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PURCHASE GAAP VERSUS HISTORIC GAAP

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1. Relevant principles and guidelines published or under consideration by the accounting and actuarial professions.
2. Specific approaches taken and problems encountered in actual purchase transactions.
3. The interpretation and significance of Purchase GAAP restatements both during and after purchase.

MR. SAMUEL H. TURNER: The purpose of this session is to review and discuss the principles and guidelines published and/or under consideration within the accounting and the actuarial professions regarding the restatement of GAAP financials of a life company acquired in a transaction to be accounted for as a purchase transaction under APB 016. Our purpose is also to review with you some of the specific approaches that have been taken, and the problems that have developed, in implementing purchase-GAAP in practice. Finally, we would like to note what we perceive to be some of the significant aspects of purchase-GAAP restatements, both during and after purchase.

To address these, to respond to your questions, and to entertain your own commentaries, we have a panel comprised of an accountant, Mr. Bobby Dunn, an actuary, Mr. Steve Bickel, and an investment banker, Mr. John Head.

We will first have Mr. Dunn give us an overview of APB 016, which provides the conceptual framework for purchase accounting, and indicate how purchase-GAAP differs from historic-GAAP.

MR. BOBBY F. DUNN: Visualize for a minute a company which has one asset, a building setting on a piece of leased ground and the lease has ten years to run. Its historic book value (depreciated cost) is \$1,000,000.00. It has no liabilities; therefore, its net worth is \$1,000,000.00. A purchaser pays \$2,000,000.00 for the outstanding stock of that company. What should be the accounting result? Common sense says the buyer did not really buy \$2,000,000.00 worth of stock, he really paid \$2,000,000.00 for the building. Under purchase accounting, we would, from the date of that acquisition, record that building at \$2,000,000.00, the amount he paid for the stock, rather than the \$1,000,000.00 historic value.

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Let us make it just slightly more complicated. Take the same situation and assume there was an unpaid mortgage on that building bearing 3% interest so that when you have paid \$2,000,000.00 for the stock of the company you now have a decision to make. How much of the excess \$1,000,000.00 over the historic cost is attributable to the value of the building and how much of it is because you have a very low priced mortgage? In accounting for that purchase transaction, first you would record the mortgage liability at an interest rate that you would have to pay to borrow money today to place a mortgage on the building. Instead of recording the mortgage in effect at its contractual 3% rate, you would record the mortgage as if it were, say, at a 9% rate. The balance of the purchase price would then be allocated to the building.

Let us create one other account. We now have a building, a mortgage, and one other account on the books. Assume that just before we bought the building the prior owners had paid \$100,000.00 for 5 years worth of fire insurance coverage. If at the time we bought the stock in the company it would have taken \$200,000.00 to buy the same coverage, then part of the reason we are paying the premium for the company is that we in effect bought the rights to this insurance, 5 years worth of insurance coverage, at a bargain. The historic cost of the insurance has nothing to do with it; so we would restate the prepaid insurance account to what the replacement cost would be.

That is all APB 016 is saying. It is saying that if you buy all the outstanding stock of a company look to what is really in the company and restate all of the assets and liabilities to fair value at the date of the purchase.

Getting away from our leased office building, let us look at a life insurance company. Assume you have a life insurance company that has a historic GAAP book value of \$10,000,000.00. A buyer comes along and pays \$20,000,000.00 for the outstanding stock of that life insurance company. The question myself and many of you here are often asked by investment bankers and others is what will the earnings of that life insurance company be once we record all the assets and liabilities at fair value?

In the example I just gave, if it is a non-taxable transaction and to the extent that you do not have any land or something that is not depreciable, the future earnings on that company on a purchase accounting basis will be exactly \$10,000,000.00 less than they would have been on a historic basis. We have paid \$10,000,000.00 more than the historic book value. That \$10,000,000.00 cannot disappear, it is going to get charged to future earnings and the whole problem is then what years will that \$10,000,000.00 be charged to. In essence we revalue bonds, home office building and other assets and liabilities, including reserves, to fair value. After revaluation, APB 016 says we should classify any difference, between the revalued net worth and the purchase price as goodwill which can be amortized in a number of ways but cannot be amortized over a period longer than 40 years. Most of the revaluation to fair value should be straight forward. Investment bankers can furnish the value of the bonds and the mortgages. Real estate appraisers can furnish the fair value of real estate. Policy loans give us a little bit of a problem. What do you do about policy loans? I would leave them alone and do nothing because, in my view, policy loans are so closely related to policy reserves that they

can not be separated. Rather, I would be aware of the contractual yield on policy loans in choosing an interest assumption. Many accountants do not agree. Many accountants believe that first you select the proper interest assumptions to use in calculating the reserves ignoring policy loans. They would then, revalue the policy loan account based on the interest assumption used in the reserves.

