assumed that a gross margin was something like a gain before tax and before deferrable expenses. It turns out that it is something a little bit different than that because there are four categories of expenses one has to keep track of. Not only must one split deferrable and nondeferrable expenses, but the nondeferrable expenses need to be divided between those that are nondeferrable acquisition costs, those that are direct maintenance costs, and those that are overhead. Certainly those last three are all period costs that are charged in the current period, but gross margins are before, not only the deferrable acquisition costs, but also nondeferrable acquisition costs and overhead. The only expenses

that are included in computing gross margins are your direct maintenance costs. This was intended to be clarified by *Practice Bulletin 8*. The applicable paragraph in *Practice Bulletin 8* says, “nonpolicy related expenses, such as certain overhead costs, costs that are related to the acquisition of business that are not capitalized under *FAS 60*, such as certain advertising costs, should not be included in expected gross profits.” That means your expected gross profits are perhaps a little higher than they would be if they were simply before deferrable acquisition costs.

In order to understand exactly why gross margins are defined that way, it’s useful to think of the treatment of expenses in a manufacturing enterprise. Gross profits are usually defined as sales minus the cost of goods sold. The cost of goods sold is the cost of the materials that were used in manufacturing the product and the direct costs of distributing the product. Gross profits then are before advertising, overhead and indirect types of expenses. So, in *Practice Bulletin 8*, we’re trying to carry this kind of GAAP paradigm over to an insurance enterprise. The reason I bring this up is because it was somewhat of a surprise that came up to our company in the middle of our GAAP conversion process, and there is apparently not full agreement between all auditing firms on the interpretation of what expenses are included in gross margins. It’s a good idea to talk with your auditing firm and make sure there’s agreement on this issue.

With the treatment of expenses clarified, I’d like to turn to the amortization of deferrable acquisition costs. What do we do with the margins once we’ve computed them this way? First, let’s review the way in which DAC is amortized in proportion to gross margins.

Deferrable acquisition costs are amortized like a loan where the payments are a level percentage of gross profits or margins over the life of the business in force. For example, let’s use 8% interest. The present value of the expected margins is \$764, and the present value of deferrable costs is \$500. Therefore, the loan payment needed to pay off the initial DAC is 65.5% of each year’s margins. The DAC balance at the end of the first year is the first-year deferrable cost, \$500, accumulated with interest, and then reduced by 65.5% of the first-year margins of \$200. So \$500 plus interest is 540 minus 65.5% of \$200 gives us \$409. And the calculation of DAC for later years follows the same kind of pattern.

It has been widely noted in the literature that DAC provides an offset to buffer fluctuations in earnings. Earnings fluctuations can occur for a variety of causes, including *FAS 115* unrealized gains, realized capital gains that actually flow through the operating statement, claims experience fluctuations, or just about any other cause. Earnings in an insurance enterprise tend to fluctuate. When earnings are higher than expected, DAC is written off more rapidly. When earnings are lower

than expected, DAC is written off more slowly or can even experience negative amortization. The point of my presentation is that this offset does not happen automatically.

In our example we used 65.5% of margins as loan payments, if you will, on our DAC balance. We would ideally expect that if margins changed, then the calculated DAC balance would change by 65% of that amount, providing a 65.5% offset.

Let's consider another example. Suppose our margins in year five are zero rather than the \$100 that was anticipated. At the end of year five the actuary must re-calculate the entire amortization schedule for this business. When this is done the DAC balance for year five is just \$26 higher than it was under the old calculation. At the end of year five, the DAC balance under this current new calculation is \$287, whereas previously it was \$261, for a change of only \$26. We expected to get an offset of \$65 for \$100 change in margins, but we only received \$26.

The reason for the smaller-than-expected offset is the retrospective adjustment of DAC. The present value of margins is now \$696. It previously was \$764. So, the ratio between the present value of margins and the present value of deferrable costs is now 71.9%. In re-computing the amortization schedule, therefore, even retrospectively, we are using 71.9% of the margins to pay off the DAC, and the new DAC calculation, therefore, reduces more quickly in the first few years. So, the DAC balances for the first four years are smaller. The balance at the end of the fifth year is larger but not as large as we wanted it to be.

In order to achieve the 65.5% offset that we want, we must adjust the projection of future margins. This is why it's not automatic. You have to adjust your future projection. The size of the adjustment is such that the present value of the change in future margins is equal and in opposite sign to the unexpected change in current year margins. Since we had an unexpected fluctuation of minus 100 in year five, we adjust the projected future margins by \$25 in years six to ten. The present value of \$25 per year for five years at 8% interest is about \$100. This change results in no retrospective adjustment to DAC and provides the 65.5% offset we wanted. Our present value of margins is now \$763, almost the same as the \$764 we had before. The ratio is 65.5%, as it was before, and the new DAC amortization schedule is effectively the same for the first four years. At the end of the fifth year we have a DAC balance that is \$65 higher than what we had initially.

