

Market Volatility, Investment Reporting, and Audit Considerations for Impairment, FAS 157, and FAS 159

Presentation to The Friendly Society Restored

February 6, 2008

Presented by:

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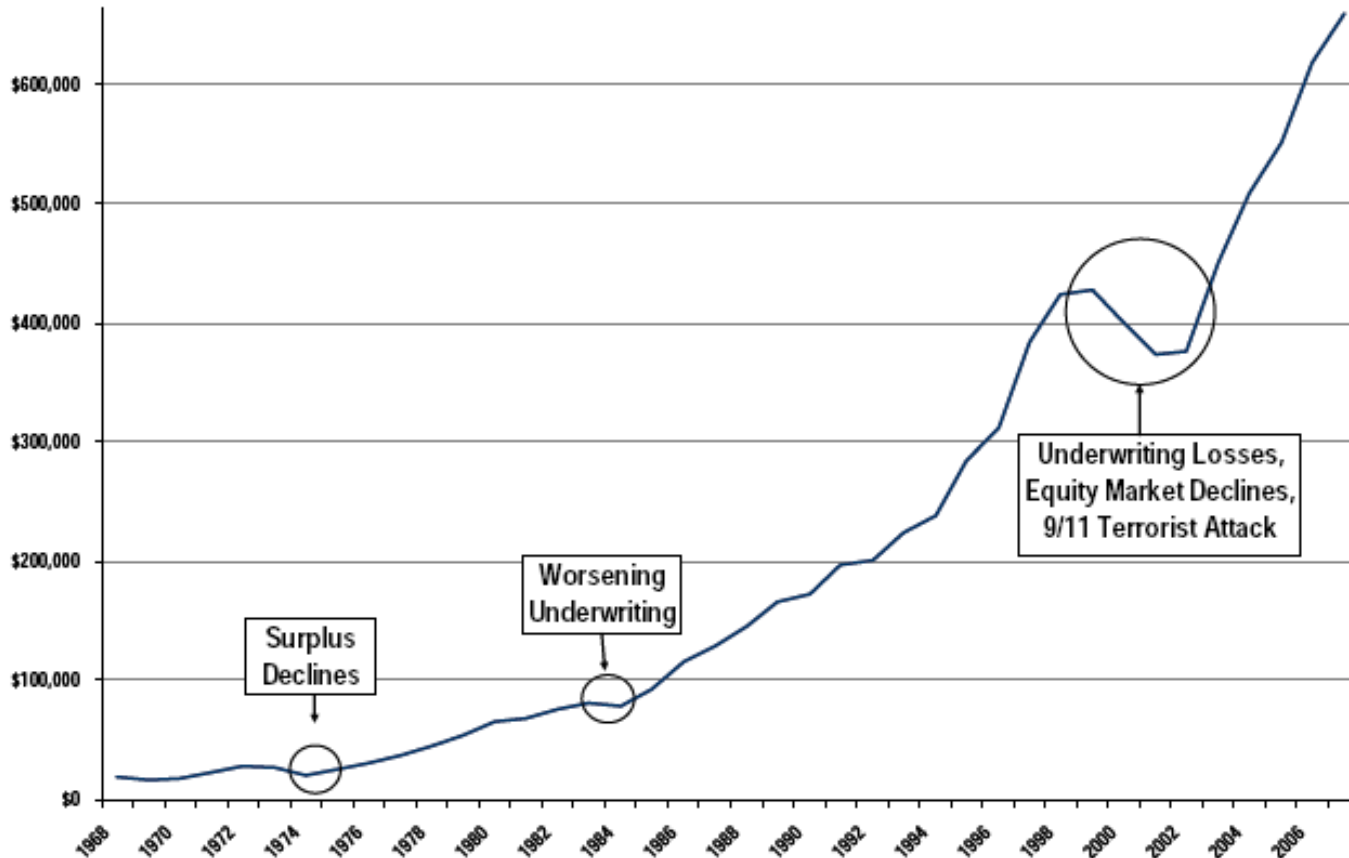
Elizabeth Forney

2008 Markets

**A Year We Would Like To Forget,
But Our Accountants Won't Let Us**

Insurance Company Surplus – Yearly thru 2007

Chart 1: Property/Casualty Insurance Industry Surplus 1968-2007



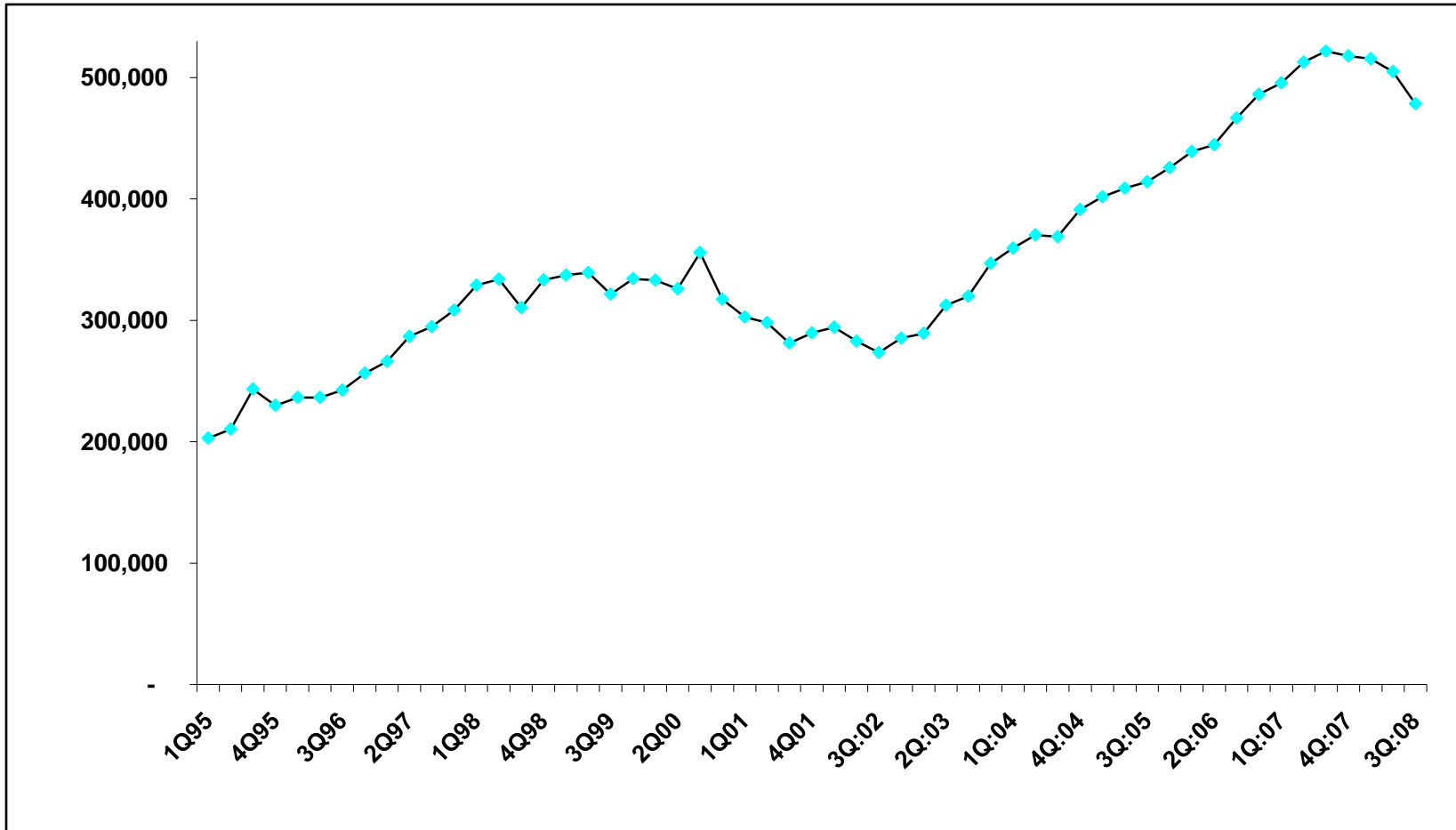
Source: AM Best



The market information contained herein has been obtained from sources that we believe to be reliable, but we do not offer any guarantees as to its accuracy or completeness. Past performance is no guarantee of future results. All information is subject to change without notice.