Outside of policy loans, there are not many other problems on the asset side of the balance sheet except for deferred policy acquisition costs. Accountants have a lot of difficulty with this one. Many accountants, as for the prepaid insurance example, would view deferred policy acquisition costs as any other prepaid expense and would say that deferred policy acquisition costs in effect ought to be restated to replacement cost, a replacement cost kind of thing. As in this case of policy loans, the acquisition costs and benefit reserves are so closely related that they should be viewed as one net account. However, for purposes of allocating purchase price among the various assets and liabilities, it probably makes for a more meaningful looking balance sheet to have the acquisition cost piece of the reserve shown as an asset rather than netted against the liability account. The most appropriate answer is to do one calculation which will give you the net value of deferred acquisition cost and benefit reserves. Whether or not we then "magic-up" some kind of number to reclassify our reserves and set up an asset is still a debatable item. We will talk about that some more.

For many of the other liabilities on an insurance company's financial statement, historic-GAAP and purchase-GAAP are probably the same; for instance, on open claims, there is no reason they should be different except to the extent that we have long-term disability claims for which it might be necessary to use a more current interest assumption in discounting the disability claims than the one used on historic-GAAP, although that could be the delta that we need for adverse deviations, and we might leave it alone. There are not many other accounts that will probably need restating except for reserves on supplementary contracts with or without life contingencies for which we should at least consider using a more current interest assumption as of the date of the purchase. The main point is - do not lose sight of the fact that in doing all of these allocations the entire chore is to decide in what periods are we going to charge income with the \$10,000,000.00 excess purchase price.

I repeat, any time you pay more than historic-GAAP book value for a life insurance company, then to the extent you do not allocate something to a nondepreciable asset such as land, future earnings will be exactly reduced by the amount of the excess you pay over the historic-GAAP book value.

MR. TURNER: To restate a couple of points just noted--one, the thrust of purchase-GAAP is allocation of the purchase price, and two, the concept is fair value. Fair value has been typically taken as fair market value on the asset side of balance sheet, especially as regards invested assets. But what does fair value of liabilities mean? We now enter the wonderful world of the actuary and I would like to call on Steve Bickel to give us some background on what the developments have been, how they came about, and where we now stand in terms of actuarial guidelines.

MR. STEPHEN D. BICKEL: The Academy of Actuaries began studying this question back in 1973. These studies led to publication of two papers. The first was written by Gary Corbett which appeared in the Transactions and outlines nine methods of purchase accounting. The second was a paper by Bill Odell published in the Proceedings of the Conference which concentrated on two of those methods. Following publication of these papers a Task Force of the Academy's Committee met with the Task Force of the AICPA and commenced discussions which eventually developed into the publication of Interpretation 1-D, September, 1977. This Interpretation identifies two methods of purchase accounting which were recognized as being acceptable. The first method is called the Defined Initial Reserve Method, where the initial reserve is taken as an amount defined by the purchase negotiations. Assumptions are chosen which reflect current experience, including provisions for adverse deviations. Valuation premiums are then calculated. If the calculated valuation premiums turn out to be greater than gross premiums, it is necessary to scale down the provisions for adverse deviations. If that still produces premiums in excess of gross premiums, the present value of the excess is classified as goodwill.

The availability of the Defined Initial Reserve Method is restricted: it can only be used if the purchase negotiations established values for the assets and liabilities in exactly the same manner as APB 016 prescribes for purchase accounting. This means that in the negotiations you must adjust the assets from book value to market value and so forth.

The second method is called the Defined Valuation Premium Method. Under this method, valuation premiums are taken as gross premiums less a reasonable profit allowance. The profit allowance should be consistent with that contained in current new business. Reserves are then computed as the present value of future benefits and expenses less the present value of future valuation premiums using current assumptions which provide for adverse deviations.

Under similar circumstances both methods often produce the same results; however, there is a fundamental difference in procedure. Under the Defined Reserve Method, the purchase price must be determined before the purchase accounting adjustments can be developed. Under the Defined Premium Method, the purchase accounting reserve adjustments are independent of the purchase price, and can be used directly in establishing the price.