We need a rationale for adjusting the projection in years six to ten. The rationale depends on the source of the original fluctuation in earnings. If the original fluctuation was *FAS 115* unrealized losses, then one can simply assume that the fixed-income assets were sold, and the money was reinvested at higher current

rates. Bonds are normally priced by the market so that the current capital loss would be offset by the present value of the higher future earnings on reinvestment. If the original fluctuation was due to something like extra death claims, the rationale becomes somewhat unique to mutual companies. Normally, a mutual company will adjust its dividend scale to reflect variations in historical experience. Lower margins in one year will be followed by a decline in dividends in later years. Since margins are after dividends, a decline in future dividends means an increase in future margins.

Given the rationale for adjusting future margins, we need a method. For investment fluctuations on participating life products, where we pay a portfolio dividend rate, a reasonable method begins with keeping a cumulative scorecard of actual-to-expected investment margins. When margins have been better than expected, the scorecard will show a positive balance, and it should be negative if investment results have been worse than expected. The exact details of keeping such a scorecard will vary from company to company, but it's important that it be done based on GAAP investment results, not statutory results. In particular, the realized capital gains that are spread in the interest maintenance reserve (IMR) for statutory purposes should go directly into the cumulative scorecard before tax. Once the cumulative scorecard amount is known, an assumed pattern of future margins can be generated which has a present value equal to and opposite in sign to the scorecard position. For modeling purposes (again on participating products that pay a portfolio dividend rate), the assumed future margin adjustment must be turned into an adjustment to future yield spreads. Note that all this must be done separately for *FAS 115*. One has to do this all twice.

Now let's assume that the scorecard shows a cumulative negative position of \$100 due to poorer-than-expected experience. To provide an offset to this, we project higher future margins in the amount of \$25 per year for five years. Please note we're looking at an entire line of business; we're not looking at one year of issue. To convert the projected margins into a yield spread adjustment, we need to know the projected assets supporting this business. Given the assets and the income adjustment, one can use a simple formula, the famous NAIC yield rate formula, to calculate the yield spread adjustment. The reason for converting this income adjustment into a yield spread adjustment is that it can then be applied separately within a model to every year of issue. Every year of issue will have a different pattern of future assets and a resulting different pattern of income adjustments. One can do this on an aggregate basis for the entire line of business and then use a model to apply the yield spread adjustments later on to each year of issue.

There are some limitations to this technique. It doesn't give you exactly the answer that you might want. First, in many companies, there is a situation where the

amortization period is less than the full lifetime of the product that's being worked on, and so some of the business gets past the amortization period. Any yield spread adjustment that is applied to the assets supporting that business gets lost in the process. Some of the adjustment goes to future new business. In a company that pays a portfolio yield rate, any adjustment in future dividends will be partly applied to new business, so that reflects what actually happens. Of course, some products are on *FAS 60*, as opposed to *FAS 97* or *FAS 120*, so that this entire procedure wouldn't apply.

There are two other items. The dividend interest rate applies to the statutory reserve, not the GAAP reserve. Therefore, when one is using yield spreads applied to the asset supporting the GAAP reserves, the dividend adjustment may not exactly be the dollar amount that one is looking for. Finally, this technique doesn't apply to the assets supporting surplus. The assets that are used in computing investment income for use in gross margins do not include surplus. Any investment fluctuations that take place on those assets do not get buffered through this technique.

To summarize, I've talked about the classification of expenses. There are some expenses that need to be excluded when one is computing one's gross margins. We've covered achieving a DAC offset to buffer fluctuations in earnings, and I've described a technique that can be used for participating products that use a portfolio dividend rate.

Mr. David W. Parsons: Of the recently enacted financial standards of accounting, it can arguably be stated that none has caused as much concern in the insurance industry as *FAS 115*. This standard affects only the balance sheet presentation and does not affect the income statement. The standard applies to the valuation of all assets other than mortgages and real estate. It calls for the carrying value of certain assets to be recorded at market value, instead of at book value. The industry concern stems from the observation that the economic health of an insurance company is inaccurately presented in the GAAP statement of surplus of that company, as affected by *FAS 115*. This is because while the assets backing a block of liabilities have a marked-to-market value, the corresponding liabilities will not be similarly valued at market.