Good News – Signs of Insurance Market Hardening

Insurance Company Surplus – 1995 to 3rd Qtr 2008



A survey of January 1st reinsurance renewals, done by Merrill Lynch Insurance analyst Jay Cohen, indicates that premiums were higher.



Source: ISO

US Real GDP

1968 – 12/31/08, Quarterly



Unemployment Rate

1968 – 12/31/08, Monthly



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Inflation CPI

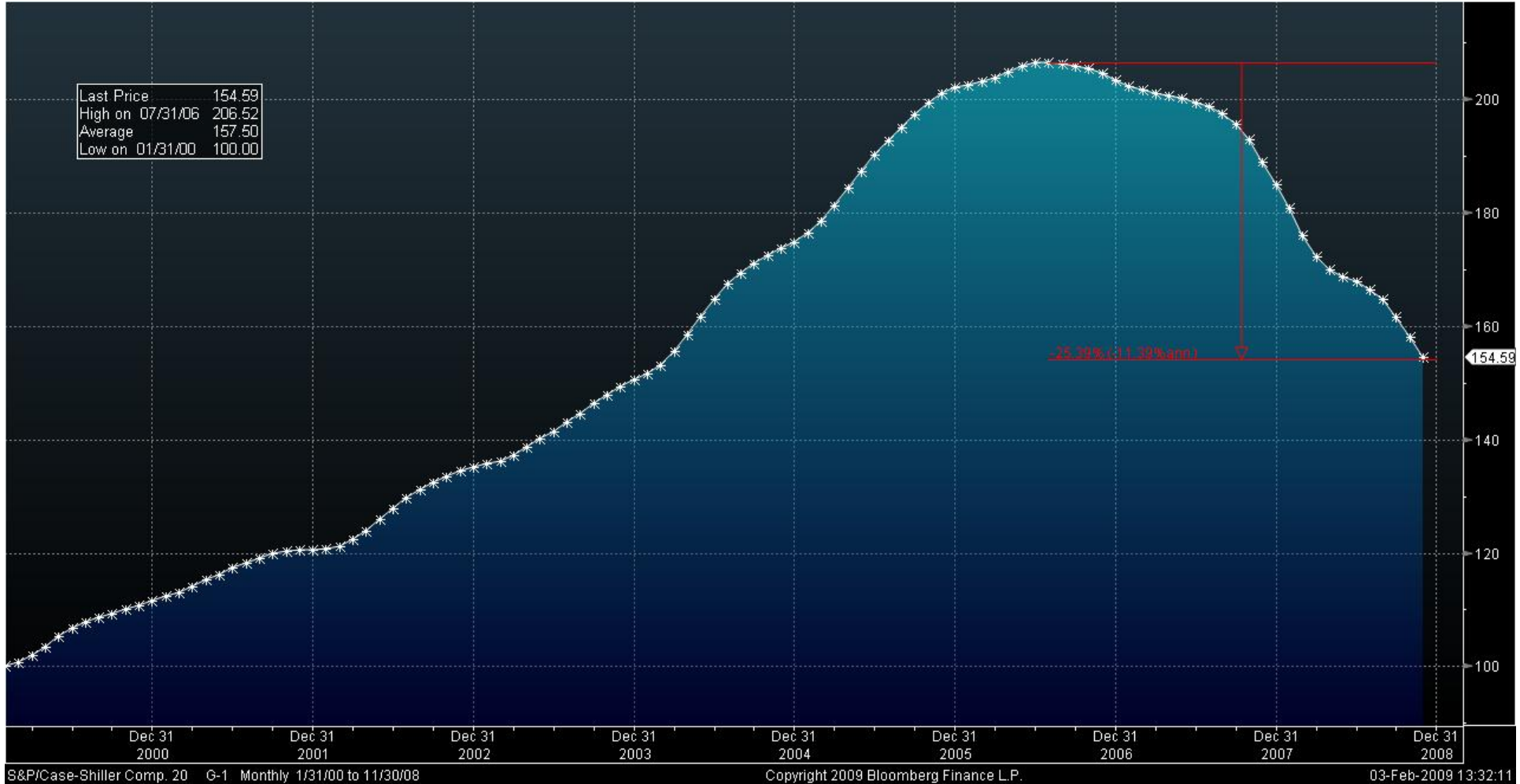
1968 – 12/31/08, Monthly



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S&P/Case-Schiller USA Home Price Index

1/31/00 – 11/30/08, Monthly



S&P/Case-Schiller Comp. 20 G-1 Monthly 1/31/00 to 11/30/08

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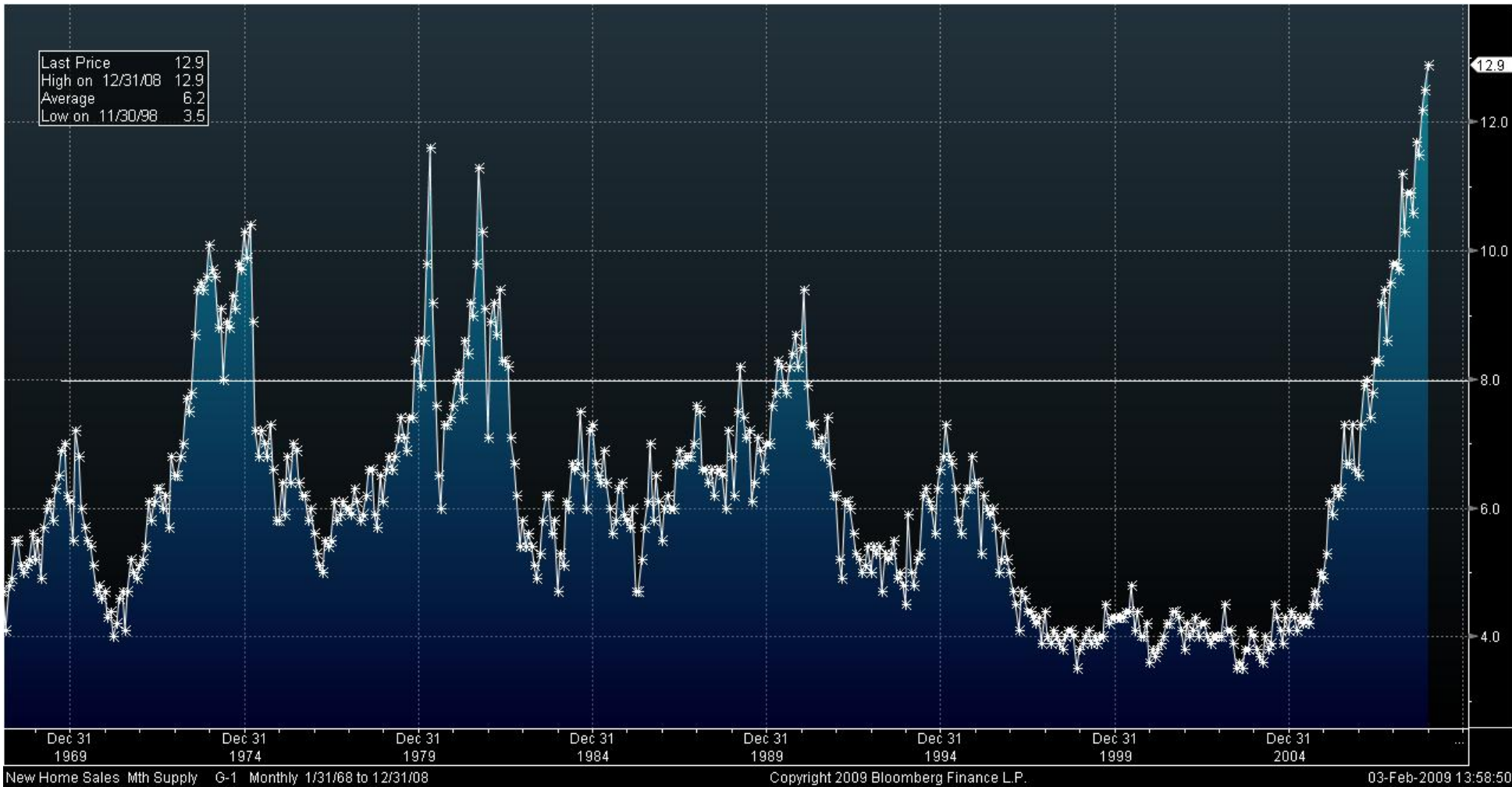
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Month's Supply of Unsold New Homes