Under Interpretation 1-D there is no flexibility in choosing the method of purchase accounting. The method is dictated by the nature of the negotiations and the assumptions are defined in terms of those appropriate for new business; however, in practice it may be frequently necessary to use other methods. The type of reserve calculation described in Interpretation 1-D is different from our usual routines since valuation premiums are functions of the gross premium rather than the benefits. Also in many cases it may be required to continue calculating historical GAAP reserves as well as purchase GAAP reserves. So that it is not economically convenient to follow Interpretation 1-D precisely. For these and other reasons, it is probably true that the other methods described in Corbett's paper are still being used. However, it should be recognized that they are justifiable only as approximations to the methods described in Interpretation 1-D. Of course, Interpretation 1-D is a statement of the Actuarial Profession and is not, by any means, the final word on GAAP. However, it is very close. The accounting profession and the actuarial profession worked together quite

closely in the development of the Audit Guide and subsequently, every Recommendation and Interpretation published by the Academy's Committee, received a prior review by the AICPA's Insurance Companies' Committee. In the case of Interpretation 1-D, this review extended over two or three years. The practical result is that, if you follow Interpretation 1-D, you can be sure you are in conformity with GAAP and otherwise you are on your own.

This is not to say that Interpretation 1-D tells you everything. There is still a very confusing area of purchase accounting which relates to the treatment of federal income tax. APB 016 states that deferred tax credits should be eliminated from the purchase accounting balance sheet and that assets and liabilities should be valued net of tax effects. Interpretation 1-D says that where this is done reserves for insurance in-force should be sufficient to provide for future federal income taxes expected to be generated by the business. The Interpretation does not proceed further than that because the actuarial profession has not developed commonly accepted techniques of providing for future federal income taxes in reserve computations. However, I will relate a few of my personal experiences in this area.

In some cases the purchased company has been expected to pay future taxes based entirely on tax situation B, where the taxable gains equal taxable investment income less \$250,000. In this situation the purchase accounting job is easy since it is only necessary to choose an after tax interest assumption in revaluing the reserves. In one case which I encountered the purchased company expected to pay taxes entirely on the gain from operations. In this case it seemed reasonable to set up a discounted liability for the taxes which would be payable on the reversal of the difference between the reserves shown in the tax return and the GAAP statement. Following this theory I proceeded to project the runoff of the business. The philosophy I was using was to estimate the tax which would be paid if no new timing differences were generated by future new business. This particular company had substantial loss carry-forwards so that for the first few years of the projection no taxes would be incurred at all; thereafter taxes became payable at 48% rate. Once the anticipated taxes were determined, they were discounted at a 4% interest rate to the valuation date. 4% was viewed to be an after-tax equivalent of an 8% pre-tax assumption. Interestingly enough, the net result was a discounted liability which was greater than the cumulative deferred tax credits which the company had been holding on its own financials.

The next issue was how to amortize the tax liability against future income. My first thought was to simply hold a liability each year equal to the present value of the assumed future taxes; however, this produced illogical results, since the future GAAP taxes were going to be determined by APB-11 and not by the discounted liability method. In the first few years the discounted liability would increase because the liability contemplated utilization of existing loss carry-forwards. Under APB-11 those loss carry-forwards were not available. The result was that we decided to write off the tax liability on a straight line basis over the same period of years being used to write off goodwill. If you think carefully about this, you realize this is the same as not doing anything at all. We simply increased goodwill by the amount of the discounted tax liability to the amount of the goodwill and wrote them both off in the same manner so the exercise had no effect on the income which we would have reported if we had skipped it altogether.

This particular purchased company was the Variable Annuity Life Insurance Company, which is a rather unique operation.

In a more typical life insurance company it seems to me that the appropriate provision for taxes should be built around situation D, where the tax is based on the mean of the gain from operations and taxable investment income. The reason I say this is that most companies would find themselves in that situation if future new business did not produce new timing differences. This would mean that purchase GAAP assumptions should reflect at least a 23% tax on taxable investment income and a discounted liability should be established for 23% of the reversal of the excess of tax return reserves over the purchase GAAP reserves. Typically a discounted liability might be about 80% of an undiscounted liability and it would probably be less than the cumulative deferred tax credits.

I would like to observe that, in our experience, purchase accounting adjustments do not materially affect future earnings regardless of how they are computed. At American General we have accounted for 19 purchases of life insurance companies. Many of these were done at the time of our original conversion to GAAP in 1972 and the methods used at that time are now understood to be totally incorrect. More recently we have followed the theory of the Defined Valuation Premium Method, but we still frequently choose one of the other methods described in Corbett's paper as an approximation to the theoretical result. For several of our companies we have had to continue computing historic GAAP reserves as well as the purchase GAAP reserves because of the purchased company's own requirements for financial reporting. The effect of adjustments for such purchases in 1978 was that earnings after purchase accounting adjustments ranged from 95% to 106% of the historic GAAP earnings and obviously this result is influenced by the price paid. The prices paid in these 8 transactions varied substantially from well above historic book value to below. The methods used are entirely inconsistent and yet the final bottom line, even if you look at the individual company by itself, is essentially an immaterial adjustment to historic GAAP earnings.

MR. TURNER: I would now like to address some of the approaches that have been observed, and some of the problems that have been incurred, in practice.