As background, the FASB enacted *FAS 115* in 1994 to reflect the market values of certain assets in the reported GAAP surplus of companies. For companies without long-term financial liabilities this adjustment was necessary, in the view of the FASB, to more appropriately reflect the true economic value of the capital owned by a company.

For the insurance industry, the FASB recognized that marking assets to market would not enhance the financial presentation of GAAP equity since the liabilities backed by market-valued assets would not themselves be valued using market interest rates. In fact, a dissenting opinion in the standard itself refers to concern over “unrepresentative volatility in capital because enterprises are not permitted to recognize the unrealized changes in fair value of the liabilities that are related to investments accounted for as available-for-sale securities.” Further, the FASB commented that “the Board believes it would be preferable to permit certain related liabilities to be reported at fair value . . . however, the Board was unable to identify any approach . . . that the Board considered workable . . .”

The insurance industry argued that market valuing the assets without market valuing the liabilities is unreasonable in the extreme case of an asset portfolio being matched against a block of financial liabilities. It was further observed that valuation of an asset at amortized cost is a valid economic measure when the liabilities are not valued at market and there is no intention to sell or actively manage the asset portfolio because of this matching. Responding to these arguments, the FASB allowed for a category of assets to be exempted from market valuation only if the company “promised” never to sell the assets.

Three categories of assets are defined by *FAS 115*. The first of these categories, trading, refers to those assets that are held for purposes of sale in the near term. This is the only category of assets for which changes in market value affect GAAP earnings.

The second category, available for sale, will probably be the most widely used category for insurance company assets. Assets in this category are carried at market value on the GAAP balance sheet. However, market value fluctuations will not affect the GAAP earnings; rather they affect only the reported GAAP equity of a company.

The third category, held to maturity, is the exception to the requirement to value assets at market value. This label is available only for assets that the company “promises” never to sell. Once so labeled, assets in this category cannot be sold except in specifically allowed circumstances such as a deterioration of creditworthiness of the insurer of the asset. Should assets in this category be sold (for example, if someone offers to purchase them at double their economic value), then the exemption from market valuation is disallowed for the entire category. In this manner, the accountants have put a “penalty” on those companies that break their promise not to sell these assets.

Since the characterization of assets as held to maturity binds the hands of a company with respect to its investment policy, this characterization as a solution to GAAP surplus volatility is cautiously applied.

Let's use a simplified example of the accounting as it was before *FAS 115*. Let's say a product is sold for \$10,000 in an environment where the money can be invested in a ten-year bond at 6% interest. The pricing reserves for this product are hypothetically equal to the present value of the future cash flow stream at 5% interest. The simplified example reflects no taxes or expenses, and there is no assumption of interest on reinvestment of earnings.

The GAAP earnings under this example are the difference between the income stream of the investment (\$600 in the early years) and the benefit stream (\$500 in the early years). GAAP equity reflects the accumulation of these earnings (under an assumption of no reinvestment of earnings).

Prior to *FAS 115*, the \$10,000 book value of the bond backing the product liability was reported as the GAAP value on the balance sheet. Prior to *FAS 115*, the carrying value would have been unaffected by changes in the interest rate environment unless the bond was sold. The GAAP equity would have represented the accumulation of the GAAP earnings of \$100 per year under this example.

Indeed, even after *FAS 115*, this example shows the handling of the "available-for-sale" bond values consistent with the GAAP income statement. However, *FAS 115* changed the asset valuation of such bonds for balance sheet purposes.

After the advent of *FAS 115*, the bond is carried on the balance sheet at market value. Because the market value changes dramatically with external interest rates, you can see here the result is that GAAP equity is quite volatile as interest rates change. In this example, the increased interest rate in year two causes GAAP equity to become negative. The presentation of this negative equity on the GAAP balance sheets will probably give an impression to the public of insolvency. As we can see here, however, the product in this example is far from insolvent as we continue to expect \$100 in annual earnings through year ten.

In fairness to the framers of *FAS 115*, let me point out that this accounting would have occurred even before *FAS 115*, under the circumstance of annual sale of the bond and reinvestment of the proceeds in a new bond having the same economic characteristics of the sold bond.

In fact, at all times through the history of GAAP, if the bond is sold, the balance sheet impact shown here would affect the reported GAAP earnings and we would

see large negative earnings in year two followed by large positive earnings in year three. The problem of a misleading economic perception is less attributable to market valuing the assets, than it is to valuing the liabilities (or reserves) at market.

Under normal circumstances the GAAP equity of a company would not be very volatile. While the asset values would be very volatile, *FAS 115* requires us to offset the impact by adjusting other balance sheet items which would normally be affected by a sale of the bond. The adjustment of these other balance sheet items, which don't affect the income statement, are referred to as shadow adjustments.

