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ACQUISITIONS AND MERGERS

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MR. STANLEY B. TULIN: The subject of this concurrent session is Acquisitions and Mergers. The program left the subject rather vague deliberately because we thought this would give us an opportunity to design a session that (a) responded to whatever was of interest today as opposed to when the program was printed, and (b) hopefully would give those attending the session an opportunity to participate in the session by asking questions and getting involved in talking to the panel.

The subject of Acquisitions and Mergers is an exciting topic. One finds that there is a new glossary of terms to learn: White Knight, Target, Shotgun Marriage and many more. In fact, I have found that every once in a while in Acquisitions and Mergers areas there are flashes of romance, usually preceded by several weeks of intense work and long hours being followed by several weeks of intense work and long hours. What we hope to do today is talk more about the intense weeks and long hours that both precede and follow the brief flashes of romance.

What I would like to do now, is have Mr. Lathrop talk to us about his view of what it is that the investment bankers do. Later, Mr. Milo and I will tell you what they really do and also his view of how we all work together and what is happening in this marketplace. Then after Mr. Milo talks to us, we will start a joint discussion.

MR. JOHN C. LATHROP: We are broadly charged with talking about problems and procedures in Acquisitions and Mergers. So with that very broad charge, let me set forth and talk to you about the way we see the procedures in the Acquisition and Mergers process, and the problems associated therewith. First, let me try to address what the role of the investment banker is.

One party of the six or seven parties usually involved in an acquisition has to orchestrate the entire process, and typically it is the investment banker. The other parties involved are the actuarial consultants, tax consultants, management consultants, and accounting consultants. The importance of the orchestration is that in the acquisition and merger arena, time is almost always of the essence.

The first task that an investment banker or sometimes one of the other consultants faces, if working for a buyer, is to identify a takeover target. This used to be fairly easy in the life insurance industry up until a year or year

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and a half ago. It is a very broad industry, highly fragmented; there are many companies out there; some of them are predisposed to sell; many are second or third generation family managements, not as aggressive or attached to the business as the founding principals had been and inclined to "cash out."

The problem that has developed is really a result of what has been taking place in the marketplace in terms of products and distribution methods in the last year and a half. It has been fairly difficult to settle on a traditional general agency or career agency operation or even a debit operation in the past. With the turbulence with regard to product and distribution, it is not so clear anymore. The product has become far more competitive than it had been. Companies are more inclined to forego keeping the excess investment income for themselves and now pass it along to the consumer. The business isn't quite the "no-brainer" that it had been because of the change in product. There are new questions being raised about distribution systems. What had been an effective and efficient distribution system under the profit margins of the old products is now called into question.

We find it an extremely difficult task these days to tell people where to look, or how to identify a target that is going to be around another ten or twenty years from now. The one easy solution to this is to look at the direct marketing companies. That choice is easy; the second step is more difficult because there just aren't that many around. Most of them are wholly owned; there are only a very few free-standing direct marketing companies.

On the selling side of the equation, the principal problem is to sell to whom and for how much. Up until a year and a half ago, the "to whom" question wasn't very difficult. There were a lot of buyers around and one could take his choice. Also "how much" wasn't a very difficult decision. Life insurance companies were commanding substantial premiums in the acquisition marketplace regularly selling over two times GAAP book value and over 14 or 15 times GAAP earnings. This is now an issue as I described about the concerns of the buyers. Besides the obvious impact on sellers, there aren't as many people to turn to, and the value question really doesn't involve as much gravy as it had before.

Another aspect of the weeks and hours of intensive work that Mr. Tulin talked about and the first one that we really face, is that of the projected returns that a buyer feels are reasonable and that a seller would feel comfortable in presenting to prospective buyers in order to justify the value that he is asking for the firm. First of all, this goes back to the changing nature of the marketplace and it is not so clear that the traditional rules of thumb or actuarial techniques hold up any more — traditional in the sense that it had been fairly easy to make the major assumptions about growth and mix of business based on the past. This process is not as easily accepted now as it had been. We as financial advisors find it difficult to accept those assumptions at face value any more and so do our clients. Often it is still the best that we can do because predicting the future and the nature of the marketplace in the midst of so much change right now is very difficult. The other aspect about projected returns that is quite complicated and involves a lot of work and consulting advice is tax. We spend a lot of time on tax issues with life insurance acquisitions because of the opportunities that a liquidation presents in an acquisition.