I would first like to address the matter of restatement of assets. Restating traded securities to fair market value has generally been no problem.

With respect to policy loans, practice has varied. For many companies, loans would be immaterial in relation to total assets. However, they may be material as regards restatement - for example, where policy loans are related to loanable funds by plan, they can represent a fairly significant portion of the assets backing reserves on that business. Some restatements have taken policy loans at book. Some have restated them to market using a higher yield rate, although a problem here is what to do about future increases in policy loans. The third view is that policy loans should be treated as a reduction in liability, or more specifically, as a reduction in cash values (i.e., times a withdrawal rate) and as a reduction in death benefits, because this is what happens in practice.

With respect to non-traded securities and real estate, most frequently you are talking about an appraisal value of real estate, and an approximate restatement to market for non-traded securities.

Tax effects with respect to the assets per se depend first of all on whether the accrual of a discount or premium will be taxable, and I understand that this depends on whether it is expected that a liquidation of the company will follow or be coincident with the acquisition. Having determined whether the accrual of discount or premium is taxable, then you have to make some decision on the tax rate and how to reflect the provision for tax.

In the liability area, Interpretation 1-D says that several methods of computing reserves in purchase situations have been developed and that two described methods are recognized to have substantial support within the profession. In practice there appear to be definitely more than two. About half of those which I have been involved, or am familiar with, have used some form of the Defined Valuation Premium Method; however, even these are in fact less consistent than they would appear on their face. About a fourth of the transactions followed some type of benefit reserve approach. While specifics vary all over the place, they essentially reflected a benefit reserve of the same kind that you would use under historic GAAP and some sort of an asset computed to go along with it. The remaining, let us say, 25 or 30% of the transactions have been about evenly split: about half of them appeared to be statutory reserves less the present value of statutory profits, and the other half represented those few cases where historic GAAP has been taken as equal to purchase GAAP. Some of these may very well be the kind of cases that Steve mentioned, where the effects of restatements are essentially immaterial.

I mentioned earlier that the Defined Valuation Premium Method has been used in something close to half the cases with which I am familiar and that some of this apparent consistency is illusory in terms of concluding that it is common practice. The reasons are several.

First, what is the allowance for profits? As you know, the Method says the reserve is basically the present value of future benefits and expenses, less the present value of future gross premiums, plus the present value of a reasonable allowance for profits. The question is what is a reasonable allowance for profit. Interpretation 1-D says that this should be consistent with the allowance used for current new business issued by the company that will be assuming the risk. Assuming that the acquired company will continue to operate as a separate entity, it is typically interpreted that the allowance for profit should be something close to the GAAP margin on new business being issued by that company. If you have a mature home service or combination company, or even a very mature ordinary company, the profit on the in-force business is very much different than the profit on new business. The risk in the Defined Valuation Premium Method is not that you will set the allowance for profit too high; most typically it is that you will set it too low. Obviously, set at zero, you are sitting right on a gross premium valuation. So a lower net reserve is the result of using a very low profit allowance.

The second area is the treatment of negative reserves, and practice varies. Your choice of alternatives can be very significant. You can end up with a negative reserve on policies and block of business under purchase GAAP for several policy years; negatives much larger than those you have under net

historic GAAP reserves. Is that negative reserve, either in total, or in part (i.e., the part that exceeds the negative historic reserve), a valid thing to recognize as an asset? Some people have said yes, the negative reserve is okay; we will leave it negative even though it is two times as negative as the net historic GAAP reserve on the same block of business. Some people have said no, that you should zeroize the reserve; obviously a major impact. If you zeroize, it makes a difference whether you simply take it to zero and let that difference fall through very quickly as the reserve moves to a zero position, or whether you zeroize by lowering the valuation premium (i.e., increasing the profit allowance).

The third area is the provision for tax; some people do and some people do not. The Academy guideline says that if the cumulative deferred tax liability is dropped, the reserves should make a provision for the future taxes expected to be paid on the block. This is great in theory, but practice is something else. First, there is a problem of determining the appropriate tax situation for a closed block of business in force on one or more of the company's lines of business. Second, I do not know anybody that keeps premium income, commissions, benefits and general expenses separate for new business and old business. As a result, it is at least a little bit difficult to do a "with and without" deferred tax calculation just on new business. As is probably clear, you run into a lot of problems in practice trying to tax effect and comply with the essence of everyone's guidelines.

The fourth area is paid-up. Future profits on paid-up business would be present-valued into the opening balance sheet under the Defined Valuation Premium Method. You have no future premiums and you set your interest rates consistent with the yield rates on assets restated to market. The Defined Valuation Premium Method results in bringing those back to the opening balance sheet, if applied literally. This obviously changes the level of future earnings which would have been, and will be, reported.