The first of the shadow items is an obvious one. That is, if we sell a bond for a capital gain, we would reflect the tax effect in our reported earnings. Therefore, taxes would also be required to be considered as an offset to the unrealized gain on the same bond for purposes of *FAS 115*.

The second shadow item is perhaps not so obvious. In certain circumstances the sale of a bond for a large capital gain would trigger an event which would require a strengthening of reserves being backed by the asset. The circumstance is called loss recognition and the test for the need for reserve strengthening on a block of liabilities involves looking at the future earnings of that block. If the sale of bonds results in large enough earnings in the year of sale that there would be negative earnings in the future, a loss recognition event has occurred and there is a need to strengthen reserves.

Since reserves would be affected by the sale of a bond in this circumstance, they would also be changed on the balance sheet when the unrealized gain is recognized. This balance-sheet-only strengthening is called shadow loss recognition.

To illustrate shadow loss recognition, let's return to our earlier example of an investment in a 6%, ten-year bond. At the beginning of the third year, the bond has a large unrealized capital gain because of interest rates dipping to 4%. If the bond was sold for its value of \$11,350, and if \$10,000 were reinvested at 4% interest and earmarked against the \$10,000 reserve, then we would see insufficient interest to support the benefit payments of \$500 each year. This would give rise to negative operational earnings in the future and a loss recognition event would occur.

By how much would the reserve have to be strengthened? The reserve would have to be increased to the amount which would give rise to no earnings in the future when the reserve is backed by assets having a like value. The effect is to revalue the benefit stream at the current interest rate of 4%, rather than at the initial 5% rate. So if the bond were sold, and a reinvestment in 4% bonds of \$10,670 were ear-

marked to back the liabilities, then there would be exactly enough to pay future benefits and have zero earnings in each future year.

In this example, our GAAP equity would have been \$1,550 in year three without shadow loss recognition. The impact of this shadow item was to reduce the impact of the unrealized gain on GAAP equity. While this item reduces the volatility of GAAP equity, it unfortunately applies only when there is an unrealized gain and cannot apply when assets are in the position of having market values less than the book values.

The third shadow item reflects the recognition of policyholder liability on those participating products where the policyholder is contractually entitled to participation in capital gains and losses on sale of certain attached assets. Because the policyholder liability would be adjusted upon realization of the capital gain or loss, so must the shadow liability be increased on the balance sheet as an offset to the unrealized gain or loss under *FAS 115*.

The fourth, and last, shadow item is one that reflects the fact that on certain insurance products, the sale of a bond for a realized gain or loss will affect the amount of write-off of acquisition costs in the year of sale. Since the DAC expense on these products offsets in earnings the realized gain or loss, so it must be considered to offset the unrealized gain or loss due to *FAS 115*.

The concept of shadow DAC applies to all insurance companies for products that are considered to be covered by *FAS 97* as limited payment products. Such products include universal life (UL) and most annuity products. Products that are covered by *FAS 97* amortize DAC in proportion to gross profits. Since the gross profit is affected by the realization of a capital gain or loss, the DAC amortization is also affected.

Certain products, such as term insurance and certain accident and health insurance products, are generally covered by the *FAS 60* accounting standard. The concept of shadow DAC does not apply to products covered by *FAS 60*. This is because, for these products, DAC is amortized in proportion to premium, not gross profits. Since the realization of a capital gain does not change the pattern of premium, the DAC expense is not changed. Similarly, there is no DAC offset to an unrealized capital gain or loss under *FAS 115*.

What about the DAC associated with the traditional product of whole life insurance? Whole life insurance is generally handled differently for stock life insurance companies than it is for mutual life insurance companies. For stock companies, whole life insurance is generally treated as a *FAS 60* product where acquisition

costs are amortized over the life of a product in proportion to that product's premium. Similar to other *FAS 60* products, there is no provision for a shadow DAC offset to *FAS 115* unrealized gains and losses.

On the other hand, the treatment of the participating whole life insurance products of mutual companies is handled under the Statement of Position 95-1, which amortizes acquisition costs over the life of the product in proportion to that product's gross margins. Since realized capital gains and losses affect a product's gross margins, these products are treated much like *FAS 97* products for shadow DAC purposes.

To discuss the mechanics of the shadow DAC calculation, I will refer back to Steve Strommen's earlier example of DAC amortization for a ten-year product. You'll note that the amortization percentage was originally expected at issue to be 65.5% of the margins in each year.

You'll also recall that this example represented the effect of an event that caused margins to be shifted from year five to years six through ten, without changing the present value of margins. One event that would create this scenario would be the realization of a \$100 capital loss in year five due to the sale of an asset whose value is sensitive to interest rates.

