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MERGERS, ACQUISITIONS, AND VALUATION OF STOCKHOLDER EQUITY

I. *Valuation of Stockholder Equity*
  A. What methods are used to determine the value of a company, whether for cash purchase or for an exchange of securities? Is there a difference between valuation for cash purchase and valuation for an exchange of securities?
  B. To what extent are tax-loss carryovers taken into consideration in such valuations?
  C. What other tax considerations are involved in a merger?

II. *Advantages of a Merger or an Acquisition*
  A. What are the benefits to the acquiring company? To the company being acquired?
  B. To what extent does a merger or an acquisition stimulate growth, new ideas, or greater productivity or cause a reduction in expense? In what ways?
  C. What other considerations and problems, including public relations, are associated with mergers and/or acquisitions?
    1. Corporate goals and objectives.
    2. Accounting.
    3. Operational problems:
      a) Marketing.
      b) Products.
      c) Administration.
      d) Esoteric.
      e) Other.

New York Regional Meeting

MR. JOSEPH H. DOWLING: I am a partner of a Wall Street firm, Dean Witter & Company, which is the fifth largest brokerage firm in the country and the seventh largest banking firm. Our business in the merger, acquisition, and developmental area obviously encompasses more than life insurance, and often our emphasis must be more on business as a whole than on life insurance alone.

From that point of view, then, when one considers value acquisitions, it is most important to recognize the business reason for the acquisition or merger. Otherwise, how can one know what he is buying? Most of the firms with which we work are trying to make an acquisition which will increase the value of the company as a going concern. Among the measurements of the going concern, the one most frequently used is that of earnings per share or the stream of earnings per share. Again, this gets away from the book value or termination value concept. The important element to keep in mind is that it is a stream of earnings per share, not just an immediate increase in earnings which might later result in a diminution in the earnings growth. As a result of this, I think that you get a point of view which boils down very quickly into the effect of a series of alternatives, of which big life insurance companies are one.

As such, ours is not a budgetary measurement, nor are we going to increase earnings per share; but, given all the alternatives open to us, does the purpose here make much sense? I am going to skip for a few minutes to what I mean by earnings, but I would like to suggest to you that there are some other considerations which immediately come into our thinking: one is the people problem and the other is the accounting problem.

Obviously, when we talk about buying a company, we are buying, as far as the shareholder is concerned, two things—people and accounting. The people situation is peculiar, because there is so much belief that one is buying management. I believe that it is fairly rare for anyone to buy management. I do think that it is important, if we are talking about buying a company, to learn whether the personalities are so dissimilar that the company doing the buying is buying nothing of a permanent nature. You may or may not be able to place a value on a particular individual's ability, but you can be fairly certain that, if his personality, his concept, or his business sense is based on different standards from those of the company doing the buying, the acquiring company will not have his services for any length of time.

I would like to state that I have seen a large number of studies made on management ability. I believe this is done by the AMA to a considerable extent. We find it very difficult to measure management ability. On Wall Street it seems that, if earnings are going up, the general consensus is that the company has good management. If earnings are going down, the consensus is that it has poor management. You can see that is a fallacious approach.

But accounting is all-important. It should, I believe, be kept in mind. Essentially there are two methods from the accounting point of view which are of the most interest to you; one is the purchase concept, and the other is the bulk concept. Under the purchase concept you buy a company; you may have to pay a premium for the company that must be paid off from the earnings. On the bulk basis the presumption is that the two companies have coexisted for a period of time, and therefore earnings are put together in the same stream. The reason for my mentioning this is that from this point on we are most concerned with the effect from each of these two approaches on earnings of the acquiring company.

We talk about valuation of stockholder equity, but you must keep in mind that we are going into a procedure where, in essence, the buyer is setting the price on an acquisition. It is the buyer's condition rather than the seller's condition that has the final say on the price of the acquisition.

There are two types of circumstances in valuing a company that are most important to us—when it is bought by a noninsurance owner and when it is bought by a company which is primarily, or at least considered to be, a life insurance operation. To a considerable extent the ultimate price of a company is decided not by a budget but by the personality of the leaders of the buying company, who make a decision on whether they want to buy in that particular industry, and by the degree of urgency or the kind of companies that they want and their availability. All this governs the price much more than all the calculations that our firm or any other firm makes.

It sounds ridiculous to say that there is no business reason for buying a company. That is not true. I am saying, in fact, those reasons are very often developed after the primary decision has been made that this is or is not a good business to go into, or, with conglomerates, whether something is available. The second question is, How much must I pay to buy it, and what business is it in?

In the case of business mergers I would like to stress something that was not seen by too many people last year. There are two reasons for buying a company: one is to run it, and the other is to dissolve it. I would be very careful not to forget, if I were you, that second situation. Reliance Insurance, the Great American Companies, and some others have found that they have been going through payment of rather large dividends which, in effect, is a partial liquidation.

Have any life companies been looked at for purchase and dissolution? The answer is yes. We know several that have been looked at, but there has been no further action taken. Right now these are primarily the very heavily asseted companies in the industrial life insurance business, in which some of the conglomerate leaders have concluded that they can take a company, run off the business, and make a considerable profit on the procedure. Obviously, during the current hearings and probably for some time to come, the deal would not be politically practical, but it must be kept in mind.

Let us turn to more pleasant topics, such as when a conglomerate is going to run an insurance company. When it does, it has a number of considerations. Are there any synergistic effects? (Excuse, if you will, the expression.) Are there any circumstances whereby the existence of two companies combined is worth more than the existence of two separately?

Certainly, for some of the clients we work with this is very truly the situation. Household Finance Corporation has 1,100 offices around the country and $40 million of annual premium. Obviously, under the right circumstances, a life insurance acquisition would make sense to them. An insurance company that has a very large tax loss to them would make some sense.

These are the types of situations that we see, and it is obvious that in this time of valuation you are not going to dissolve the company you are buying at all. You are valuing a forward stream of earnings which is almost unrelated to the existence of the plant you buy.

Obviously, then, after a consideration of a number of circumstances under which you can justify the running of the life insurance company as a life insurance company, it would make sense not to overlook the recent very tight money situation. A number of years ago the idea of buying a life insurance company for utilization of its assets without dissolution would have been ridiculous. Yet, look at the number of companies that are trying to move into a number of entirely unrelated industries—the oil industry, the chemical industry, and a number of other fields, where they have financial plans right now which involve the availability of money and where investment bankers such as us are not able to guarantee them availability of money in the future without some equity loss at the same time. To these companies, then, the opportunity to purchase a life insurance company and thereby to control its cash flow and the utilization of that cash flow under the laws of the state—I am not talking about anything illegal—is very much a matter worth considering.

For those of you who are interested in business in general, I suggest that the return on capital calculation is extremely important to the conglomerate way of thinking and that as the return on capital in life insurance companies diminishes, the capital and surplus increases. One of the things that you must do is to get capital out. I do not know whether some of you see conglomerates moving here to the Commissioners Reserve Valuation Method and, in fact, moving the company out of the life company into other operations (fortunately for them, as a matter of fact, one that will have good effect on their ultimate currency without diluting their life insurance base). We have, therefore, a concept here that is quite important.