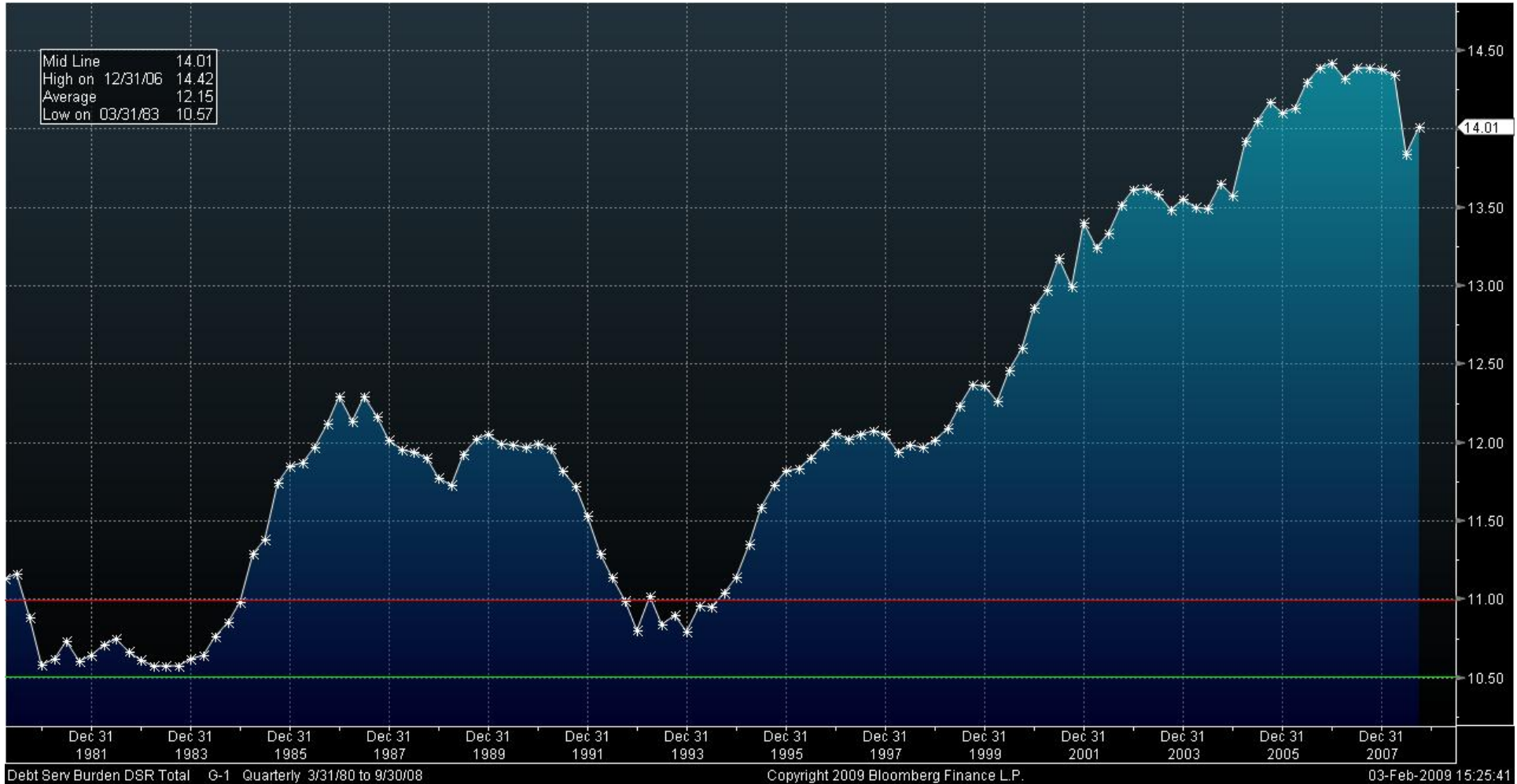
1968 – 12/31/08, Monthly



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Household Debt Service Ratio

1980 – 9/30/08, Quarterly



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Personal Savings Rate

1968 – 12/31/08, Monthly



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Initial Jobless Claims

1968 – 1/23/09 Weekly (4 week moving average)