You'll remember also in his example that the effect on earnings in year five of this \$100 reduction in margin is \$35. That is, there is an earnings offset of 65.5% of the \$100 realized loss due to a reduction of \$65.5 in the DAC expense. You'll note that this 65.5% offset is exactly equal to the original DAC amortization percentage calculated before the capital loss was realized.

For *FAS 115* applying to mutual company traditional whole life insurance products, the exact same offset would be recognized on the balance sheet as an offset to a \$100 unrealized loss in year five.

To summarize then, mutual companies have an additional degree of temporizing offset for the volatility of GAAP surplus expected under the application of *FAS 115*. That is, for traditional whole life insurance products, mutual companies have available a shadow DAC item which serves to offset both unrealized gains and unrealized losses.

Unlike mutual companies, stock life insurance companies do not have this offset available, since whole life insurance for stock companies is covered by *FAS 60*, where the DAC amortization does not vary with capital gains and losses.

Furthermore, for the assets backing the traditional whole life insurance products of mutual companies, the shadow DAC offset is about equal to the income statement DAC amortization percentage. That is, the DAC amortization percentage calculated without regard to the unrealized gain or loss is a good approximation for the percentage of shadow DAC offset available to *FAS 115* unrealized gains and losses.

Since acquisition costs usually represent a large portion of the margins of traditional whole life products, the shadow DAC available to mutuals is an important stabilizing factor in the volatility of GAAP equity created by market value accounting for available-for-sale assets under *FAS 115*.

Mr. Charles A. Sinex: It's my pleasure to spend some time with you sharing experiences that I've come across in my role as project leader at Indianapolis Life Insurance Company.

Indianapolis Life is a medium-sized mutual company. We have a very capable FSA who handles the technical aspects of GAAP for mutuals. We have a very capable CPA who handles the accounting and technical aspects. My job is to run around the company and pat people on the back and tell them what a good job they're doing and to keep the work flow going; that's the perspective I'm coming from. One thing I spend much time thinking about is how we get these results to the people who need to see them. How do we communicate the results? Who's the audience? And then related to that, I will talk about variance analysis and give a couple examples of how we've tried to simplify all this regulation and complication into something that's understandable for someone who doesn't have a financial background. In some cases, the audience does not know the statutory statement, which is the beginning point at our company. So, you've got to figure out ways to communicate so that your audience understands.

As I mentioned, I'm from Indianapolis Life Insurance Company, a mutual company that was founded in 1905. We've been managed since 1905 by statutory results. It's done well for us. We've tried a few other explorations into different reporting systems. We did do a gain-by-source for UL, so we had that background. We spent quite a bit of time with not much success on doing some gain-by-source attempts for participating business two or three years ago, and, as you'll see at the end of the speech, maybe we've come a long way towards accomplishing that goal with what we've learned doing GAAP.

We began our conversion in December 1993, with two days of training. We had 15 people on our team and wanted to do a couple days of training to get everyone started on the same foot, but what was important about this training was that the

president of the company invited the officers to come to the overview session. One of the communication successes that we have experienced is the visibility.

I was lucky in that the steering committee consisted of me, a controller who had a great deal of experience with the company (he's since retired), and a chief actuary who understands the ins and outs of getting tasks done. For a financial reporting project, if you want to get your funding and if you want to get people to pay attention to what you're doing, you do need some high visibility. So the controller was able to take our concerns to the president of the company during his meetings. The chief actuary was able to take them to officer meetings. And the visibility helped us quite a bit, and it turned out in the end, when we're talking about communicating results, we didn't have to tell people what GAAP was. They had a sense of what GAAP was.

Also on the GAAP team, but not on the steering committee, was our head of internal audit. This turned out to be a great benefit because, as we went on, one of the tasks he had periodically was to bring presentations to the audit committee. GAAP as a financial project was a natural one to bring, and so he was up-to-date with what we were doing, and he could time very well his recommendation to me of when we could take our results to the audit committee to make the most use of it. We were still preliminary. We didn't have audited results, but the timing was right.

You have to work with people's personalities. You have to work with their background and where they're coming from. Our chief actuary wants to be involved with the details. So from early on I would meet with the FSA, who's our technical actuary, weekly for an hour or two, to talk about how we were thinking about things, how we were treating things, and I would get his buy-in and his suggestions early. I think that one of the keys to a successful project for us was the ability to be able to review results early and often with the chief actuary. Once we had two year-ends that we could compare side-by-side, we started meeting with the chief financial officer (CFO) and took to him this conversion perspective, statutory converted to GAAP.

