BY TOM HERGET

Writing the Book on GAAP

BECAUSE THE LURE OF THE U.S. CAPITAL MARKETS IS STRONG, many actuaries around the world find themselves having to prepare Generally Accepted Accounting Principles (GAAP) financial statements for the first time. In addition, actuaries who work for companies that demutualize fully or partially are preparing their inaugural GAAP statements.

While GAAP for insurers was introduced only 30 years ago, its sources of authority have proliferated. There are standards, concepts, interpretations, bulletins, consensuses, and opinions. Which is more important? Where do you find them? Which ones are out of date? How are these interpreted in light of evolving products and environments? Are there illustrations of these principles that help in understanding the objectives?

In the past, the actuary had to ask others for the answers. Now there is a single source. A new textbook, *U.S. GAAP for Life Insurers*, addresses the principles underlying GAAP, the accounting model used by publicly-traded companies and many mutual life insurers as well.

The Society of Actuaries' Financial Reporting Section initiated this book in the spring of 1999. A project oversight group consisting of Tom Herget, Mike McLaughlin, and Shirley Shao organized a writing team and sponsored the effort. The authors, selected for their knowledge, experience, and ability to communicate, are Frank Buck, Tom Kochis, Dan Kunesh, Mike McLaughlin, Ed Robbins, Dave Rogers, Eric Schuering, Brad Smith, and Jay Zellner.

U.S. GAAP for Life Insurers is aimed at three target audiences:

- Near or recent fellows who need to understand GAAP
- Seasoned accountants who want to know what the actuary is doing
- Non-U.S. actuaries or accountants who need education in U.S. GAAP accounting

The book took a year to write. It went through a rigorous peer review process that involved numerous technical experts, veteran practitioners, and professional editors. The goals of the review were to eliminate ambiguities, avoid omissions, and ensure that the text and supporting examples were educational. This layer of review provided very valuable input to the book.

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Following is a summary of the contents of each chapter.

1 **Objectives of U.S. GAAP.** Accounting perspectives and terminology; numerical representation of the financial health or performance of an enterprise; the essential components of the balance sheet and the income statement; the concept of regular income and comprehensive income; relation of income to change in surplus; measurement, disclosures, and materiality.

2 **Authorities.** Standard setter identification; authoritative GAAP literature hierarchy; perspectives on accounting by analogy; role of the auditor; measurement of materiality.

3 **Expenses and Capitalization.** Basic instruction in the Audit Guide, SFAS 60, and other subsequent standards; identification and categorization of deferrable acquisition costs, nondeferrable acquisition costs, maintenance costs, investment expenses, future utility expenses, and overhead expenses; illustration of methods to convert such expenses into per-unit values; formulas and numerical examples for developing factors and worksheets.

4 **Traditional Life Insurance (SFAS 60 & SFAS 97).** Provision for adverse deviation; considerations for selecting assumptions; the lock-in concept, recoverability, and loss recognition; formulas and examples of factor development and earnings emergence; establishment of an undistributed participating policyholder's earnings account; methods for indeterminate premium policies; calculation of a deferred profit liability for limited-pay contracts; formulas for converting terminal reserve factors to values applied on a statement date.

5 **Traditional Life Insurance (SFAS 120).** Participating traditional life insurance where dividends are determined by the contribution principle; dynamics of how dividends are determined and awarded; identification of such contracts; the SFAS 120 accounting model, the nature of the estimated gross margins, and the selection of assumptions; retrospective and prospective unlocking; the impact of realized capital gains; recoverability and loss recogni-

tion; formulas for and examples of deferred acquisition costs and terminal dividend liability calculations.

6 **Universal Life Insurance.** Product classification and typical product designs; comparison of SFAS 97 income statement presentation to that of traditional products; estimated gross profits and the selection of assumptions; techniques underlying retrospective and prospective unlocking; amortization issues, capital gains impacts, recoverability, and loss recognition; establishment of deferred acquisition costs; examples of unearned front end load and special benefit reserve liabilities.

7 **Deferred Annuities.** Classification of annuities by their accounting model; differences between accounting models SFAS 91 and SFAS 97; the nature of estimated gross profits and considerations in selecting assumptions for its components; retrospective and prospective unlocking; recoverability and loss recognition; accounting treatment for specialized products, such as market value annuities, two-tiered annuities, and bonus annuities.

8 **Variable and Equity-Based Products.** Variable universal life, variable deferred annuities, variable income-pay annuities, and equity-indexed annuities; the impact of guaranteed and nonguaranteed aspects on this accounting model; the impact of embedded derivatives and market volatility on the GAAP financial statements; options, numerical examples, and formulas for selecting assumptions for a future earned rate.

9 **Annuities in Payment Status.** Contract classifications between limited-pay and investment contracts; selection of assumptions and provisions for adverse deviation where appropriate; formulas for and examples of reserve calculations.

10 **Individual Health Insurance.** Types of coverage (medical, disability, long-term care, and many more), the nature of policy management (company guarantees and premium rate increases), and product classification; calculation of benefit reserves, deferred profit liabilities, and expense reserves; selection of assumptions and provision for adverse deviation; recoverability and loss recognition; the impact of SFAS 5 on claim reserve establishment; numeric examples and formulas.

11 **Credit Insurance.** Short-duration life and accident and health contracts under SFAS 60; recoverability, loss recognition, and claim reserves; formulas for benefit reserve establishment; examples of earnings emergence.

12 **Group Coverages.** Group life, group health, and guaranteed investment contracts; accounting model selection; benefit reserve methodologies; establishment of deferred acquisition costs; recoverability and loss recognition.

13 Invested Assets. Callable bonds, noncallable bonds, collateralized mortgage obligations, other asset-backed securities, real estate, mortgage loans, derivatives, policy loans, partnerships, common stocks, preferred stocks, and stocks of subsidiaries and affiliates. At publication, SFAS 133 was being amended and is not effective until 2001. Consequently, it has been excluded from the scope of this textbook. This chapter has numerical examples of the calculations of book values.

14 Shadow Adjustments (SFAS 115). The reporting and impact of unrealized holding gains and losses; the impacts on benefit reserves, deferred acquisitions costs, loss recognition, and claims; formulas and sample calculations.

15 Purchase Accounting. The difference between pooling and purchase; the evolution of authority for purchase GAAP, including Academy, AICPA, SEC, and FASB involvement; the elements of the opening balance sheet; considerations for selecting assumption; calculation of benefit reserves and value of business acquired.

16 Foreign and Hybrid Products. Determination of SFAS applicability to foreign products; product features foreign to the U.S. market and examples of how such characteristics can be input into the accounting model; selection and application of an accounting model to products not addressed by the SFASs.

17 Reinsurance. The purposes and uses of reinsurance; the major types of reinsurance treaties; summary of GAAP authority for reinsurance under SFAS 113; accounting requirements for reserves and deferred acquisition costs. The spreadsheets presented come from the preceding chapters and have reinsurance superimposed, allowing the reader to easily observe and reproduce the effects of reinsurance.

18 Other Topics. Deferred taxes; riders; fair value SFAS 107 requirements and techniques; GAAP accounting for closed blocks of business in a demutualization; surplus notes; determination of materiality.

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