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Fed Funds Target Rate

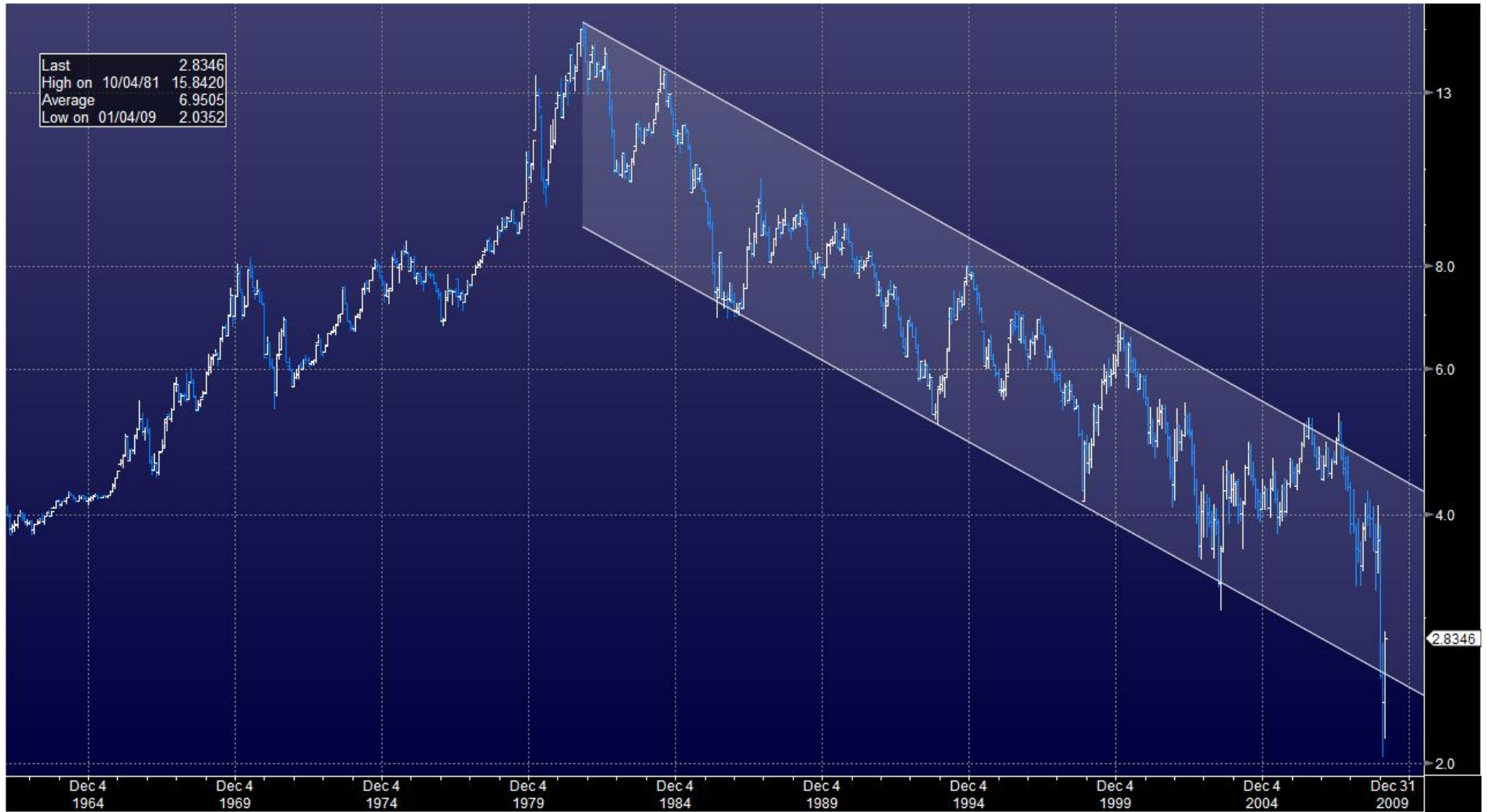
1970 – Current, Monthly



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Yield on the 10 Year US Treasury Bond

1964 – 12/08/08, Monthly



US Generic Govt 10 Yr G2 Monthly 2/4/62 to 2/4/09

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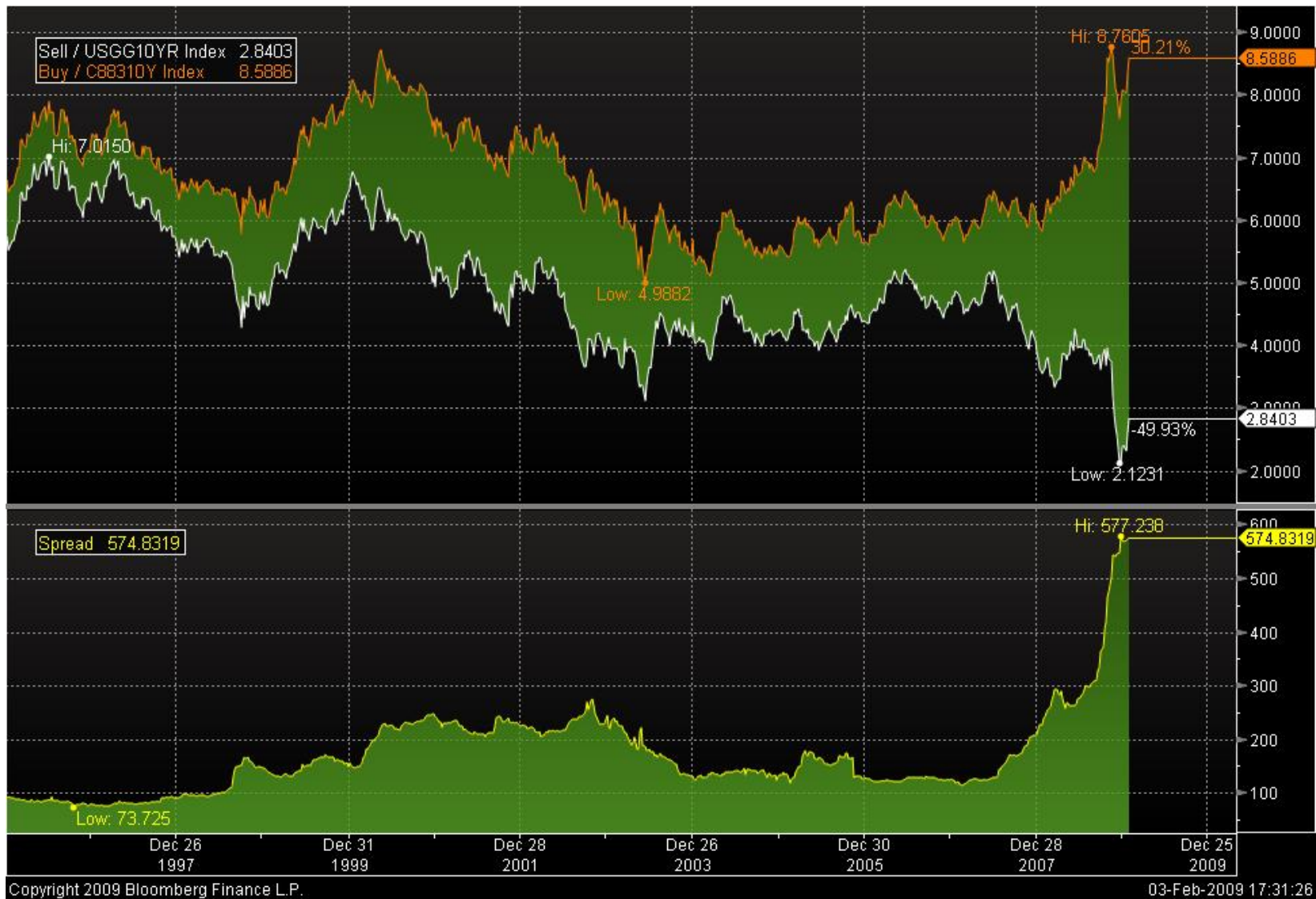
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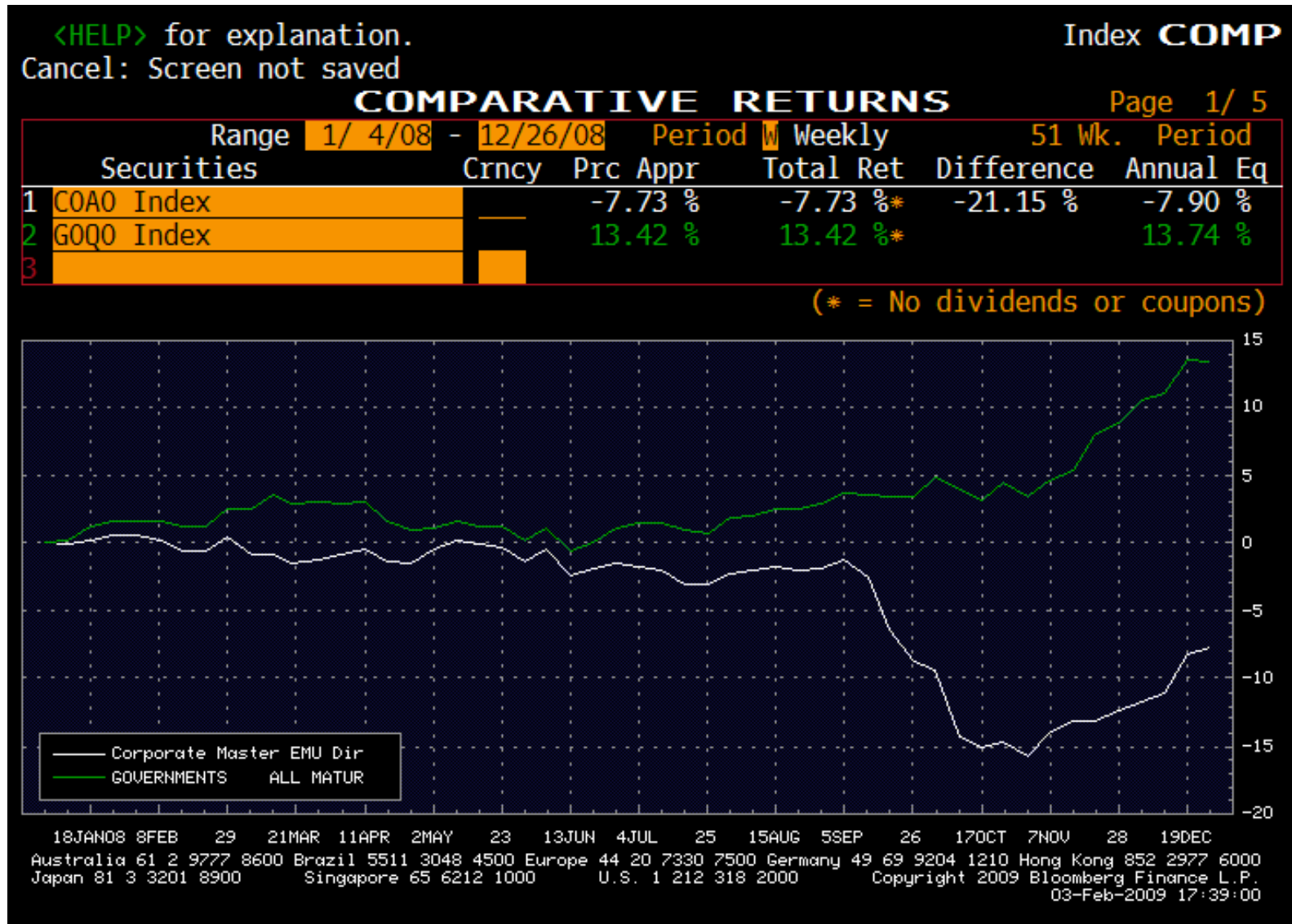
10 yr US Tsy Yield vs. 10 BBB Corp Bonds