I have avoided earlier the concept of the earnings. Most of you know that this is a perennial topic on Wall Street. How much does a life insurance company earn? There are some people who have been exposed to this question for twenty years and have made a good living from writing on it. This past year, financial analysts devised an approach that I do not think will hold for long. It is important to keep in mind that the conglomerate's reported large earnings are statutory earnings.

A life insurance company buying another life insurance company should probably look at two sets of earnings, one being statutory and the other a realistic, adjusted base. There is a recent article in *The Actuary* by Bob Espie, which, together with Bert Winter's *Modern Applications of Gross Premium Valuation to Participating Insurance*, is the essence of how my firm values adjusted earnings. To me it seems critical that actuaries take more interest in this topic, and Bob's paper is extremely valuable as a base to start from.

When you come down to it, you must pay for a company after you have bought it. There are a number of ways of doing so. Common stock, though most frequently used, is probably very often the least rational method. You have the choice of debentures, common stock, preferred stock, warrants, or cash. Our company has a very definite feeling that some companies are going to be bought for cash or for debentures in the near future, without regard to the Phase III problems developed in trying to pay the interest on the money borrowed to pay this off. We normally advise our clients to use common stock and warrants in a package as a method of acquiring the life company. I would not look askance at warrants, as some do; in some cases they have value; in a good many they do not, of course.

The debenture method of acquiring life insurance companies creates a problem. There is a constant demand to obtain the money each year to pay the interest on the debentures. Obviously, you have created a tax problem for yourself. It does not make much sense. I think that we have seen one company right now looking to us—it is very near chapter 2—because it forgot about the fact that its earnings were calculated without respect to Phase III tax.

Dean Witter's first insurance company debenture last year, a convertible, was very successfully received in the market. Those of you who can afford to do debentures, all or part of after earnings, figure out that it would be a lot easier to do that than to issue new common stocks. Again, from the conglomerate's point of view, those are higher than the dividends of the insurance company that it is acquiring, and it likes to use something on the order of a warrant in order to diminish the outlay.

More often than not in our work we have advised our clients not to do more acquisitions than they have to. There are other solutions to this problem. This problem right now, we will agree, is a more or less academic one until the hearings in Washington are over. It is the feeling of my firm, however, and I think that it is a rational one, that this will not be of academic importance down the line because of the squeeze on money. The major companies are in the target area.

I would like to mention two aspects of this question which are not on the program but are quite important to the group here. One is the aspect of the mutual companies' diversifying into noninsurance areas through the holding company approach. You will find more of this being done. I would, as an officer of a mutual company, look with favor upon this as a method for taking some of that stream of earnings that you have been developing for some time and channelling it into other ways. One of the nice things about it is that, in doing this, you are able to develop stock options and stock purchase agreement options for your officers and hence are able to give some equity arrangements to the people who built your insurance values as well as the people who built your stocks.

The final comment concerns consulting actuaries. We have made, and will continue to make, extensive use of consulting actuaries in the evaluation of companies, in the manner in which we use them in the audit process, particularly in the valuation of our casualty companies, where there seems to be considerable difference in point of view. We have not as yet, though, used any retrospective valuation techniques, and I think that our techniques will continue to be prospective rather than retrospective.

MR. FREDERICK S. TOWNSEND: You may find this difficult to believe, but it is only in recent years that many companies have begun to establish corporate objectives. And, once these objectives had been determined, many companies found that they could not be achieved by their companies' present operations. Merger and acquisition are no longer unspeakable words. They are recognized as valid and desirable ways of achieving many objectives.

If one could summarize the objectives of the life insurance industry, probably the majority of such objectives would concern themselves with above-average growth rates in sales, in force, premium income, and earnings per share. The corollary to this would be that a company growing at 15–20 per cent per year is already achieving an above-average growth rate for its stockholders. Although an acquisition might be made on terms which would improve earnings per share, the inclusion of a large and slower-growing earnings base in the company's operations would result in a slower growth rate than would be true if the company had remained independent. Very few of the rapid-growth companies in the life insurance industry have effected mergers or acquisitions to date.

What are reasonable corporate objectives which do not necessarily represent the saving of a sinking ship? A regional company may decide that it wants to become national in its operations. A company with a limited product line may wish to offer a full range of financial services. The company with a capable management team may wish to create more jobs and responsibilities for competent executives. These objectives would take years to meet if they were not achieved by acquisition or merger.

Now we come to what one might refer to as the "more narrow-minded advantages" of a merger or acquisition. Such goals are more likely to be found in new companies or smaller companies. If a large, established company were to make an acquisition for a very narrow reason, one might question the judgment of management, depending upon the particular situation.

Acquisition can accelerate the production capabilities and the size of the agency force of the acquiring company. If the company acquired is a relatively dead company, however, the survivor is merely acquiring production capabilities which will show below-average growth in future years. The acquisition of an increased number of bodies in the field may represent either of two philosophies. In the worse case, management has simply found that it is unable to increase the size of its agency force under present conditions other than by merger. In the other case, management may have decided that the intangible price put on an agency force in a merger is less than the investment required for the company to increase its own agency force by the same number of agents.

Territory may be a consideration. We all know of the new companies which like to be licensed in nearly every state of the Union, even though they have no licensed agents farther than one hundred miles away from the home office. There are, however, some imaginative companies with mass-marketing schemes which find it necessary to be licensed nationally in order to operate at maximum efficiency.

The proliferation of small companies with technical expertise in marketing has created a further reason for acquisitions. Established life insurance companies which lack such technical expertise in marketing have ample capital funds, whereas many of the smaller companies do not. The marriage of the two has either saved the smaller company, which was about to run out of surplus, or accelerated the growth of the smaller company in its area of specialization by the larger company's providing the needed capital funds for immediate expansion.

This would suggest that a merger or acquisition might be the way for a company to add to its product line with a terrific savings of time and expense. Indeed, subsidiaries have been acquired by life insurance companies for the purpose of entering the variable annuity or mutual fund business. Companies have also been acquired for the purpose of handling a segment of the parent company's business. A company might be acquired for the purpose of having a subsidiary to write *only* in New York State. A subsidiary might be acquired in which all participating lines of business would be written, on which profits to stockholders are limited by various state statutes. A subsidiary might be acquired to handle all group insurance and/or other unprofitable lines of business.

Not all narrow objectives are bad. They may serve a very useful purpose insofar as long-term considerations are involved. Obtaining first-class management is an intangible which does not show in increased sales, in force, or earnings. But, in the long run, it may provide the greatest impetus to future growth in the insurance and earnings accounts through the implementation of the new management team's philosophy and the demonstration of their abilities.

The company growing at an above-average rate probably enjoys an above-average price-earnings multiple. Such a company could easily increase its book value per share and earnings per share by acquiring mature, slow-growth companies with a below-average price-earnings multiple. This is a very desirable goal but one which must be avoided if it will seriously retard the future growth rate of the company after the merger takes place. On the other hand, it is this type of situation which may be most profitable to the acquiring company. The mature company usually has level or declining production and a high overhead in the home office and in the field. The insertion of an above-average management team into such a mature company can stimulate the field force with new products or new sales methods, and such a management team not only can reduce duplicate expenses within the two companies but also can cut back sharply on the fat in the company which they acquired.