A summary of the problem. Even if everybody says that they have followed the Defined Valuation Premium Method, there are several not-so-obvious considerations in a practical application of the Method that can result in completely different results coming out of what appears to be the same method. There can be surprising and sometimes illogical results. If you apply the Method literally, you would not have zeroized reserves; you would have taken back all the future profits on paid-up business; you would have set the profit allowance equal to that on new business, etc.

Just considering the write-off of goodwill, there is a lot of difference in incidence depending upon whether you are amortizing this over, say, 10 years or 20 years, or you are using a sum-of-the-digits type of write off on a block of business (and even then depending upon whether the write off is based on premium income or future profits), or you are spreading it uniformly over forty years. Purchase GAAP earnings can materially differ from historic, even if the Defined Valuation Premium Method is used in all cases.

Interpretation 1-D says you have to judge the reasonableness of the results by looking at goodwill in relation to other items in the balance sheet. This is an easy thing to say; it is a very difficult thing to do. Most frequently, there is a lot of pressure to restate quickly. Somebody does a purchase deal and you have to have pro-forma earnings within 30 days.

Away go the actuaries and the accountants. It is a major project because most of the time you have to recalculate all liabilities just like an initial GAAP conversion. Out comes the first answer and everybody sits back and says we do not believe it. So if I can say one thing, it is do not get pressured into a very quick response; take time to get comfortable with the numbers and test the impacts of alternative approaches in treating certain items; and get management involved. Management is obviously going to have to report on purchase GAAP results; it is the new "score card" of management's efforts. Even though there is a lot of pressure to restate quickly, this is one area where actuaries and accountants have to pull together, have to take enough time to be satisfied that expected future earnings (and the opening balance sheet) effects appear reasonable.

The provision for tax is a very general problem in that it overlays assets, it overlays liabilities, and it overlays the treatment of the in-force block versus what you do for new business. The problems in restating assets are essentially ones of dealing with the treatment of policy loans, appraisals of real estate and non-traded securities, and the amortization of premium/discount on bonds. Let's say that bonds were written down \$20,000,000. Do you amortize them over (1) the average lifetime of the bond portfolio, 13 years, or (2) the actual life by individual security? You can get a completely different incidence of write off. What are the tax effects on the adjustment to assets?

On the restatement of liabilities, you must first come up with what general approach or method are you going to try to take. Is it going to be Defined Valuation Premium Method, or is it going to be something else? You then have to develop some feel for the assumptions and the allowance profit. There is a lot of discovery to be done in the initial stages. The specific techniques and treatments of various items involved must be determined, one of the more difficult of which is taxes. Are you going to make full provision for tax in reserves, as called for under Interpretation 1-D, or are you going to leave it to the accountants (e.g., say here are the reserves, you worry about tax effects)? To extend the practical application a bit further, I would like to call upon Steve Bickel, then I would like to have John Head talk to us.

MR. BICKEL: I have four or five things I would like to mention. First, when a company uses some of these other methods, say historical GAAP reserves or statutory reserves, much of the inherent error in this can be cured by a careful job with goodwill. If it is necessary to keep using historical GAAP reserves, for example, so long as you project the future earnings recognizing that they will be determined by the historical GAAP reserves, you can work out a pattern of goodwill amortization which will offset much of the difference caused by not having revalued to current assumptions. When Corbett wrote his paper I submitted a discussion which demonstrated this conclusively for the case of his 5 year endowment policy example.

Secondly, on the negative reserve question, I have not run into that myself and I wonder if it is only the unitary reserve that is coming out in the negative. If so, frequently you could avoid the negative reserve when you re-classify 30 or 40% of those valuation premiums as a deferred acquisition cost asset. If that does not work, it is an asset and you should not zeroize it.

Thirdly, there is not going to be any good answer as to how we handle taxes until APB-11 itself is reconsidered. Maybe Bobby can enlighten us more on this. There is some indication that it may be reviewed some day. The FASB seems to be paying more attention to current value balance sheet approaches and maybe when they get through some of the other areas, they will pick up on the tax question.

There was an interesting development last fall when the International Accounting Standards Board came out with a recommendation that a discounted liability approach be permitted as an alternative to APB-11. If the FASB ever does pick up the subject again, they will consider this recommendation from the International Board.

Fourthly, on paid-up business, I do not understand the problem. The treatment Sam was describing is appropriate for paid up business.

Lastly, let me mention one technique which we have used at American General that is helpful in restating bonds to market and in keeping track of them in the future. We have generally done this on an aggregate basis, we have taken the entire bond portfolio, determined the aggregate discount to market, set it up and written it off over the average remaining lifetime of the bonds. If a bond is sold, we make a proportionate write down to the remaining aggregate balance of the unamortized discount. This technique has been quite helpful, since in some cases we have 3 to 5 different bond values for the same bond being carried in our statement because of partial purchases of the same company.