1996 – 1/30/09 Weekly



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Corporate vs. Treasuries Total Returns 2008

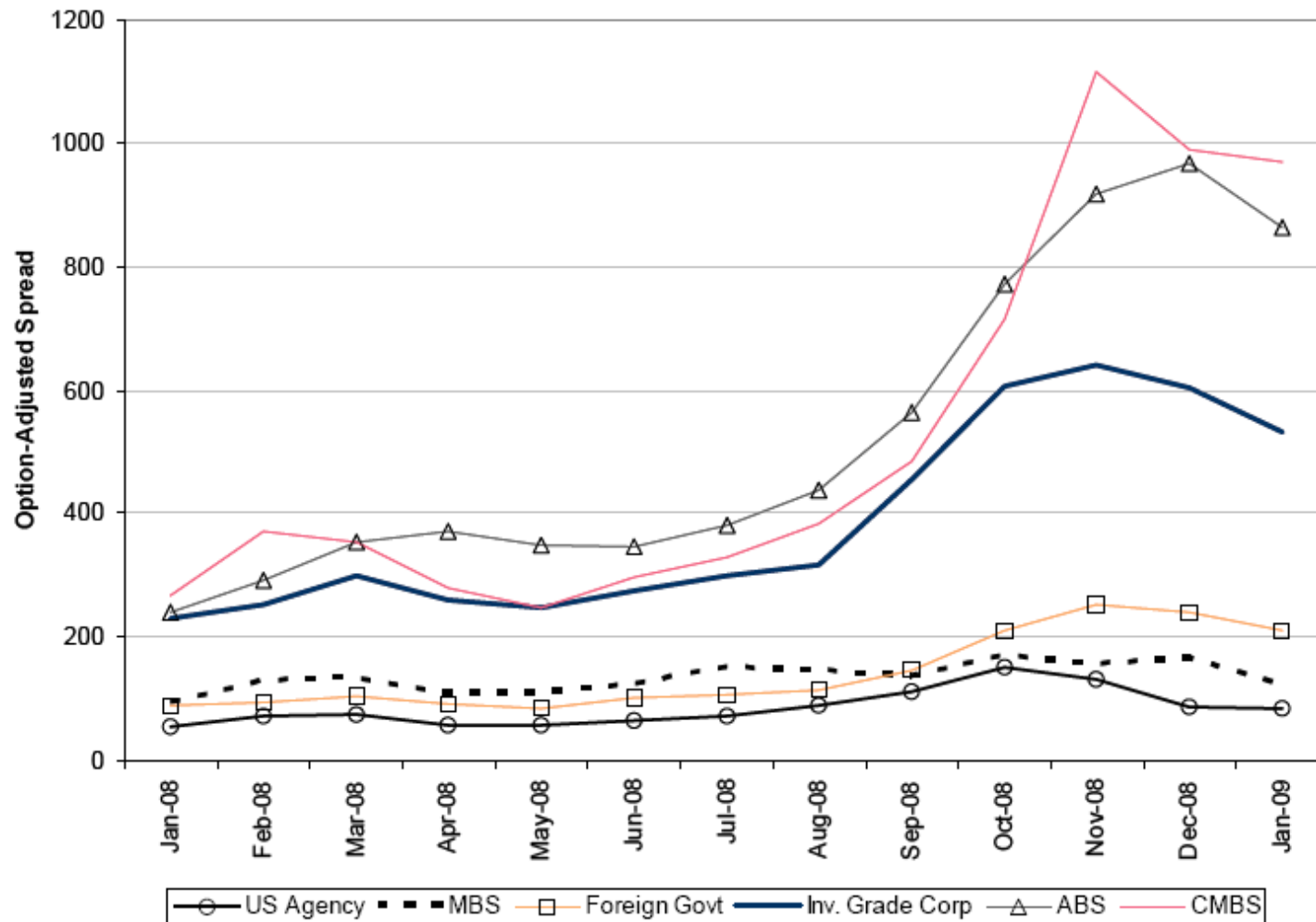


Bond Market Sector Performance – 2008

	Total Return		
	1-month	3-month	12-month
US Broad Market	3.343	4.047	4.529
Treasury Master	3.544	8.954	13.978
US Agency Composite	3.623	6.76	9.601
Corporate Master	5.554	1.554	6.818
Financials	5.174	4.579	-10.397
Insurance	3.363	-5.931	-17.479
Mortgage Master	1.656	4.238	8.304
CMBS	7.497	-13.878	-20.157
US Treasury Inflation Linked	5.713	-2.523	-1.132
High Yield Master II	7.474	-17.628	-26.389
Municipal Securities	1.362	-.073	-3.953