I have already spoken of the inability of some companies to increase the size of their agency forces. Some managements, which have had the sense to probe this problem in depth, have discovered that they are writing in the wrong markets. They have made acquisitions, not necessarily to increase the size of the agency force but primarily to acquire an agency force operating in a market which offers the opportunity to achieve satisfactory growth in the future.

We are often critical of the seemingly fanatical merger activity of young companies. At the same time, however, particularly in the role of actuaries, we recognize the terrific surplus drain involved in writing new business. The new company must establish a healthy block of renewal premium-paying business generating sufficient profits to sustain the operating loss incurred on new business. In the case of an aggressive new company that is registering substantial increases in sales each year, almost the only way to obtain a much larger block of renewal premium in its total premium mix is to make an acquisition of a larger company. In addition to obtaining statutory profits sooner, such a merger can also show a sharp improvement in unit expense costs.

Low-priority objectives for making acquisitions would include the company which tries to soothe impatient directors or stockholders by making a peanut acquisition. This would also be true of the company interested only in increasing its total insurance in force so as to impress life insurance agents and the rest of the life insurance industry with its ranking by insurance in force.

Up to this point I have spoken about the acquiring company. Initiation of mergers often starts with a proposal from an acquiring company, but there are valid reasons for some companies actively to seek out potential parent companies.

Foremost among these reasons would be the company which has made a thorough evaluation of its position and has determined that sales and earnings will be flat over the next five years. If the company's markets, products, and sales techniques offer no salvation, management may be saving its own skin by recommending that the company be made available for acquisition. A corollary to this would seem to be that even a growing company could improve its lot by being acquired by a company which is growing faster than its own rate of growth. Such mergers usually find no opposition from stockholders.

From a purely monetary point of view, life insurance companies usually demand premium prices. If a company is selling at a low price-earnings multiple, a cash offer may be substantially in excess of current market value in order to make the tendering of stock attractive. In the case of an exchange of stock, stockholders are not likely to give up their interest in a company unless they end up holding the stock of a company with superior growth prospects.

Another type of monetary consideration is a company's surplus position. Many new companies reach the point at which they must either be acquired or go out of business. And there is always someone around to acquire them.

In the case of closely held companies, the merger of the closely held company into a company with broad stockholder ownership will improve the marketability of the assets of the selling stockholders. This is a very real and important consideration.

One final advantage to the selling company occurs in the situation in which a controlling stockholder correctly decides that his company is headed by an ineffective management team and wishes to insert a proved management team into a dead situation.

How does a merger or acquisition stimulate growth, ideas, or productivity? Generally, one company feeds off the other for ideas, and the realignment of the field force in competing territory may result in greater productivity on a per-man basis.

If the transaction is handled properly, the surviving company can retain all the worthwhile agency personnel of both companies. Depending upon the ability of management, the field force may be stimulated by the prestige of working for a larger company and the benefits of the company name for cultivating mass markets. With the larger agency structure, the company may be able to afford larger compensation for top field positions. Such positions may also be increased in number. The lure of such top spots in the field force may result in a stronger recruiting program because of the availability of above-average advancement opportunities.

In summary, growth must be stimulated by the insertion of an above-average management team and new products or sales methods into either the acquiring or the acquired company.

A merger can most effectively reduce expenses by implementing a thorough review of all home office and field positions. The elimination of unproductive offices, or offices which do not pay their own way, offers the greatest savings in the field. After an acquisition, there are usually two home offices and two home office staffs. The elimination of one home office building and/or one complete home office staff has obvious expense savings. To do this, an acquiring company would have to have the ability and compatibility necessary to place all policy records and accounting functions on its own computer and to file all policy forms, and so forth, in a few filing cabinets.

I would be quick to point out, however, that the immediate elimination of regional offices or home office staffs in their entirety is not necessarily a desirable goal. At least one major company makes no immediate moves which would upset the management or clerical staffs of newly acquired companies. As a result, this major company has been looked upon favorably by other companies which have become subject to acquisition. In fact, other companies about to be swallowed up have run in desperation to this major company because of its reputation for leaving the status quo.

I might mention that the question of expense reduction is opening up a new area of activity for life insurance companies. Expense reduction is primarily the ability of an acquiring company to service business at a lower cost than that being incurred by the writing company. It also reflects the ability to handle increased premium writings at marginal expense ratios. I know of at least two life insurance companies which are not seeking mergers but are seeking out other life insurance companies willing to let them perform home office operations for a percentage of the writing company's premium income. In theory, both these companies feel that they have superior internal operations which permit them to process business at lower costs than those experienced by the writing company.

This, in turn, brings up another type of merger situation which I have not yet discussed. One company uses a merger technique which I call the "Sears & Roebuck method." This company has averaged nearly one acquisition per year over fifteen years but has never issued a single share of stock in such acquisitions. In effect, it makes a small down payment with small monthly payments thereafter for a period of years determined by negotiation at the time of the merger. Thus it makes acquisitions without paying a premium. The down payment is never more than the capital and surplus of the acquired company. The monthly payments are a percentage of premium income as collected, which avoids paying for business which might lapse quickly. This type of acquisition is attractive to both parties. The acquiring company operates on an expense ratio less than that of the company being acquired. The differential is usually such that both parties benefit. The writing company receives a percentage of premium income which is greater than its normal profit margin, and the acquiring company enjoys a normal profit margin which exceeds the percentage of premium income paid to the ceding company. I am surprised that more acquisitions are not made on this type of basis.

What other problems or considerations arise in an acquisition or merger? The greatest problems, obviously, arise in the case of unfriendly acquisitions. Such acquisitions do occur, and the acquiring company must demonstrate its ability to save as much as possible of the good will, agency force, management team, and other intangible assets as will benefit the future operations of the company. This is not easy. For this reason, acquiring companies prefer to make friendly acquisitions or to woo managements before making their proposals. This may be done by paying off management with either long-term employment contracts or generous severance contracts. The prospective acquirer may agree to keep the company and its employees intact, which results in a "long-term" merger. Or, quite frequently, an acquiring company falls into a bed of roses when controlling stockholders, for any of a number of reasons, decide to sell out and the paths of the acquiring company and selling stockholders happen to cross in the right place at the right time.

The respective valuations of the two companies and the settlement of the merger terms can be major stumbling blocks. I suspect that the inability to settle on merger terms has resulted in more merger failures than successes.

Once terms have been decided upon, it becomes necessary to decide upon the method of merger. Should the new parent company acquire the desired company or merely the assets of the desired company? Acquiring the company may result in 92.7 per cent ownership, whereas acquisition of the company's assets will result in 100 per cent ownership of the insurance accounts.