MR. JOHN C. HEAD, III: In essence, what we are really talking about is earnings, earnings per year, earnings per share per year. When I talk about earnings, when I talk about dividends, I am talking about earnings or dividends payable to shareholders, to stockholders, to owners of the company rather than the policyholders.

What we are really talking about in a purchase transaction is earnings, and again, almost on a replacement cost accounting basis, a current value accounting concept. My colleagues have talked about some of the theoretical approaches to merger and acquisition transactions in the insurance industry. Buying and selling life insurance companies, not policies, not blocks of insurance, but insurance companies. All of this is consistent with APB 016 on business combinations. Just to get some numbers in your mind, I would like to talk about specific transactions.

First, earlier this year was the closing of American Brands' acquisition of Franklin Life Insurance Company. This transaction had a \$650 million value. This transaction was accounted for as a purchase. In the proxy statement which was sent to shareholders of Franklin and of American Brands to approve the merger, historical net assets, net worth that is, of Franklin was \$350 million. The pro-forma adjustments were along these lines: investments were written down by \$20 million, deferred policy acquisition costs were written down from \$159 million to zero, the reserves for future policy benefits were written down by \$93 million, the present value of future profits was stated at \$263 million, and there were other adjustments of \$32 million; meaning that the net tangible assets of Franklin were \$558 million as compared to \$349 million immediately prior to the merger. American Brands paid \$647 million for Franklin Life, meaning that there

was \$89 million of goodwill created. So, there are some of the orders of magnitudes of the numbers that we are talking about; they are substantial, and they can have a big effect on earnings. The pro-forma earnings of Franklin were \$72 million on a historical basis for the year prior to the transaction as compared to historical earnings of \$76 million. So all the purchase accounting adjustments decreased earnings by only \$4 million.

Another transaction which again was very large, was announced in June 1976 and consummated in June 1977, was the acquisition by Continental Group of Richmond Corporation, the holding company for the Life Insurance Company of Virginia. The net assets at December 31, 1976 were \$336 million. Investments were written down \$46 million, deferred policy acquisition costs of \$82 million were eliminated, future policy benefit reserves were written down by \$141 million and deferred taxes of \$41 million were eliminated. There were some minor miscellaneous changes meaning that the net tangible assets subsequent to the merger were \$389 million compared with the historical net worth of \$336 million. In this case, however, Continental's investment to purchase Richmond was \$373 million; therefore, there was an excess credit, better known in the jargon as negative goodwill, of \$16 million. Actually, if you read the footnotes to the financials of Continental after the transaction took place, and after the accountants and the actuaries did all their work and review, the actual negative goodwill was \$39 million or approximately 10% of the net assets prior to the merger.

In the Continental Richmond transaction the pro-forma earnings were \$30.7 million for the year prior to the transaction compared to the historical earnings of \$30 million, so there really was no significant difference. I use this transaction because this was a very large transaction, really one of the first in the merger mania that is taking place in the industry. It is also one that has taken place long enough ago that we can now get a full complete year of financial results in a company after a merger. Also, since Richmond was acquired by an industrial concern, it was not fully consolidated with the operations of Continental Group and one can get a good feel for what is happening after the transaction. Let me recite to you the earnings stream of the Life of Virginia as reported for the five years, starting in 1971, \$18 million, \$20 million, \$23 million, \$24 million, for two years, and \$25 million; \$25 million being the earnings for the Life Insurance Company of Virginia for the year 1976. In 1978 that same company earned \$34 million. As you can see there was a rather large increase in the earnings for the Life Insurance Company of Virginia.

I would like to take a second to talk about, in essence, one number. One of the biggest numbers we have talked about here is deferred policy acquisition costs. Again, deferred policy acquisition costs are eliminated - wiped out from their historical basis to zero. In most transactions what you have then is an intangible asset called goodwill. Most of the time deferred policy acquisition costs are charged to income over a time period that is relatively short. Goodwill, however, is amortized over 40 years. I enjoyed the comment of my accountant colleague who said that this was a matter of judgment, but every time I come up to this matter of judgment, the number comes out 40 years. It is amazing how judgment equals 40. So, in essence, what you have done is amortize costs over 40 years which normally are amortized over a significantly shorter

period of time. What you have done is defer income by lessening an expense. You have shifted an expense item into the future which you would normally take on the front end.