One of the communication difficulties that you either have experienced or will experience is when do you share your results? On the one hand there are people like me who want to get things out on the table early, get all the input I can and make all my revisions and refinements upfront and save myself a great deal of work at the back-end. Then there are other personality types who like to hold on to what they're doing until they're very comfortable with it and then take those results and show what they have. Obviously, you need a middle-of-the-road approach. It's a two-year project for us. We were required, just by the nature of the length of time, to share things early. As I had described, we had those sessions with the chief

actuary, and we were able to get things out in a very nonthreatening environment, get things discussed, share results early. The advantage of doing it early is you get the input and the feedback. The advantage of doing it late is that you have a finished product. The difficulty in a company our size is that the same group of people are preparing the presentations as are getting work completed. If I schedule a meeting to present to a group, say, the audit committee, or if we have a session with the chief financial officer, the people who should be getting the next round of financials done are busy putting together exhibits to explain what we're doing. On the plus side, there's a good, honest give-and-take of creative differences at that point.

Who are these audiences? Well, you may have some of your own, but I've just tabulated some. Early audience. By early I mean people I want to get input from, people who you definitely want to take results to before you've reached the audit stage, the CFO, chief actuary, and controller. I've already discussed their points of view. We did work with Ernst & Young. It was in an advisory role for us. Obviously, when you're getting advice from someone you need to share what you're doing with them. You have your external and internal auditors, and it was a great help to have the chief internal auditor on the team. One of our early formal presentations was made to the audit committee of the board. We brought in our external auditors for that presentation, and it went over quite well. Take some time and learn the background of the people who are on the committees you're presenting to. Three outside board members plus the president of the company were there for the presentation. Two of those were CPAs, and they had stayed up-to-date with what was going on with GAAP. One was even an MBA. So, it helped me structure the discussion to their level and what they were prepared to listen to. You want to keep it simple.

Sometimes these people approach you in the hallway, sometimes at the lunch table, but eventually you will talk to all these audiences. The president and the CEO is a member of the audit committee so he received an early taste of it. He has since asked for periodic updates from the chief financial officer. And I was happy to see that of the victories at our company in 1996, GAAP was listed as third. I don't know if it was done on a priority basis, but it made me feel good.

The board of directors eventually needed to be brought into the loop, and company employees too often do what I call "lunch table communication," but there are some concerns, especially two years ago when we started doing GAAP. There were several rumors about demutualizing; you have to address those issues.

Rating agencies will come into play. We're trying to raise money for a downstream holding company that we have formed with stock companies underneath. We anticipated investors will be more interested in our GAAP statements than our statutory

statements. A big issue is whether you share with policyholders. It's already hard enough to explain statutory. So, do you put GAAP beside it and try to explain that, too, or do you just let it go until it becomes an issue? We'll wait until after audit for that one. And the general agents and agents are interested in what we're doing. We have quite a few agents who are in the survivor whole life market where CPAs and attorneys get involved, and they'd much rather see our GAAP statements than our statutory statements. You probably have some audiences you've thought of.

You want to keep your audience in mind and keep things simple. Try to take a complicated concept and break it down to its most simple part so that your audience can understand. Let's talk about *FAS 60*, *FAS 97* and *FAS 120*. To me, if you can explain DAC and what DAC is and how it gets amortized and what this DAC asset is all about, you have achieved a good victory when you're talking to an informed audience. When we list DAC amortized as a percentage of premium, or expected gross profits or expected gross margins, it gives a chance to detail what that's all about, and then we put our specific company products beside the FASB treatment because that gives the committee members something to hang their hat on. They understand how Indianapolis Life products relate to these FASB directives.

We look at GAAP for mutuals as a conversion from statutory to GAAP. We discussed whether we want a GAAP accounting system that, three years from now when management's asking for GAAP two weeks ahead of statutory, we'll be able to produce it, but we've stayed with the conversion perspective. We're looking from statutory to GAAP. We discuss tax issues with the tax accountant. We do not have management-based financial, although I think as an outgrowth of GAAP we'll probably do that, and I'll explain a little bit about that soon. We don't do value added, but you may want to be comparing your results to any of those bases. When we meet with the chief actuary or the chief financial officer, we're literally walking through conversion entries a line at a time. When we're meeting with the audit committee, we're giving them the financials, and we're highlighting two or three lines that are really important, and we're pointing those out and analyzing those from a conversion perspective. You want to keep it focused on what exact story you want to tell and who your audience is.

One key difference that we really focus on is the capital gains treatment since our first GAAP year was 1993. We saw huge capital gains in that year. Some mutuals are choosing to set their capital gains up as a liability accruing to the benefit of the policyholders. We chose at this point in time to recognize those all at once. That's quite a contrast to the IMR on statutory.