After a merger there might appear to be a duplication of legal departments, investment departments, actuarial departments, policy forms, ratebooks, and the like. The elimination of duplication of effort, or the elimination of inconsistencies, would seem to be a natural management goal. One of the more difficult problems in this area is that of contrasting agency forces operating in the same territory. It would be incompatible to run a true general agency system, or a branch office system, and to have brokerage operations and personal producing general agents all in the same cities. An answer to this problem should be well in mind prior to any merger negotiations.

One of the greatest headaches, yet a most frequent one, is the incompatibility of accounting systems between acquiring and acquired companies. As actuaries, we may have the somewhat slightly easier task of bringing the convention statements of the two companies into uniformity, but the chief accounting officer is faced with many long hours of exasperating toil.

The melding of the product line depends upon whether an acquired company is merged or retained as a separate company. In either circumstance, consideration must be given to territories in which the respective companies operate, the consistency of similar products, not only in rates and values but in policy-form features as well, and the respective markets which the companies are serving. The permutation of problems or considerations in this area seems almost infinite.

How can all these remarks be summarized? If the stock life insurance companies of the United States are going to operate in a manner which is responsible to their stockholders, they must determine sound management objectives which are consistent with long-term growth. The older, established methods of recruiting agents and levels of compensation paid to such agents are no longer capable of producing long-term growth for the life insurance industry. The same may be said of many of our prospecting techniques and marketing methods. So what can the stock life insurance companies do?

The stronger companies will find recruiting methods or markets, prospecting techniques, or compensation levels which will enable them to sustain above-average growth rates in their respective agency forces. The poorly managed companies will be unable to find solutions to these problems and will have to merge or acquire other companies or throw in the towel and be merged or acquired.

CHAIRMAN RICHARD M. SELLERS: Analysts usually are in the position of asking questions. At least, that is the experience that I have had with them, living on Maiden Lane as I do. I have the privilege of talking with one, not every day, but three or four times a week, at least. What questions are in the minds of our distinguished audience this afternoon?

MR. MELVIN L. GOLD: Has the increasing spread between the book value and market value of bonds affected your approach toward the valuing of life insurance companies?

CHAIRMAN SELLERS: I do not think that is a subject people pay attention to. However, that is one of the things at which we always look. I will not say that we have turned down any particular company for that reason, but it certainly is a facet of the company that we always study in detail.

MR. DOWLING: In the acquisitions business we look at that question, because we presume that there will be some run off. You must consider it.

The difference between book and market value has meaning only if you are going to be in the position of liquidating some of your bond portfolio. If by valuing you mean for acquisition purposes, then I would take this into account if the acquiring company plans to liquidate the life company. If not, I would continue to be interested only in the stream of earnings.

In pricing a stock for the market, you must bear in mind that, when people are buying stock in a company, they overlook such things as the basis of book value, but, when they are looking for a reason to sell the stock, this sort of thing is very often brought into play. Hence, in a very pragmatic way, I must stay conscious of the relationship between book and market, not only in the bond portfolio but also in the mortgage loan portfolio, but let this affect only my decision making, as the market psychology dictates.

MR. ARCHIBALD H. McAULAY: About twenty years ago there was emphasis on the optimum size. My own opinion is that management for a company up to $1 billion requires a certain type of management. From, say, $1–$3 billion, another type of management is required; it probably should be a professional management. Once a company reaches $3 billion, in my opinion, an agency man should not be running it. A noninsurance man must run it. In an attempt to get the optimum sized company, you could start with a company with, say, $500 million in force, merge it with another company of $600 million in force, and make the management worse simply because you are beyond what you can handle with your type of management.

In the twenties I was with a company which made a dozen mergers in one year. My company was making so much money that it had to get rid of it. Mergers are a good way to do that. One of the results was that ten years later we discovered that these companies each had some small peculiarity that required keeping a certain employee there because he was the one employee who could remember how to handle this peculiarity in the annual statement. When you think of companies and mergers, you have to consider how efficient they are going to be ten years from now.

I sometimes wonder whether we are forgetting that life insurance has been isolated for half a century and that it is now time to get out into the main stream. Even if we do get into the main stream, we must remember that we are not steel mills—we are a personal business with some peculiarities in it, and increased size is not the same as increased efficiency or increased earnings ratio.

MR. DOWLING: One of the problems that we have here is whether the definition of "actuary" is a limiting one; ours is a very much more constructive or expanding one. You would have to go a long way, in my opinion, to find a man like Bob Slater, who has the personal power and ability to make things go, yet he is an actuary. By your definition you would eliminate him. I have talked to lawyers and to many other people trying to run the business, and I would rather live with someone who really knows and loves the insurance business.

MR. GATHINGS STEWART: Joe, you mentioned a problem in regard to life insurance company acquisitions when the acquiring company used debentures as the means of purchasing the other company. Would you clarify that?

MR. DOWLING: The acquiring company wished to help service its debentures by means of large cash dividends to itself from the company acquired. This would result in the triggering of a Phase III tax for the acquired company, and the acquiring company did not take this into account when it made its plans.

MR. ABRAHAM HAZELCORN: I would like to hear the panel touch on the matter of acquiring management. Fred seemed more sanguine about this subject than Joe. At least that was my interpretation of their remarks.

MR. TOWNSEND: Perhaps Joe is more the investment banker and I am more the security analyst. I look for internal factors which can improve the company's operation rather than external factors. I do not know whether this causes the difference in our remarks.

MR. DOWLING: My remarks were directed primarily to the point that, when you acquire management or when you say that you are acquiring management, you are acquiring people. Twenty years ago in this business people did not move; if you acquired a company, you acquired the management with it. Today, particularly if there are dissimilar circumstances, you create emotional problems in the minds of the personnel of the company being acquired. There are many companies, including some in this room, which are looking for people and which will come in at a time like that and acquire them. Also, it is very difficult for a company that has been alone, a separate entity, to be, suddenly, a subsidiary operation. If you have not made arrangements for management contracts, I do not think that you can be hiring people who are going to be there tomorrow. That was primarily my point.

CHAIRMAN SELLERS: Let me add, Abe, that there is more than one type of acquisition being conducted today. We have acquired several companies, and we have different objectives for them; necessarily, therefore, we have different objectives for the management of the companies that are being acquired. All of these, I think, need to be taken into consideration. We debated long and hard whether we would acquire a mutual fund or create one. We decided to acquire one, because we were not quite sure that we had the necessary know-how. In our case, I believe, it has paid off.

MR. ROBERT G. ESPIE: It was pointed out this morning that this is particularly true in the variable annuity field. We debated a long time on whether we would buy know-how or attempt to develop it in our own people; we came to the conclusion that it was much smarter to buy our own.

We have on two occasions within the last ten years had to make a choice between using our own personnel and buying a company when entering into a new field. Our experience has been that, if the field which we plan to enter is one having need for substantial amounts of expertise which we do not currently have, it may be much more efficient to buy an existing organization in the field. Acquisition of an existing organization involves quite difficult problems of integration of people and practices, but the alternative of diverting the most able members of your existing staff to the exploration of new activities may be much less desirable.

Our two principal moves were the acquisition of Excelsior and PALIC. Although we had been in Canada for one hundred years, we were finally faced with the decision either to get in actively or to get out, and the latter was not a satisfactory solution. In the case of PALIC we spent a very considerable amount of time discussing whether we should enter the business directly or whether we should buy existing know-how. Obviously, the latter decision won out, and we have never felt that it was a wrong decision.