Another area that we find difficult and time consuming is the projected financial statement returns. This is usually of primary interest to buyers and al-

most supercedes the interest in projected economic returns, sometimes. But really, the question of dilution and the amount of goodwill is the one that is foremost in a CEO's mind as much as the question of economics. This again is very difficult because of the flexibility and uncertainty involved in GAAP assumptions and, particularly, under purchase accounting guidelines.

Two issues that we face are whether we want to structure the transaction as a taxable deal or tax-free deal and, whether we want to use cash or one of the various forms of securities. In addition, an important role for the investment banker is coordination of the negotiating process. It is an area where one is better off having an outside advisor rather than trying to handle it by oneself. It is like the attorney who tries his own case. He has got to pull for the client. The same thing applies to one who tries to negotiate his own deal. A client may be a skilled negotiator in his traditional business transactions, but when it comes to the subject of his entire company, we find that clients often lose their perspective. They don't have the judgment and perspective in the marketplace as to what kind of values are commanded and also they tend to get very emotionally involved, which is certainly no way to negotiate.

An interesting point is how the valuations and negotiations tend to develop vis-a-vis the actuarial appraisals which are almost always evident in a life insurance acquisition. There is almost always a complete appraisal done by one party or the other and the other party almost always does its own appraisal or launches off the model of the other party's appraisal and inputs his own assumptions. I have seen the valuations and negotiations cover the whole spectrum from total disregard to the actuarial appraisals to very close adherence to the appraisal where the negotiations actually revolve around the related major assumptions and components of value. That is about as rare as the total disregard for the actuarial appraisal. Usually it falls somewhere in between and the appraisal is often used as a starting point for negotiations.

I would like to conclude with a brief summary of my outlook for the market for acquisitions of life insurance companies. The supply and demand equation has shifted rather substantially in the last year and a half, moving from one where demand greatly exceeded supply to one that is much more in balance now. A number of buyers have retreated from the market. Neither foreign buyers nor U.S. industrial corporations are nearly as active as they have been. In both cases, companies are intimidated by the turbulence in the marketplace for the life insurance products leaving the large domestic U.S. insurance companies as the principal acquiror of other life insurance companies. You have seen two classic cases in point here of the strategy in play with American General's acquisition of NLT and Gulf United of trying to create economies of scale by being on the buy side of the transaction. The frequency of acquisitions is going to continue apace, though. The economics are just too compelling, the industry is too fragmented and we really don't see any letup for the next five years ahead.

MR. RALPH MILO: We are going to put something on the board which will serve as a frame of reference for a case problem. I would like to speak from the standpoint of the objectives of a company in regard to the financial tax when they are looking to acquire.

Illustration (Blackboard)
(Figures in Millions)

Purchase Price		\$ 30
Liabilities Assumed		
•Statutory	\$175	
•MSVR	(5)	
•Policyholder's Surplus Account (46%)	2	
•818(c)	<u>28</u>	<u>200</u>
		\$230
--Allocated--		
Statutory Assets		\$260
Adjusted to Market		
•Non-Admitted	\$ 2	
•Bonds	(40)	
•Mortgages	(25)	
•Real Estate	<u>5</u>	<u>(58)</u>
Market Value of Assets		\$202
Intangible Assets		
•In Force Business	\$ 21	
•Agency Force	2	
•Goodwill, etc.	<u>5</u>	<u>28</u>
Total Assets		\$230

From the standpoint of a public company, earnings are very significant. Therefore, we have two opportunities. One would be a pooling arrangement, and one would be a purchase accounting arrangement. In a pooling arrangement where I utilize my stock to acquire stock or assets which meets all the rules of a pooling, I just take on that company as it is. I don't worry about amortizing goodwill or amortizing any of the intangibles which would serve as a reduction to my income in the future. I just take this company on as if it were always with me. I have a dilution of stock, but my earnings are enhanced greater than would be the case under purchase accounting, which in many instances would probably give you a decrease in earnings, depending on the amount of intangibles.

Being very earnings conscious, my first objective would be to look for a target company which I may be able to obtain on a stock basis as opposed to buying it with cash, and I want to meet the rules of pooling. Also, looking at my stock, right now, it is selling at a very high multiple which puts me in a position of saying, it is cheap paper to make the acquisition. My management doesn't like hearing that statement, but from the standpoint of a high multiple, the stock is doing very well. If you think of companies who did a lot of acquisitions while the stocks were high, they are in much better positions. So again, the pooling to me is appealing.