12 Month Yield History by Spread to US Treasuries

Chart 2: Option-Adjusted Spreads by Sector



Source: Merrill Lynch Global Bond Indices

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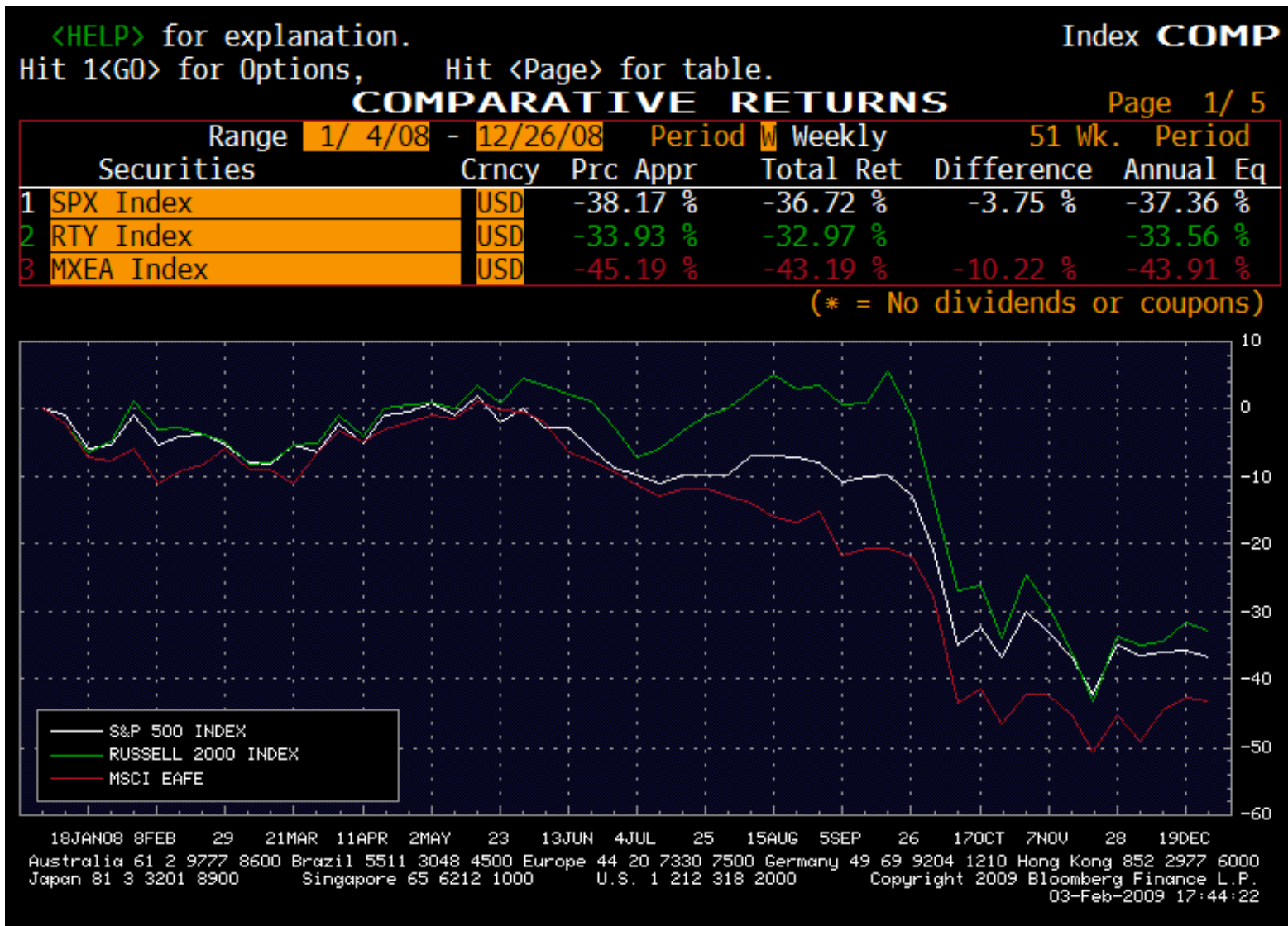
S&P 500 Long Term Price

1928 – Current, Monthly



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2008 Equity Returns



Intent and Ability to Hold to Recovery?

S&P 500 Weekly 3/28/00 – 12/31/08 Change %



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Audit Considerations

To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. federal tax advice contained in this communication is not intended or written to be used and cannot be used, for the purpose of (a) avoiding penalties under the Internal Revenue Code or (b) promoting, marketing or recommending to another party any transaction or tax-related matter[s].

Other than Temporary Impairment

- What is an impaired security? What is OTTI?
- The purpose of OTTI recognition is to improve financial reporting – for financial statements to best reflect economic reality
- 3 Issues to consider
 - Is the impairment likely to reverse in the foreseeable future?
 - Does the Company have the ability to hold the investment until recovery?
 - Does the Company have the intent to hold the investment until recovery?

Are Impaired Securities Other Than Temporarily Impaired?

- Traditional impairment policies have emphasized a certain % decline for a specified time period
- Standard rule of thumb: Decline > 20% continuously for longer than 6-9 months
- This was a general rule; not in standards – analogous to the 10/10 rule for risk transfer
- Does not allow for any security specific data to be considered

Are Impaired Securities Other Than Temporarily Impaired?

- Rigid analysis will lead to overly broad impairment
- Look at performance relative to the market
- Considering market conditions, most securities will meet old impairment criteria
- We don't want to impair GE, PG, JNJ – This **will not** lead to better financial reporting!!!

Are Impaired Securities Other Than Temporarily Impaired?

- Best OTTI guidance: SEC Staff Accounting Bulletin Topic 5M
- Consider a new work-flow including auditors
- OTTI analysis should start with a comparison between cost and MV as a percentage.
- Individual creditworthiness/future earnings prospects should then be considered on a security by security basis
- Equities will have to be analyzed separately from bonds because of inherent differences between securities
- Impairment policies that have been adopted may need to be updated – not following a formal policy can be viewed as evidence of internal control issues

Are Impaired Securities Other Than Temporarily Impaired?

- Judgment will be required – however some rules need to be drawn for ease & consistency
 - Securities with fair value less than 50% of cost basis indicates impairment with virtually no exceptions unless adequate support is provided.
 - Securities with a one month drop in fair value greater than 20% are likely impairment candidates
 - Securities with fair value greater than 85% of cost basis will not be impaired unless intent/ability to hold does not exist
 - The “grey area” of 15-50% down will require more analysis

Should I Recognize OTTI: Equities

- Factors to consider:
 - How depressed is market value in comparison to cost?
 - How has the security performed relative to its index?
 - How long has the security been in an impaired state?
 - Have dividends been reduced?
 - Have any of the company's debt obligations been downgraded? Has the outlook changed?
 - Has anything fundamentally changed in the company's longer term profitability?
 - What is the company's operating history? Is this a tried and true blue chip or a newcomer?

Should I Recognize OTTI: Bonds

- All of the equity impairment factors should be considered in addition to:
 - What type of security is this (ie corporate, MBS, etc)?
 - How quickly have the investments lost value?
 - Any interruption in interest payments?
 - Have any of the company's debt obligations been downgraded? Has the outlook changed? Are securities of investment grade?
 - How reliable is pricing information (FAS 157 Level)?
 - How long until maturity? (The notion of duration may be helpful)

Does the Company Have the Ability To Hold an Investment Until Recovery?

- Does an external portfolio manager control the portfolio? Can they sell securities at a loss without approval from management?
- What type of coverage is written? Is it possible that unexpected claims could necessitate rapid selling of impaired investments?
- How well capitalized is the company? How much liquidity exists compared to operating/financing needs of the company?
- Are there any liquidity concerns at the parent level that would force liquidation at the captive?

Does the Company Have the Intent To Hold an Investment Until Recovery?

- May require representations from management
- Auditors will look to subsequent activity to demonstrate/validate intent to hold
- Management cannot take the position that the Company intends to hold a security until recovery if it is sold at a loss subsequent to year end
- Impairment back to MV at year end will be necessary

Does the Company Have the Ability To Hold an Investment Until Recovery?