In essence, what you are talking about here is a means for altering the time of the recognition of profits. This is very, very important as the stock market looks at it. The market pays for consistent growth in earnings, consistent growth in earnings dividends to shareholders. So you have a major mechanism for altering the recognition and the timing of reported earnings. Also as a corollary to this, you have a method for changing or altering your ratio of net worth to liabilities, the largest liabilities being the reserves for policy benefits. Therefore, if an insurance company is being acquired by an industrial concern, which is very concerned about its ratio of debt to equity, you have a method in essence for increasing or decreasing net worth and for changing the debt to equity ratio. This being very important for industrial concerns as they go to market selling their debt securities and wish to have the highest bond ratings. One of the major concerns of the rating agencies is the debt to equity ratio. One real trade off we have is that earnings in the past produced the retained earnings of the company. A purchase transaction will allow one to re-report these earnings, if different actuarial and accounting assumptions are made. There is even the possibility of increasing policy reserves, lowering book value, and increasing future earnings; therefore, those earnings that you reported in the past to build up the net worth of the company may be re-reported.

The market really is earnings oriented, it is dividends oriented, it is bottom line oriented. However, I caution company officers that the stock market will penalize companies if historical trends, and historical patterns of earnings are altered dramatically due to purchase accounting adjustments.

Finally, I would like to give again a brief comment on what is driving all this, why there is so much concern, and why there is so much literature being written. The life insurance industry is undergoing a dramatic evolution and change. The merger activity in the industry is continuing at an absolute furious pace and I do not mean small transactions in terms of \$10 million to \$20 million. I am talking about transactions that have a market value in excess of \$100 million to \$200 million. This is being fueled by high inflation leading to higher interest rates; higher interest rates leading to higher investment yields; higher investment yields leading to higher income taxes. One way to decrease income taxes is to buy more premium income. The industry has been unable to find a cost effective method of selling more insurance and basically found it is cheaper to buy in the market than it is to produce. It is cheaper to go out and buy a company that is selling than it is to go out and try to alter an agency structure, or to create more salesmen, or to do something that enables one to sell more insurance products. So one way is to go out and buy a company.

MR. TURNER: I would now like to call on Bobby Dunn to wrap it up, because he is on the Task Force of the AICPA now dealing with purchase GAAP, to give us some feel for where we are now and where we are headed.

MR. DUNN: Right now at the committee, we would like very much if we could decide as between the Defined Reserve Approach and the Defined Premium Approach, as to which really has the best theoretical support so that we could only have one method. It is becoming more and more obvious that the FASB wants and will, in its future pronouncements, do everything it can to narrow accounting alternatives for the same kind of transaction. So in the spirit of that, the Task Force would like very much if we could decide which really made the most sense in doing a purchase transaction with respect to revaluing reserves.

We are pretty much split up at the present time, some of us believe that there is more theoretical support for the Defined Premium Approach, others believe there is more theoretical support for the Defined Reserve Approach. We will probably end up not being able to solve that problem but we may be able to speak to it and in effect say: "if you acquire a company and you do not acquire much of an agency force or anything else, all you are really doing is acquiring a block of business". Then in effect you can conclude immediately that there is no goodwill and so all of the purchase adjustments, other than the obvious ones in revaluing assets, etc., in effect get forced into the reserves. So, in effect, you deal with the Defined Reserve Approach. On the other hand, if you have a company where it is fairly clear that there were intangibles acquired, agency force, etc., then there is probably more theoretical support for the Defined Premium Approach.

What makes some accountants most uncomfortable about the Defined Reserve Approach is that you have to first determine what portion of the purchase price was attributed to insurance in-force and quite often that purchase price is determined from the present value of future statutory profits. That is not necessarily a good number. You can come up with a lot of different answers to what you really paid for the business, depending on whether you are discounting statutory profits, GAAP profits, doing a gross premium valuation, etc. It becomes an arbitrary number. That makes the accountants uncomfortable because we cannot audit it. On the other hand, in using the Defined Premium Method, the selection of a profit margin even though it can be controlled a bit by saying it should be about what the profit margin is on current issues while we can audit that, in the real world because of paid up business and other items, companies can be a bit arbitrary in selecting the profit margin. Accountants do not like that. We are going to have to decide on which method is the lesser of the evils and select one.

MR. JOHN M. LOFTIS: Mr. Bickel, you mentioned several specific purchases where the earnings after purchase ranged from 95 to 106 percent of the historic GAAP earnings. Could you tell us, if it is not private, for those same companies what would be the range or the weighted average of the purchase price to the historic GAAP book value?

MR. BICKEL: I do not have the figures handy but they would range from 90 up to 150 percent. Some of these were different partial purchases of the same company and the price was based on market prices at that time.

MR. NEIL M. ANDERSON: I would like to ask Mr. Dunn if he thinks that there is any substantial likelihood, when the accounting profession does narrow the alternatives, if there will be retroactive application of such pronouncements.