Another reason why pooling is appealing, is because of my tax position--my company has significant tax loss carryforwards. Having significant tax loss carryforwards puts me in a position of structuring the transaction so that it is consistent with my tax position, but more importantly it puts me in a better competitive position. If a company wants to purchase a life company, it has two options: a non-taxable and a taxable acquisition. A non-taxable acquisition, would be utilizing your stock. A taxable acquisition would be where you utilize cash and some stock, but cash is involved. If you make a taxable acquisition, the effect of the transaction is such that a portion of your purchase price can become a tax deduction -- a tax benefit to you. That would be extremely important for companies that are acquiring life targets where they have taxable income and they want to generate as little taxable income as possible from the acquired company. Therefore they would look for a taxable acquisition. There is a disadvantage, however, when you go through this make-believe liquidation which is what it is right now. That is, you trigger a Phase III tax to the extent of the policyholder surplus account. Now you have a trade off. I am going to get a tax benefit for a portion of the purchase price deductible over ten years. The present value of that tax benefit needs to be compared to the cost of the Phase III tax that you will pay immediately. Since I am in a position that I don't need a tax deduction from the acquisition, and I don't need the liquidation to give me tax deductions, I might opt to try to do a non-taxable deal. I would look for a company which would have a high Phase III tax. Any company against me in the bidding to acquire this particular company is not going to be able to avail itself of a tax deduction according to Section 338 for a portion of their purchase price, because the cost of the Phase III tax will be much greater than the amount of tax benefit they get from this tax deduction. With that in mind, my target companies will be companies which will have a high Phase III exposure so it rules out anybody going against me who is going to get a tax benefit on this acquisition. Also, I would try to utilize my stock. If I utilize my stock rather than utilizing cash for the acquisition, the sellers would have a deferred capital gain. The principal difference from a seller's standpoint of a tax-free and taxable deal is the treatment to them as far as the capital gains tax.

To the extent that the sellers have a very low basis in this company and you have a taxable acquisition, they have a capital gain, and they pay tax immediately. To the extent they have this low basis, they may find very appealing the possibility of deferring any capital gain by giving them stock. What happens on a tax-free acquisition is that you give the target company stockholders stock of your company. What happens is the government says, well they haven't really closed the transaction because all they did was give stock for stock for assets so the transaction wasn't closed, therefore, there is no tax incidence involved and that is tax-free. Tax-free acquisitions involve the acquiring company giving stock for the most part to the stockholders of the target company. They do not have any gain at that point. They have a gain only when they sell the stock. Their basis in this new stock they got from the acquiring company is the same basis they had in the target company stock. So what happens is you just carry forward the basis. So if I had a \$1 million basis, which is what it cost me to develop my target company and now the target company is worth \$100 million, and I give them \$100 million of my stock, they have no capital gain. When they sell the stock, they will have a capital gain for the difference between the \$100 million and the \$1 million, which is their basis.

I have a loss carryforward and now I am going to utilize my objective to buy a company that will generate income utilizing that income against my losses. The rule on consolidation is if you purchase an insurance company and you are permitted to consolidate with that company and that company has a carryforward loss (e.g., you purchase a company in 1983 and at the end of 1982, that company had a carryforward loss of \$5 million) that company is part of your group in 1983. That loss of \$5 million can only be utilized against the income of that company. That loss cannot be utilized against the income of the acquiring company — the parent company. That is called a SRLY (Separate Return Limitation Year). The loss was generated in a year in which you were filing separate returns, in a year which you were not filing consolidated, nor could you file consolidated. That loss can only be utilized against the income of the subsidiary which generated the loss. Therefore, I can't buy any subsidiaries which have existing carryforward losses and expect normally, without creative planning, to utilize those.

What I would probably do is convert those losses from SRLY to non-SRLY. The way I would probably do that is before acquisition, I would go in and have that company enter into a reinsurance arrangement. The reinsurance arrangement would generate \$5 million of income which will offset the \$5 million of losses. This would be in 1982 — 1983 being the year of acquisition. In 1983 this company comes into the group without any losses. In 1983 assuming I wanted to be frivolous about the whole thing, I would cancel the treaty, and in cancellation of the treaty, the loss which was transferred out (the surplus relief) now becomes surplus strain. So the loss emerges now in 1983 of \$5 million. What happens is, that \$5 million is no longer a SRLY because the loss emerged in the year in which we were finally consolidated. There is no reason why if you had to make an acquisition in which there was a loss carryforward, you couldn't structure it so that you can convert the SRLY loss to a current loss through reinsurance. You may not want to be this aggressive to trigger the whole transaction in one year, but it is justifiable because usually what happens is you enter into the transaction before the acquisition. Now there is new ownership, and they see no reason for surplus relief. They have enough money that they don't need to pay reinsurance costs for surplus relief. I think you can develop a very good business argument that a company considering sale or a company that is considering purchasing another company should do a lot of pre-planning before the date of acquisition.