The integration of people into your organization is very difficult. Generally, the people whom you acquire are highly individualistic and accustomed to methods of operation different from those of your original company. They will generally feel that, unless they are given a free hand to run the business "the way it ought to be run," the result that is wanted will not be obtainable. Frequently, this is merely an excuse for being unwilling to submit to the organizational disciplines of your existing organization while being willing to take advantage of individual areas. If this kind of problem is handled incorrectly, there is a great danger that you will lose the people, or at least lose their enthusiasm, and thereby fail to achieve your objective. Integration may involve "living out" the original executive staff of the acquired company, but even this will not be successful unless you can convey the idea to the next generation that they should think of themselves as being part of the whole company rather than as simply specialists in their particular fields.

MR. DOWLING: On this question of buying mutual funds, there are sixteen publicly held ones left and about fifty private ones available for purchase. Keep in mind when you buy them that the fellows who work in these places are able to move tomorrow morning. Fund managers get paid more than life insurance presidents. You get a lot of problems on this if you are not cautious.

CHAIRMAN SELLERS: One other aspect that has not been mentioned this afternoon is the use of joint ventures to diversify and expand your operation into other fields where you do not necessarily have the talent to operate yourselves or to start a company. There is quite a bit of this being done, as I am sure you have all observed.

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CHAIRMAN ARTHUR G. WEAVER: Professional stock analysts generally agree that methods used to determine the value of industrial stocks have limited application to life insurance stocks. Instead, a variety of rules of thumb has evolved, the most important of which arbitrarily adjust stated earnings or stockholder equity to reflect unamortized investment in new business. The real significance of Mr. Bowles's actuarial note is that it provides a scientific basis for valuing stockholder equity by using only information generally available to the analysts.

Ideally, the actuary attempting to value a life insurance company would like to have available a current gross premium valuation. Unfortunately, the preparation of such a valuation is time-consuming and expensive. In recent years, however, some of the consulting actuarial firms have developed EDP programs which can approximate the desired results once the detailed source data have been made available. Since the gross premium valuation measures only the value of business presently in force, an empirical adjustment to reflect some of the future profits on future new business may be indicated.

In many situations the data needed to determine the return on stockholder equity or to prepare a gross premium valuation are not available to the acquisition-minded company. However, a reasonably reliable valuation can be secured, as follows, from published information:

1. Adjust stated capital and surplus to reflect nonadmitted assets, any difference between book and market values of the various assets, and any special reserves to the extent they are deemed to be a form of earmarked surplus.
2. Capitalize expected future earnings. These earnings can be estimated as follows:
   a) Calculate adjusted book values at the beginning and end of the most recent five- or ten-year period. From these figures determine the compound annual rate of gain in book value over the study period. Unless the mix of business has changed significantly, this rate of gain is not affected materially by the particular adjustment formula employed.
   b) Adjust the annualized rate of gain for expected future conditions.
   c) Add stockholder dividends, if any, paid during the study period to the difference between adjusted book values at the beginning and end of the period. This is a measure of earnings generated in the study period.
   d) Estimate future earnings for the next ten to fifteen years by applying *b* to *c*.
   e) Capitalize the earnings in *d*, using a rate of interest no less than the desired return on investment, possibly 10–15 per cent.
3. Add items 1 and 2.

A valuation determined along the lines suggested above would generally produce results higher than a capitalized earnings valuation based on static assumptions. As a result, life insurance stocks appear less overvalued, thereby removing some of the acquisition penalty usually associated with cash tenders.

MR. WILLIAM A. BROWN: I wish to add my endorsement to the concept set out in Tom Bowles's note on return on stockholder equity. My company was reorganized at the beginning of last year into a holding company form, and it has since become involved in finance operations and general insurance in addition to the life insurance business. At the time of the reorganization, the directors set out certain objectives for the corporation. Among these were earnings of a specified percentage on stockholder equity and a specific rate of growth on its earnings. They indicated that the results of our life insurance operations should be adjusted for the investment in new business in meeting these goals.

Recently I saw a tabulation of some five hundred companies in which the return on stockholder equity and the rate of increase in earnings were given along with considerable other information. There were very few life insurance companies included on the list, and these did not compare well with the companies shown in other industries. The life companies included are companies which have been in business many years. There were only two of the life companies with a five-year average return on stockholder equity of 10 per cent or more. One company reported 10.3 per cent and the other 11.0 per cent. Only one of the companies shown had a five-year annual increase in per share earnings over 10 per cent. There were nearly four hundred companies on the list with return on stockholder equity of 10 per cent or more and over two hundred companies with 10 per cent or better growth in earnings per share.

No wonder some people in other industries feel that they can do more with the large funds in our industry than we have been doing. We need to find more profitable uses for some of our money.

I would be a poor actuary indeed if I did not immediately refute the statistics to which I referred. I have collected a large amount of information from published reports on life insurance companies and have worked rates of return on stockholder equity for comparison. My list is made up of 116 stock companies reporting statutory earnings of $1 million or more in both 1966 and 1967. I would not dignify my work by calling it a study, but the results may be of interest to you. Ten of the companies showed statutory gain in both years equal to 20 per cent, or more, of capital and surplus; 29 of them, 15 per cent or more; 81 of them, 10 per cent or more.

The remaining 35 companies realized less than 10 per cent return on capital and surplus. As you might expect, most of the companies with a high return do some type of "special" business. Many of them concentrate in accident and health business or credit insurance or are captive companies. Many "regular" companies do fall in the 10–14 per cent group.

None of the results in either of the two lists were adjusted, and, of course, the numbers might be substantially changed if based on adjusted results. I suppose that the differences would be greater for the companies concentrating in life insurance than for those in the nonlife or special business.

I would like to call your attention to two specific problems mentioned in Tom's paper which arise when you attempt to relate the profit margin on individual policies to a return on the stockholders' investment in writing the policies. The first problem is that certain policies require little or no stockholder equity. In this situation, the relationship between the profit margin and the investment of stockholders' funds has little or no meaning. The second problem is that mature insurance companies have substantial amounts of capital and surplus which are held for the protection of the company's policyholders but which are necessarily invested at a lower rate of return.

As an alternative to establishing individual policy profit margins as a return on equity, a company might take the approach of relating profit margins to the amount of insurance or to a percentage of premium. Once having done this, the company can still establish over-all profit objectives for a given accounting period in terms of return on stockholder equity. The important point is that management must have a clear understanding of what its profit margins are, and this can only be accomplished if the profit margins have been established in a consistent manner for various classes of insurance. Having a clear indication of how much profit a given volume of business will yield and having established over-all profit objectives in terms of return on stockholder equity, management can now establish production goals which are designed to yield the desired results.

VALUATION METHODS

The classic approach to the valuation of insurance companies is on a net-worth basis. This approach is usually composed of three elements: (1) capital and surplus on a statutory or adjusted basis, (2) the value of insurance in force, and (3) a going-concern value for the company.