MR. DUNN: I would be about 80% confident that retroactive application would not be called for, that purchases which have already been recorded will probably stay as is, and it would probably be only prospective for future purchases. There are a lot of purchases that were recorded in companies' GAAP that were using approaches that were quite a bit different than either of the two 1-D methods, it is inconceivable to me that we would go back and restate goodwill again.

MR. BICKEL: Let me add a couple of comments to that. First, when 1-D came out we did not redo any of ours. Secondly, the difference between the two methods is not very great. If you go back to Corbett's paper and review the numerical examples there, you will see that the only time there is a difference is if the purchase price is in the range where under the Defined Reserve Method, you have to start scaling down deltas. Under the Defined Premium Method you never scale down deltas.

MR. THOMAS K. PENNINGTON: Mr. Dunn made a comment I am a little puzzled about. I thought that the objective was to make accounting more consistent, but he indicated that there is a thinking that on purchase blocks you may net the acquisition cost out of the reserves or the unitary factor methods. It does not make much sense if I spend \$10 million to sell a block or to sell business, it winds up an asset, and if I buy a \$10 million block of business it does not become an asset, which does not seem consistent.

MR. TURNER: Bobby, would that only be then for purchase or would that thinking also go to historic?

MR. DUNN: No, that would be for purchase only, it is clear to me in reading APB 016 that what the selling company's deferred acquisition cost is at the date of purchase is an academic number and is no longer meaningful. What would be meaningful is if we did in fact know what we paid for a block of business and call that an asset. I have no problem with that; the problem is that often we do not know what we are really paying for the existing block of business and under these methods we usually end up with an arbitrary number. I am saying that there is some possibility that since that number becomes so arbitrary maybe we ought to view the whole valuation process as one unitary reserve and not bother with a reclassification in a purchase transaction. If we did know exactly what we paid for the block of business, yes, it should be called an asset, the problem is we do not know that number, most of the time.

MR. BICKEL: Let me add that Interpretation 1-D says that it is required to make the split. The reason it says that is because that is what Bobby's committee told us to say two years ago.

MR. BRUCE E. NICKERSON: Regarding the problem that was eluded to several times of the paid up insurance situation, certainly many actuaries are accustomed

to looking at a paid up life policy as merely an extreme example of the limited payment life policy and this becomes even more so in a purchase case where the business is aged somewhat and at the other extreme you find a yearly renewable term policy to age 100 as being the other part of the scale. The question from Mr. Dunn is whether the accountants have been giving any thought to the possibility in this profit margin type calculation that investment income might also be considered part of the revenue stream to which profits are attributed.

MR. DUNN: We have not, simply because we decided with respect to historic GAAP, at least, that the principle would be that we would recognize loading profits only with premiums, e.g. if you had a single premium policy you get all your loading profits at the time you wrote the single premium policy. That was a very controversial thing; we closed our eyes and did it because we were not getting anywhere as we debated whether or not to put investment income in the revenue stream. The overriding historic GAAP answer was: "no, we are not going to do it, investment earnings will flow through as they happen as you have favorable or unfavorable variances". So, we cannot use purchase accounting as an excuse to do that. When audit guide #2 comes out this may be reconsidered but it will not be reconsidered in the purchase accounting context.

MR. TURNER: I have worked with two of the big-8 accounting firms that say that purchase GAAP is not conceptually the same as historic-GAAP; therefore, profits need not emerge solely on premium income; a delta on paid-up is acceptable as an allowance for profit and that there is nothing that says that expected purchase-GAAP profits must emerge as percent of premiums.

MR. DUNN: On paid up business the most practical answer is to just deltaxize the interest assumption enough so that you can get some profits and do not fool with anything else.

MR. TURNER: It points to the difference between theory and practice. Theory now is really an interpretation. The bottom line is exactly what John Head said, that top management and everybody involved in a restatement understand that any major change in the earnings, let us say, level and incidence, would be penalized in the market place. You could not come up with purchase GAAP at 50% of historic or 150% of historic without creating a lot of raised eyebrows. He cited two cases where the pro-forma was dead on historic. Steve cited examples of eight companies whose purchase prices ran from less than historic book to 15 times historic GAAP book and whose earnings after restatement were nevertheless essentially the same as before restatement. I submit to you that those are not all by accident.

MR. DUNN: With respect to these new purchase financial statements some of you may have noticed that some companies in effect incorporate down into the acquired company level the purchase adjustments and do away with the historic-GAAP numbers. This is in fact the most practical approach to doing a purchase transaction, if you acquire 100% of the company. The problem is if you have minority shareholders left, the financial statement to the minority shareholders are still historic-GAAP and you are trapped

into having to prepare historic-GAAP numbers and purchase-GAAP numbers, but no use in keeping up with historic-GAAP numbers if you get 100% of a company. Just push the adjustments down and drop your historic-GAAP numbers.

MR. BICKEL: A registered separate account caused the same problem.