DAC is, what I call, the essence of GAAP. If you can come up with a simple example, it seems like most everyone you talk to can relate to heaped commissions and spreading

the heap part out over the lifetime of the policy. It's a pretty simple way to explain it and which people seem to understand.

In considering reserves, we've come up with some differences in them because we're using net level reserves for our participating business, and depending on the duration, they may increase at a different rate. For the actuarial audience, there are many things to look at in reserve and DAC treatment.

As for the issue of premiums, it goes away with *FAS 97*. For UL and annuity products you just look at the fee-based income. That's a big shock to someone who's only used to looking at a statutory statement.

With regard to taxes, there are these deferred tax assets and deferred tax liabilities that are based on the timing of expenses and the timing of premium and DAC. You come up with a number that represents your current tax and come up with a number that represents your deferred tax. Then I turn it over to the tax accountant and ask him to explain it.

Finally, I must mention GAAP equity. Our GAAP equity is a little over two times our statutory equity, made up mostly from the combination of the DAC asset and the deferred taxes, but that number sure jumps out at a person who's looking at the statements side-by-side.

Then there are some minor differences such as home office real estate. It's a fixed asset under GAAP. For nonadmitted assets, you admit everything, and then go through one-by-one and pick out things for which you need to set up evaluation allowance. Our pension numbers are different. We spend a great deal of time talking about it and end up doing what the consultants advise us to do.

When we get in with an audience, we find we spend a lot of time trying to explain away the oddities from period to period. There's much fluctuation based on either the way the statements are written or the way the numbers happen to fall in a period. For example, let's compare 1994 GAAP income to 1993. We had an income before taxes of \$4 million and \$40 million, respectively, which is a difference of \$36 million. Obviously, the first question is, what happened? To answer this question, we need to take out the way we handled capital gains by adding back in the amortization of DAC due to those capital gains; then we need to account for the unlocking number of \$9 million which was related to tightening the margins in the future on our projections for DAC amortization. After making these simple adjustments, we come down to \$13 million and \$17 million of income, a difference of \$4 million. It would be better if 1994 income were \$21 million, but it is a little bit easier to accept a difference of \$4 million rather than \$36 million when you're looking at the income statement. Then, of

course, what I didn't show is beneath that \$13 and \$17 million, we put it on an after-tax basis. We went from a \$4 million difference to an \$11 million difference after we factored in the effect of taxes.

Because the company's perspective and the assignment, as it was given to me, was to do GAAP for compliance, we want a clean audit opinion. We are interested in complying with the regulations and getting a clean audit opinion. I, and maybe the chief actuary, did a great deal of lobbying to see what we could get out of these for management reports. We didn't want to shut any doors. Two years from now we would be asking for insight into what GAAP's telling us. Let's build the systems to gather that information, even if we don't want to deal with it today. That's what we did. We put all of our systems on a cost-centered basis and product-level basis and collected data or created the ability to collect data in a pretty fine comb. Right now we have six or seven lines of business that we look at, but if we needed to, we could go down to product levels.

Early on, the GAAP line of business was requested in order to compare it to the statutory line of business, and it was hard to fit that work in the timeframe. We did just specific pieces. We did the reserve change and the DAC amortization on a line-of-business basis early on, and then eventually we got our GAAP line of business done, which is very insightful. It's a good thing to do. It showed us where we'd made some errors. It helped people who were responsible for particular lines of business. Their interest perked up when they saw just their line sitting out in a GAAP format. That was a very healthy thing to do.

It is important to consider future uses. We're already starting our gain by source because we've done so much data collection and have really gotten into our historical data and projected future data. We're at the point where the chief financial officer wants to parlay that into gain-by-source numbers. Value added has just been mentioned. We're not really planning to do that right now. It's typical to tie this into your pricing, and at Indianapolis Life, we're probably two or three years away from making our profit measures based on GAAP instead of statutory numbers.

Have fun with your GAAP. Hopefully, you picked up some new ideas, or perhaps I shed a different light on some ideas you already had.

Mr. Daniel J. Kunesh: You talked about participation liabilities without really defining what product lines they relate to. Certainly they cannot relate to variable annuities because variable annuities already are not affected by *FAS 115*. What type of liabilities are you talking about?

Mr. Parsons: The accounting literature states that the contract holder must be contractually entitled to participation in the realized gains or losses. At Metropolitan, we have immediate participation guarantee (IPG) products, products in the annuity business which we view as being those type of products where the contract holder is contractually entitled.