A determination of the amounts of capital and surplus and the valuing of the insurance in force are generally not difficult. Placing a value on the going-concern concept is more controversial. One method relates the going-concern value of the company to the value of insurance that is expected to be written by the company's sales organization over a reasonable number of future years. This approach involves an estimate of how much new business might be written in each of the next five or ten years, an assumption as to the value of that business, and discounting those values back to the current date.

If an acquisition or merger involves an exchange of stock between two insurance companies, the precise method of valuation is not too significant as long as the same method is used for each company. This will usually result in the determination of relative values that can be used for the establishment of a fair rate of exchange of one company's stock for the other.

Diversified companies interested in acquiring an insurance company would probably find themselves unable to use the net-worth approach. Since in multiple-industry companies there is great emphasis on the return on stockholder equity, it is essential that acquisitions be evaluated in terms of their earnings potential. Thus the relationship between the price-earnings ratio of an insurance company's stock being valued and the price-earnings ratio of the diversified company's stock becomes an important consideration. These circumstances may require the restatement of statutory insurance company earnings to a generally accepted accounting principles basis. Otherwise, the acquisition of a rapidly growing life insurance company would be impossible to justify. In the restatement, earnings are adjusted to recognize the company's investment in the acquisition of new business by capitalizing excess acquisition expenses in the first year and amortizing these excess expenses over the average lifetime of the policies written. It is interesting to note that after this is done, it is possible in most cases to come up with a realistic evaluation in terms of current market values of most insurance companies' stock and that a reasonable relationship exists between an evaluation on this basis and an evaluation on the classical net-worth basis outlined above.

There are, however, special situations that cannot be justified on this basis. One such situation is the acquisition of a corporate shell which might be valuable in providing an insurance facility but which has virtually no insurance in force to produce earnings. Another situation would be the acquisition of a very small but rapidly growing insurance company which is still operating at a loss even on an adjusted-earnings basis. In order to justify such acquisitions, one may use a projection of anticipated earnings over a period of years. This type of projection necessarily involves a great many assumptions about the volume of business that may be produced and the potential earnings on that business. Even under these circumstances, the discipline of a reasonable return on stockholder equity within a reasonable period of time may be retained.

TAX CONSIDERATIONS

There are two levels of tax considerations involved in the acquisition of an insurance company. The first level of consideration is the effect of the transaction on the selling stockholders. It is usually possible to effect an acquisition on the basis of an exchange of stock on a tax-free basis. In this case, the tax basis for the new shares received in the exchange is the stockholder's original tax basis on his old shares. Thus he is able to defer the payment of any capital gains until such time as he disposes of the new shares.

On the other hand, an acquisition for cash would result in a taxable transaction to the selling stockholders. This is sometimes an important consideration and may result in the necessity of paying a somewhat higher price on a cash basis than would be required on the basis of an exchange of the shares.

The second level of tax consideration is the effect on the company itself. Because of the multiphase nature of the federal income tax treatment of life insurance companies, there are numerous combinations that can result in tax advantages or disadvantages from the acquisition of one life insurance company by another or from the merger of two life insurance companies. A couple of examples will help to illustrate this point:

1. If a company that is in a Phase I tax position is merged with a company that is in a Phase II tax position, the merged company may end up in either a Phase I or a Phase II tax position, depending upon the relative size of the two companies. Thus the effective tax rate of the merged company may be either higher or lower than the effective tax rate of the original company which initiated the acquisition.
2. A life insurance company with substantial tax-loss carryforwards may be in danger of losing these tax benefits. A merger with a profitable life insurance operation may result in substantial tax advantages to both companies.

It is often desirable to maintain an acquired company as an independent subsidiary rather than to merge it with the parent company. In this case, it may be desirable to file a consolidated tax return for the insurance group. This situation leads into a vast area of ill-defined tax law.

The general rules for consolidated tax returns must be combined with the federal income taxation of life insurance companies. Two distinct bases have been used by different groups of affiliated life insurance companies for filing consolidated tax returns. One group has combined all income and disbursement items, as if the group were a single company, to determine the consolidated federal income tax. Other groups have prepared separate returns for each unit within the group and established the total tax as the sum of the parts.

For companies with dissimilar income tax characteristics within a group, you can see that the results of the two methods could be quite different. To date, no regulations have been promulgated to establish the proper method. The method used can be especially significant when there is some question about whether one or more units might be in a Phase III tax position.

One general regulation from consolidated tax rulings is quite clear. Tax-loss carryforwards from an individual unit cannot be used against current earnings of a consolidated group but can only be offset against earnings of the unit which developed the tax losses. This requirement might argue strongly for merging a tax-loss company rather than carrying it as a subsidiary.

One additional special tax situation has an interesting application. A life insurance company with a strong capital and surplus position might be unable to make substantial distributions to its stockholders without incurring a substantial Phase III tax. Alternatively, this company might be able to acquire another life insurance company on a cash basis. Acquisition of a wholly owned life insurance company is frequently allowed under state investment regulations, whereas the acquisition of other wholly owned subsidiaries may be forbidden. In this case, the parent company is substituting the earnings of the insurance subsidiary for the investment income that it would have received on its surplus funds. Under these circumstances, the parent company may be able to justify an acquisition on a more favorable basis than it would otherwise be able to do.

MR. D. ALAN LITTLE: In my work, most acquisition transactions fall within the small-company category and usually involve an exchange of stock between two or more insurance companies. Usually, one of these companies has one or more serious problems, and it is the satisfactory negotiation of these hurdles that can spell the difference between a "deal" and "no deal." Let us consider some of the more frequently encountered problems.

1. *Expenses.*—One of the companies to the transaction is operating at expense levels substantially above the other. In the appraisal of the value of business in force and the going-concern adjustment, the question of what expense levels to adopt as part of the basic assumptions usually comes up. For example, should the existing stockholders of the higher-

expense company be valued as though no merger were to take place and therefore the expense problem would continue, or should some adjustment be made in the value for solution of these problems by the more efficient postmerger management? On the other hand, one of the attractions to the acquiring company may be the potential improvement after the merger and its ability to improve earnings per share of the combined situation.

2. *Product rate problems or negative profit lines.*—If rates have been set at levels substantially below those of the competition or if the particular market is showing a substantial negative result, it is extremely difficult to allow for these negatives in the appraisal technique. For example, if agents have been attracted to the company because of the competitive rate structure, retention of such agents is unlikely if rates are increased. The question then becomes how much stress to place on the going-concern adjustment. On guaranteed renewal health plans, it is difficult to determine how satisfactory rate increases will be in solving loss problems, particularly if there is no previous history of rate increases. If a product line can be canceled, it is then important to determine how long this will take and what objections state regulatory officials might make to the cancellation procedure.

3. *Participating business.*—Many states do not restrict the earnings from participating lines that can be retained by a stock company as profit. However, some states have adopted restrictions on profits from such lines, and, if the acquiring company happens to be domiciled in one of these states, it is important to know the effect on earnings. Occasionally, one suitable method of handling this problem is to determine the values before adjustment for dividends and then to make an adjustment based upon a dividend philosophy, such as a 90 per cent payout of margin shown.