- How well capitalized is the company? How much liquidity exists compared to operating/financing needs of the company?
 - Consider calculating a cash burn rate

For example:

- Company has expected cash flows from operations of 100,000 excluding claims for 2009
- Actuary projects that claims payments of 850,000 will occur in 2009
- Captive is required to redeem two shares at 40,000 each in 2009
- Cash needs for next year = $-100,000 + 850,000 + 80,000 = 830,000$
- Company has 600,000 of cash on hand as of beginning of 2009
- Therefore, will have to sell investments worth 230,000 during 2009
- ~\$230K of cash need should be compared to unimpaired portion of investment portfolio
- If the company will need to sell impaired investments to raise the cash, it cannot claim it has the ability to hold them until recovery

FAS 157 & 159

- FAS 157-Fair Value Measurements (effective for financial statements issued for fiscal years beginning after November 15, 2007) adoption is **required**
- FAS 159-The Fair Value Option for Financial Assets and Financial Liabilities (effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007) adoption is **optional**

- Establishes a framework for measuring fair value
- Fair Value Hierarchy (disclosures)
 - **Level 1**- inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities
 - **Level 2**- inputs other than quoted prices that are observable for the asset or liability, either directly or indirectly
 - **Level 3**- inputs are unobservable for the asset or liability

General Hierarchy Guidelines

- The level is determined based by the lowest input that is significant to the measurement in its entirety
- Level 1- Mutual funds, commonly traded stocks, US Treasuries, actively traded bonds, index funds, any security with a daily net asset value (NAV)
- Level 2 and 3- Most bonds, preferred stock, stocks of closely held companies, auction rate securities (see next slide), mortgage backed securities, collateralized debt obligations, mortgage and mortgage related securities, subprime loans, loans held for investment

Auction Rate Securities

- If securities are liquid (no failed auctions), likely will fit into Level 2
- If securities are illiquid (single or multiple failed auctions), these will go into Level 3
- If auctions have failed, management will need to identify the securities and value them with the aid of the investment custodian (if they can't be sold, and/or the Company cannot hold them until a market returns, impairment is likely)

Classification of Fixed-maturities – Q1 2008 Filings:

Company	Total \$	Level 1	Level 2	Level 3
ACE	\$ 35,579	3%	96%	2%
Aetna	\$ 15,159	7%	89%	4%
AFLAC	\$ 33,290	26%	74%	0%
Aig	\$ 404,862	0%	96%	4%
Allstate	\$ 85,782	1%	75%	24%
Assurant	\$ 9,692	0%	98%	2%
AXA	\$ 34,878	1%	91%	8%
Cigna	\$ 12,033	0%	94%	6%
Genworth	\$ 53,031	0%	91%	9%
Hartford	\$ 44,211	1%	71%	27%
Lincoln Financial	\$ 55,624	0%	92%	8%
MBIA	\$ 28,406	3%	77%	20%
MetLife	\$ 244,088	3%	88%	10%
Prudential	\$ 179,116	0%	98%	2%
Travelers	\$ 64,492	3%	97%	0%
Total	\$ 1,300,243	2%	91%	7%

Classification of Equity Securities – Q1 2008 Filings:

Company	Total \$	Level 1	Level 2	Level 3
ACE	\$ 1,660	99%	0%	1%
Aetna	\$ 38	12%	0%	88%
AFLAC	\$ 23	83%	0%	17%
AIG	\$ 40,244	88%	11%	1%
Allstate	\$ 4,121	89%	11%	0%
Assurant	\$ 729	1%	98%	2%
AXA	\$ 1,359	100%	0%	0%
Cigna	\$ 144	3%	85%	12%
Genworth	\$ 394	9%	84%	7%
Hartford	\$ 668	25%	0%	75%
Lincoln Financial	\$ 3,188	2%	93%	4%
MetLife	\$ 6,341	36%	27%	37%
Prudential	\$ 10,962	53%	40%	7%
Travelers	\$ 479	98%	2%	0%
Total	\$ 70,350	72%	22%	6%

Key Considerations for Upcoming Year

- Understand that a significant amount of judgment is required to classify securities
- Discuss investment policy and compliance at BOD meetings
- Contact investment managers and custodians to get a head start on classifying securities
- Inquire with Brokers and Custodians about pricing and the existence of SAS 70's
- Consider your controls and procedures as they relate to the classification and valuation of securities
- You don't need to be a valuation expert but you do need to understand basic controls over pricing and be ready to ask the right questions

FAS 159

- Permits entities to **choose** at specific dates to **measure** many financial instruments and certain other items at **fair value**
- Discussion of pros and cons of adopting
- Decision should be made at the Board level

FAS 159

- Summary if adopted at 1/1/08:
 - For the available-for-sale portfolio, on the balance sheet, you would reclassify unrealized gain/loss out of accumulated other comprehensive income and put it in retained earnings
 - For the held-to-maturity portfolio you would get an increase in beginning retained earnings for difference between amortized cost and market value
 - All subsequent changes to market value would flow directly to the income statement (and to retained earnings)
 - Adoption of FAS 159 virtually eliminates issues relating to impairment of securities, and therefore eliminates a degree of management judgment in the financial statements

OTTI vs FAS 159

- Completing an OTTI analysis is very time consuming, for both audit team and management
- Adopting FAS 159 removes the need to do an OTTI analysis
- In a down market, there is very little difference in earnings between FAS 115 and FAS 159 accounting
- It is not too late to adopt FAS 159!

Investment Reporting

Security Detail Report

Description	CUSIP	Purchase Date	Quantity	Cost Basis	Market Value	Unrealized G/L	G/L%	Product Class
COCA COLA FEMSA SP ADR	191241108	9/6/2006	175	5250	7614.25	2364.25	45.03%	Stocks & Related
COCA COLA FEMSA SP ADR	191241108	7/25/2006	850	26775	36983.5	10208.5	38.13%	Stocks & Related
JOHNSON AND JOHNSON COM	478160104	2/8/2008	145	9012.52	8675.35	-337.17	-3.74%	Stocks & Related
JOHNSON AND JOHNSON COM	478160104	7/2/2007	82	5060.23	4906.06	-154.17	-3.05%	Stocks & Related
MICROSOFT CORP	594918104	2/8/2008	325	9310.02	6318	-2992.02	-32.14%	Stocks & Related
MICROSOFT CORP	594918104	6/22/2007	55	1641.2	1069.2	-572	-34.85%	Stocks & Related
VOTRNTM CEL PN SPSD ADR	92906P106	9/22/2008	110	2314.94	872.3	-1442.64	-62.32%	Stocks & Related
VOTRNTM CEL PN SPSD ADR	92906P106	9/19/2008	430	8835.68	3409.9	-5425.78	-61.41%	Stocks & Related
CBS CORPORATION	124857400	9/22/2008	135	2432.63	1771.2	-661.43	-27.19%	Preferred Stock
CBS CORPORATION	124857400	2/4/2008	1245	29163.35	16334.4	-12828.95	-43.99%	Preferred Stock
CITIGROUP CAP TRUST IX	173066200	2/4/2008	191	4173.65	2777.14	-1396.51	-33.46%	Preferred Stock
CITIGROUP CAP TRUST XV	17310G202	2/4/2008	543	12518.64	7520.55	-4998.09	-39.93%	Preferred Stock