Mr. Kunesh: Where in the literature do you support that?

Mr. Parsons: Actually, in a footnote or in the background material it refers to the amortization of capital gains and losses being verboten. At the end of that particular piece of literature there's some background information referring to certain products where the policyholder is contractually entitled to the realized gain or loss. You can adjust your liabilities where they're contractually entitled to the realized gains or losses.

Mr. Kunesh: Believe me, I agree with the concept, and it's the Emerging Issues Task Force's interpretation of what the SEC said, but in a recent personal experience (I can't mention the name of the company or the accounting firm), they made it very clear that they would probably not accept your position with respect to stock companies.

One final question. You talked about *FAS 115* loss recognition events, and I know of at least one major accounting firm that would say that you cannot have a loss recognition event with a *FAS 115* situation simply because it's a shadow effect. I'm curious as to where in the literature you are getting the idea that you can get a loss recognition event from *FAS 115*?

Mr. Parsons: Generally the idea is that if you can offset realized gains and losses, you can also offset the unrealized gains and losses. It's kind of a notional idea.

Mr. Kiffel: To help clarify the issue, you'd only be required to make a shadow loss recognition adjustment when there was an unrealized gain to such an extent that the liability would be insufficient on the unrealized basis. You wouldn't make an adjustment to reduce your liability, of course, in the reverse situation where you had unrealized losses. So, for example, if your liability was at 7%, and if, because of movements in interest rates, you now had an unrealized position at 6%, you'd set up a so-called shadow loss recognition liability.

Mr. Allan W. Ryan: Dan, I believe that a letter from the SEC does say something about shadow loss recognition. Also, you could in a "shadow" sense have a shadow DAC adjustment for a *FAS 60* product, in case of a large enough gain, because that would really be the first step in loss recognition to write off the DAC.

From the Floor: There's one other thing I wanted to mention. You talked about in your other adjustments deferred taxes, specifically the tax adjustment in shadow. I'm no expert on this, but I think it's *FAS 109* that governs many of the timing differences between GAAP income and tax income, which is essentially statutory income with certain adjustments. Wouldn't that tax adjustment probably be the last adjustment you'd make because it would reflect everything including all timing differences? Again, they're just temporary in the sense that they're only being reflected in equity and can all be reversed. All of the stuff can go away the next time period anyway.

Mr. Kiffel: Right, the major deferred tax asset/liability adjustments you will have will be because of the unrealized gain and loss and because of the DAC. Those will be the biggest causes for that deferred tax asset or liability. And, by its nature it will be a partial offset to the volatility caused in the equity, as Dave mentioned. So, there is somewhat of a silver lining there.

From the Floor: There seems to be some controversy, and not everything is crystal clear even among consulting firms, I guess.

Mr. Kiffel: Many of the items that are ambiguous get resolved through emerging practice, not that the practice is ever 100%, but to a large extent you get a sense of what companies are doing. One controversial issue that came up in several GAAP conversions that we were involved in was treatment of capital gains and whether or not there could be a situation where those might be deferrable.

Charles had alluded to his company where it thought of that but did not do it. That really is a controversial issue, since the literature seemed to forbid such IMR-like treatment, though there are situations where one could see a rationale for supporting such an approach. Such a rationale would be based on a documented process, and an approach that was sound and historical within the company, but, beyond that, most companies, of course, will recognize their gains and losses as they occur and not do anything that is IMR-like, but I wouldn't be surprised if there were a minority of companies that did do it.

Likewise, there's still some varying interpretations regarding the definition of DACs and exactly how to treat those with respect to the gross profits. There still will be some discussion about that. I think even within some of the accounting firms, different professionals will give you different answers, but to a large extent most issues have been resolved through practice. There is, in most cases, a majority of companies that have gone a certain way. Shadow loss recognition can be looked at as an example of one of those cases where it can be used as an offset to smooth out some of the volatility in the equity, so that it's not all that bad to set up such an item if it seems to be necessary or if the actuaries think that it makes sense.

From the Floor: Unfortunately, shadow loss recognition only offsets realized gains only. It doesn't offset realized losses. If there were more tools to offset realized losses, I think they would be more palatable.

Mr. Kiffel: And it is one of the reasons why in many of the situations we've been involved with, we have suggested setting up reserves on *FAS 60*-type business such as immediate annuities or disability income business. We've suggested it particularly for those lines that have had problems setting up those reserves at time of conversion at a low enough interest rate and/or provisions for adverse deviation in other assumptions like mortality. This is in order to avoid those types of questions and problems; in fact, if anything, we would err on the side of possibly embedding some profit inside those reserves, and we like to call those reserves conservatively moderate.