4. *Management contracts and employee benefit plans.*—The critical question here involves which stockholder group should be charged for the cost of these benefits. For example, should a management contract granted as part of the merger be charged to postmerger results, or should the existing stockholders of the nonsurviving company be charged? Similar problems exist if unfunded past-service liabilities are present in a pension program or if it is proposed that the acquiring company's pension program be extended to employees of the nonsurviving company with full credit for service in the predecessor corporation.

The problems that I have outlined are only a few of those that can arise during the course of merger discussions. Because of these problems, a range of values rather than a single value must be determined, and the acquiring company must be in a position to know its yield at various price levels.

The previous speakers have discussed the differences between the cash transaction and one in which securities are exchanged. There are several additional items to be considered. Under most state laws, dissenting stockholders have the right to receive cash in lieu of an exchange for securities. For this reason, it is important that an accurate appraisal be made even though a cash transaction is not involved. It is also important that the acquiring company be prepared to back up its opinion in court.

In smaller companies another problem in a cash acquisition is the question of remaining capital and surplus, particularly if the acquired company is to be run as a subsidiary. If securities have to be liquidated to provide cash, substantial capital losses may occur (for example, in the bond account) and may serve to reduce surplus below required levels. Also, the method of valuing a subsidiary life insurance company in the Convention Blank may cause a further drain on surplus. For these reasons, a cash transaction is seldom encountered among smaller companies.

The two previous speakers have also covered in detail the tax considerations involved in a merger. To these I would like to add the potential of a Phase III distribution. The purchase of stock from dissenting stockholders through use of capital and surplus funds potentially could cause a Phase III tax if such a purchase were determined to be a stockholders' distribution. To the extent that the stockholders' account is sufficient to cover this distribution, no tax problem would arise. If the distribution exceeds the stockholders' surplus account, however, the distribution would involve previously untaxed items.

MR. MEL STEIN: The value of a company consists of the following:

1. Statement blank net worth (capital and surplus) adjusted for disguised surplus (e.g., MSVR), certain nonadmitted assets, and artificially valued assets (e.g., the difference between the market value and the statement blank value of investments)

   plus
2. The value of insurance in force

   plus
3. The value of future sales

   plus
4. The value of certain intangibles, such as the number of states a company is licensed in and the quality of its management and employees

   plus
5. The value of any tax-loss carryovers

   less
6. The value of future unabsorbed overhead

Ranges of values of insurance in force, future sales, and future unabsorbed overhead may be determined with enough accuracy for meaningful negotiations only through the use of a computerized projection system, which includes a series of sufficiently sophisticated gross premium valuation programs. Some of the refinements such a system should contain are the following:

1. Reinsurance costs
2. All premium-payment modes
3. Due and deferred premiums
4. First-policy-year modal withdrawal distribution factors
5. Calendar, as opposed to policy, year formulas

Ranges of values are referred to because of the necessary negotiation of the assumptions to be used. The above description is, of course, meant to be a general guide rather than a detailed analysis of this topic.

Under *no* conditions should unamortized investment in new business be used in valuing a company. This item is too easily subject to manipulation and distortion, as is stated in my discussion of Mr. Bowles's fine paper.

CHAIRMAN WEAVER: In regard to topic II, many different reasons are given for the merger or acquisition of life insurance companies. These reasons include the following:

1. The desire to gain quick entry into other jurisdictions and other lines of business
2. The judgment that it is cheaper to buy business than to produce it
3. The need for executive talent
4. The desire for greater in-force volume in order to achieve economies of size
5. The need for greater adaptability to changing market and business conditions
6. The desire for an expanded agency system
7. The need of the undercapitalized to obtain additional surplus
8. The need of the overcapitalized for additional premium volume
9. The desire for broader ownership and active market for the company's stock
10. The desire to spread the cost of entering new fields, such as mutual funds

Clearly these reasons and the benefits associated with them need not all be present in every merger or acquisition. What is important is for each party at interest to recognize the logic and economic justification for the combination and to feel that all gain and no one loses under the proposed arrangements. In the ideal situation an aura of enthusiasm and even excitement is generated, encouraging a release of creative energy, an acceptance of necessary changes, and a willingness to use manpower and financial resources to best advantage. In this way the whole can be greater than its parts, synergistic growth can be achieved, productivity can be increased, and expenses can be reduced.

There is, however, one benefit which always accrues to the acquiring company, even if the deal itself is not consummated. This is the focus on strategic planning which results when senior management undertakes to change its environment. By "strategic planning" I mean the determination of objectives and the best strategies to determine these objectives. Since major "trade-offs" must be considered in developing the best strategies, strategic "trade-offs" are fundamental to the success of any corporation. This is true because this success depends on corporate policies, objectives, and growth strategies that reflect the optimum combination of such "trade-offs."

Once the strategic planning for acquisitions has been made by top management, it must be communicated effectively to the army of specialists who become involved as the acquisition process progresses. It is fundamentally important that lawyers, actuaries, accountants, administrators, and financial experts all have the same understanding of these plans, since it is they who must make every detail workable.

To this end the strategic planning should be carefully reduced to writing, together with information on commitments or undertakings made in the course of negotiations. It is also desirable that organization charts, PERT charts, and other operational planning material become available as soon as possible, in order that the transitional period following the merger or acquisition can be achieved effectively, expeditiously, and harmoniously.

A successful merger or acquisition requires that top priority be given to the human aspects involved. Nicholas M. Salgo, chairman of the highly successful Bangor-Punta conglomerate, points out that "anyone talking about acquisitions or mergers, if he is not specifically talking about the plain buying of assets . . . , is really focusing on the critical problem of how to get another group of people under the same corporate umbrella." He goes on to say that there is no way to buy the good will of these people but that much can be done to avoid alienating them.

Mr. Salgo's formula is to extend the same confidence that he has in himself and his own people to the other group from the very first day of negotiation. I suspect that Mr. Salgo would agree to extend this same desire for openness and communication to the rank-and-file worker, to the community, to the customers involved. In insurance company mergers and acquisitions, this would involve an effort to communicate with the policyholders. After all, we are handling their money, their security, their aspirations, and they have a right to know exactly what is going on. Also, just possibly, it will make the task of the would-be "twister" just that much more difficult.

There is one consideration associated with mergers and acquisitions that is likely to become more and more important as time goes on. I refer to the legality of prospective mergers and acquisitions from the standpoint of the antitrust laws. I am hoping that the other panelists may be able to throw some light on this subject and to comment on recent developments as the new administration reviews the whole merger-acquisition situation.

In the meantime, I can say that antitrust consultants retained by us examined the matter in detail last year. Their principal conclusion was that, since any very large life insurance company was a likely target of antitrust policy it should adopt the most conservative procedure and appraise all prospective mergers from the point of view of each important center where both companies do business, as well as from the viewpoint of both national and state markets. This conclusion was arrived at despite the belief that the state is the most meaningful economic market in which to appraise the competitive effects of an insurance merger or acquisition.