Description	CUSIP	Purchase Date	Quantity	Cost Basis	Market Value	Unrealized G/L	G/L%	Product Class
PUERTO RICO COMWLTH PUB	74514LNB9	10/4/2007	400000	429453.69	384,624.00	(44,829.69)	-10.44%	Municipal Bonds - GO Insured
TENNESSEE ENRGY ACQ CRP	880443DX1	12/15/2006	350000	376080.5	272,107.50	(103,973.00)	-27.65%	Municipal Bonds - Revenue
GENERAL ELEC CAP CORP	36962GXS8	6/6/2007	400000	403979.78	411244	7264.22	1.80%	Corporate Bonds
TOYOTA MOTOR CREDIT CORF	892332AQ0	9/6/2006	200000	200940.85	203076	2135.15	1.06%	Corporate Bonds
FEDERAL NATL MTG ASSOC	31398AKX9	2/26/2008	1000000	1005690.42	1025630	19939.58	1.98%	Government Bonds
U.S. TREASURY NOTE	912828FE5	1/22/2007	1500000	1500076.36	1525725	25648.64	1.71%	Government Bonds

Tennessee Bond Description

880443DX1 Muni DES dg? mubig1 Muni **DES**
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MUNICIPAL BOND DESCRIPTION Page 1/ 4

TENNESSEE ENERGY ACQUISITION CORP GAS REV CUSIP:880443DX(1) **24K**
 SER C

TICKER: TNSUTL CPN: 5 MATURITY: 2/01/2019 DATED:12/20/2006 STATE:TN Page 2

18) BONDS ARE SUBJECT TO "MAKE-WHOLE" CALL AT A PRICE EQUAL TO THE GREATER OF (I)

SECURITY INFORMATION		TRADING INFORMATION	
9) TDH MSRB Trades		1ST SETTLE DATE	12/20/2006
ISSUE TYPE REVENUE BONDS		NEXT SETTLEMENT DATE	2/05/2009
MATURITY TYPE 1) CALL		INTEREST ACCRUAL DATE	12/20/2006
31) ERP MANDATORY EXTRAORDINARY REDEM		1ST COUPON DATE	8/01/2007
COUPON TYPE FIXED		WEEK OF SALE	12/11/2006
PRICE/YIELD @ ISSUE 108.620/ 4.090		FORMAL AWARD	12/14/2006 17:00
COUPON FREQ. SEMI-ANNUAL		FIRST TRADE	12/15/2006 09:00
TAX PROVISION FED & ST TAX-EXEMPT		NOTES: Personal Office Firm	
FORM BOOK-ENTRY		24) NOT 25) ONTS 26) FNTS	
RATINGS WATCH OUTLK		11) CF View Documents	
MOODY'S	Baa1		
S&P	AA-		NEG
FITCH	AA-		
12) RCHG Rating changes			

Hit page for additional des, call sch, series os notes information.

Australia 61 2 9777 8600 Brazil 5511 3048 4500 Europe 44 20 7330 7500 Germany 49 69 9204 1210 Hong Kong 852 2977 6000
 Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000 Copyright 2009 Bloomberg Finance L.P.
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Tennessee Bond Ratings Changes

<HELP> for explanation. Muni **RCHG**
 1<GO> For Global Scale Rating details
MUNICIPAL RATING CHANGES PAGE 1 OF 2

TENNESSEE ENERGY ACQUISITION CORP GAS REV CUSIP: 880443DX1
SER C
 Coupon 5.000 Mty 2/ 1/19 Issued 12/20/06 @ 108.620(4.090) State:TN

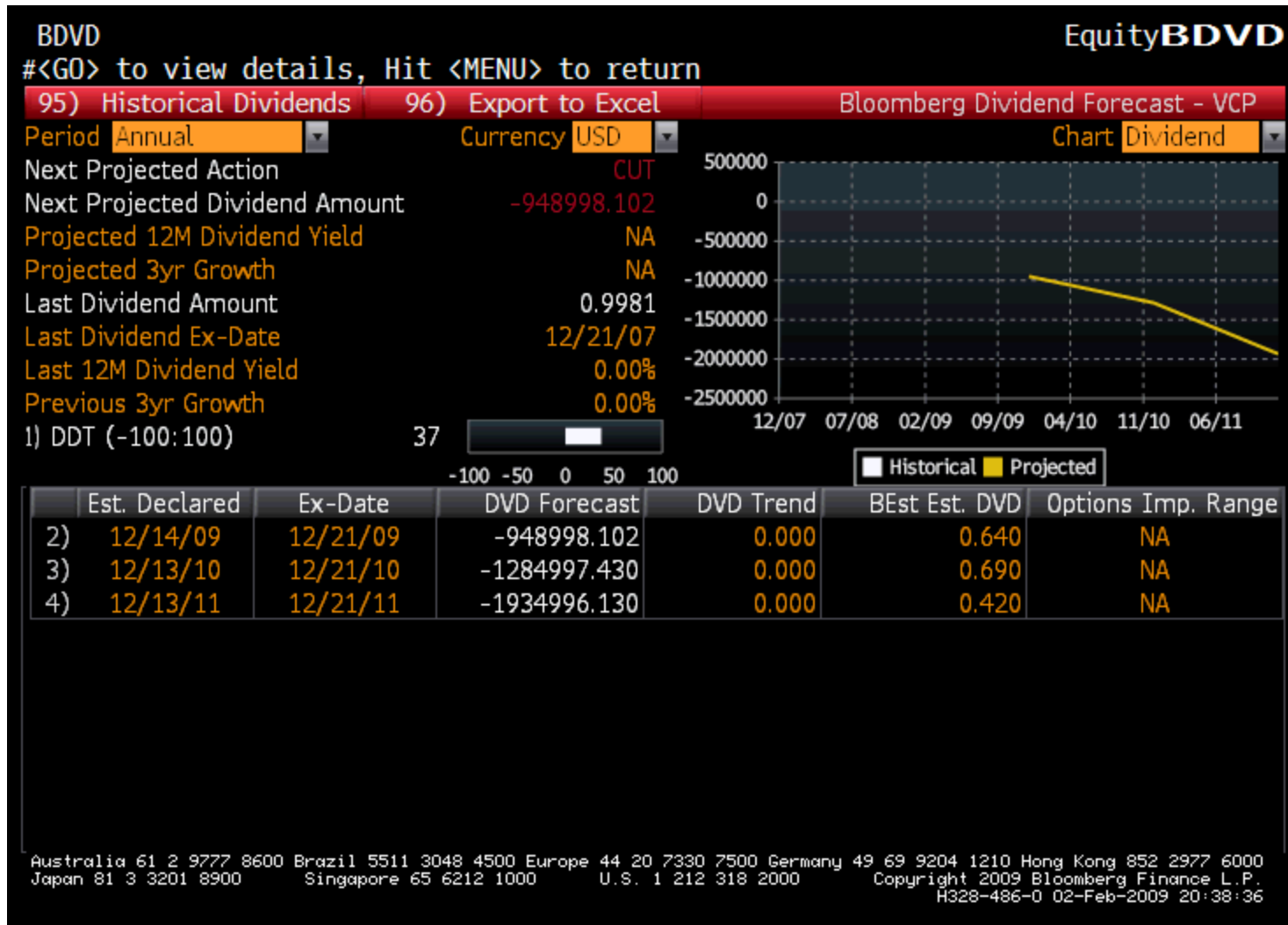
Agency	Current Rating	Watch List	Out Look	Effective Date	Prior Rating	Watch List	Out Look	Effective Date
MOODY'S	Baa1			11/13/08	A2			7/10/08
S & P	AA-		NEG	3/25/08	AA-		STA	12/14/06
FITCH	AA-			12/14/06				

Bloomberg records changes to bond ratings as soon as we become aware of them.

Australia 61 2 9777 8600 Brazil 5511 3048 4500 Europe 44 20 7330 7500 Germany 49 69 9204 1210 Hong Kong 852 2977 6000
 Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000 Copyright 2009 Bloomberg Finance L.P.
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VCP Projected Dividends



Questions?