MR. LITTLE: Advocates of mergers or acquisitions have frequently stressed that such transactions, in and of themselves, tend to stimulate growth, provide new ideas or greater productivity, or cause a reduction in expense. In my experience, the opposite has more frequently been the case. Often the merger or acquisition has not been well thought through, and the acquiring company has entered the transaction simply because this is what the Joneses are doing this year. Some of the more common problems are the following:

1. Expenses of putting the companies together may be fairly high. If the companies are located in different geographic areas and it is intended to merge the operations, there are the expense of moving employees and equipment and the cost of selling any real estate owned or negotiating out of any long-term leases on home office buildings.
2. At the same time two companies that have been struggling for a substantial period of time often will decide after a merger that now is the time to expand salaries of upper level executives substantially or to go on an expensive building spree.
3. Substantial increases in terminations may occur, as well as loss of most of the agency of the nonsurviving company.

Like most other activities in the insurance business today, management working with well-thought-out objectives and goals is the key to future success; where these objectives are absent or management is absent, no merger or acquisition is in and of itself going to create a favorable atmosphere.

The chief advantage of a merger comes, perhaps, from people competition. For example, if each company to the transaction has a sales vice-president and only one can survive, this may create a competitive aspect in which one will thrive at a rate greater than he could have achieved without this pressure. This is true for other senior-executive levels as well. Since people also look at problems from different viewpoints, a new slant or direction may be attached to a problem and stimulate thinking.

The third part of topic II asks, "What considerations and problems, including public relations, are associated with mergers and/or acquisitions?" I have been asked to cover the accounting subdivision of this question.

Accounting problems break naturally into two subdivisions—financial data published for stockholder use and internal gathering and management reporting systems. Perhaps a third division could be the reporting of data to regulatory officials, including state insurance departments, the Internal Revenue Service, and the Securities and Exchange Commission.

Accountants are currently debating the respective merits of a number of methods of accounting both for an acquisition and for subsidiary corporations once a merger has taken place. Among some of the problems that they are trying to resolve are the following:

1. The basis on which to report assets acquired in exchange for a package of securities. Should such assets be carried at values shown by the predecessor corporation, or should they reflect the cost basis that would have been incurred at current market or replacement values?

2. Should the earnings of the parent and its subsidiaries be reported on a consolidated basis, or should they be reported separately for comparative purposes? Should earnings be adjusted to eliminate an increase in per share earnings resulting solely from the terms of the exchange? One could use a number of examples to illustrate growth in per share earnings resulting solely from the terms of a transaction. These per share earnings can be increased even more after taxes if part of the package involves debt securities exchanged for common stock.

3. Complications also arise from trying to combine earnings of companies in unrelated fields. For example, how can the earnings of a life insurance company be combined with an auto manufacturer? The combining of earnings from such subsidiaries may tend to disguise underlying unfavorable long-term trends. At the same time, a complication in showing separate financial results is the problem associated with the allocation of the parent's management expense to subsidiary companies.

While accountants are concerned with the over-all technique of reported earnings to stockholders, there are numerous other internal accounting problems, however:

1. The first problem is the combining of annual statement data and the combining of income tax data. If the merger or acquisition takes place at a time other than year end, this may involve partial-year statement returns and may mean that only partial-year results will be available for the first year beyond the merger. On both the annual statement and the tax forms, substantial differences in treatment of items may be involved, and these could be very difficult to reconcile in combining items. For example, in one company, coupon and pure endowment deposit funds may be treated as life insurance reserves, while in another company they may be treated as policyholder at interest funds. Substantial swings in the tax form are possible where these differences occur; in one situation that I have seen it could have caused loss of a company's life insurance qualification, depending upon how the problem was resolved. Further complications are caused by such items as different elections selected for federal tax purposes, reporting of items in different locations in the annual statement, and so on.

2. The cost associated with the merger is important, and it is difficult to report these items properly in the annual statement, since there is no specific room left for identification of one-time expense items. For this reason, many companies choose to use the surplus account to report the merger expenses associated with the transaction. Accountants, however, would seriously question this practice.

3. Another critical problem is the conversion of internal procedures and systems to a common basis when both companies are to be merged into one operating unit. Frequently, even if both companies use the same basic programming packages, there are specialized routines that the other does not have available, and there may be considerable differences in machine configuration. If one company is not nearly as advanced as the other, there may be rather serious conversion problems, extending well beyond the merger date.

4. A further complication, and one that creates a serious problem, is the lack of consistent management data. This lack can occasionally be remedied by a thorough review of prior years and a regrouping of this into the form needed by postmerger management. More frequently, however, it will take a period of two or three years after the merger before consistent data again can be used with any real meaning. If the company to be acquired is operating as a subsidiary, there is the added problem of incorporating those controls and management reports needed to see that management of the subsidiary is doing its job.

MR. BROWN: Having acquired one or more life insurance subsidiaries, the management of an insurance group is probably faced with new problems that it has not experienced before. If the home office of a subsidiary insurance company is maintained at a distant location, a program must be established to assure consistency of operations and the ability to meet desired objectives. Georgia International is a partner of ITT in a joint venture, Abbey International Corporation, operating insurance companies outside the United States. In this connection we have become familiar with the devices that ITT uses to manage its group of companies. These methods are used in the management of Abbey and may be of interest to you.

The basic management tool used is the business plan. The business plan represents a major effort for local management. It is a detailed description of the company's marketing and operating strategies for the coming year, together with supporting financial data and a five-year financial projection. Every level of company management participates in the development of this business plan and is committed to its fulfillment.

The business-planning process starts with an objective-setting program in the spring of each year. At this time the parent company's staff meets with local management to develop over-all objectives for the next calendar year. At this point objectives are set by top management and are measured against the over-all objectives of the parent company. After these objectives have been accepted and approved, work begins on the detailed development of the business plan in early fall.

At this time the business plan is built up from the smallest unit to develop the company's over-all plan and indicates, in great detail, how the previously agreed-upon objectives will be reached. The business plan is then submitted to corporate headquarters, where it is reviewed by staff and functional personnel. A formal presentation is made in November or December to the corporation's top management. At this point the plan is either accepted as originally presented or with specified modifications. From the approved plan a detailed monthly budget is prepared.

Local management is now charged with the fulfillment of that plan. They have full authority to execute all programs outlined in the plan, and no additional corporate approval is required. This includes the addition of new personnel, the development of new products, the investment of capital for major development projects, the opening of new marketing areas, and so forth.

Measurement of actual experience against the budget is done on a monthly basis. Significant variations from budget are explained. If it becomes apparent that actual results are going to fall short of, or exceed, the budget by a significant amount, a revised forecast is prepared. The revised forecast is again reviewed at the corporate level, and, when approved, it becomes the new business plan.

The development of the first business plan for a company is a monumental chore. It necessarily involves a great many assumptions. Subsequent business plans are prepared with a great deal less effort. Continuous measurement of actual experience against the original assumptions allows a continuous improvement in the assumptions made. The result is that forecasts become more meaningful as time evolves. Because of participation in the development of the business plan at all levels of local management, individuals charged with staff functional responsibilities are more aware of the impact of their operations on the company's over-all results.