In a non-taxable deal there are three forms that life companies use. The first form is an A Form. It is Section 368(a) of the Internal Revenue Code. That is a simple merger. You merge two companies together or you merge a new company and an amalgamation. These all fall within the umbrella of an "A" reorganization. A "B" reorganization is where you just exchange the acquirer's stock for the target stock. A "C" reorganization is where you utilize the acquirer's stock to take the assets. In a B and C reorganization, the stockholders always have to agree to take stock, which is somewhat difficult unless it is very closely held, as there are many stockholders who would object. Some want stock plus they want a tax deferral and others don't want your stock. The only flexible tax-free acquisition method is an A reorganization. An A reorganization which is a merger type, and you can do it through subsidiaries, can be done in the same fashion a B or C. In an A reorganization which is a merger you are allowed to pay as much as 50% in cash and 50% in stock. Where you have certain stockholders who do not want stock of the acquiring company, you can give them cash without hurting the taxability of the other

stockholders who elected to take stock. You have got to do more than a 50/50 split. You can probably have 30% in cash, but the IRS will only rule on a situation where it is 50% cash and 50% stock.

A merger is probably the only flexible way of obtaining a tax-free deal because of certain stockholders who will not accept stock of the acquiring company. However, once you give \$1 of cash, you rule out the possibility from an accounting standpoint of a pooling. Even though you have a tax-free deal you will not have a pooling. The rule on pooling is in order to have a pooling from an accounting standpoint, you must have a tax-free deal. But just because you have a tax-free deal does not mean you fall within the scope of a pooling for accounting purposes. Pooling for accounting purposes is very strict. In fact, if there is treasury stock involved, you can blow the pooling. You can achieve tax-free status, but not necessarily posture yourself to have a pooling for accounting.

The taxable transaction is where you are giving cash for stock or you are giving cash and stock. If I acquire the stock of another company, and give them 99% of the purchase price in stock and give them \$1 in cash, that is a taxable transaction. On a taxable transaction you have the potential of taking a tax deduction for a portion of the purchase price. The seller has a capital gain, so he is going to adjust his price accordingly. You avail yourself of a potential deduction for a good portion of the purchase price. In some acquisitions I have seen as much as 60% to 70% of the purchase price allocated to this intangible called inforce insurance where you can take a deduction over the reasonable determinable life of that business which has generally ranged from 6 to 12 years. I question with the type products that exist right now that persistency will be that great that you will be able to take that long. It probably will be more like two years.

In a Section 338 liquidation what happens used to be found in another section called 334(b)(2) which is probably one that you might have some familiarity with. What 334(b)(2) did in the old days (prior to October of 1982) was to permit you to purchase a company for cash and then take that company because you now own the stock of that company and liquidate it. You can liquidate it into a newly formed company that was used to make the acquisition or liquidate it into the parent. Usually what happened was when you went into purchase you formed a holding company and that holding company made the acquisition with the plan involved that you were going to liquidate that subsidiary into the holding company who was going to be relicensed as an insurer and it would carry on the business of the subsidiary.

The purpose of the legal liquidation was to avail yourself of an opportunity to take a deduction for the purchase price. Now it is as if you purchase assets. That was a tedious requirement on many companies, especially insurance companies who had to go out and relicense themselves. Often it took as much as two years to accomplish this. This is very easy now under Section 338; in effect Section 334(b)(2) was repealed, and is no longer in the IRS Code. Section 338 says you can make believe you did what 334(b)(2) actually did. You have 75 days after the acquisition to elect irrevocably to make believe liquidation. If you don't make the election within 75 days, you cannot avail yourself of Section 338. This has made it very easy for companies who want to try to get a deduction for a portion of its purchase price. What they do is step up the basis of the assets so that they can take a tax deduction for the

intangibles that they purchased, which have a reasonably determinable useful life. Of course, there are some costs in doing that.

To the extent you liquidate a company, even though you make believe you liquidated it, you make believe you did everything else. You recapture your depreciation and investment credits which means that you pay tax. Your whole policyholder Surplus Account is considered to have gone. So you have a tax on your Phase III. There was a theory on the tax benefit rule which held that to the extent you took a tax deduction for an item (e.g., a manufacturer takes a tax deduction for tools) and now you liquidate under 338 and there is some value for those tools, you should pay tax on the value of those tools. This is referred to as the tax benefit rule. The IRS tried to apply the same tax benefit rule theory to acquisition costs and failed. They came back and said that it doesn't apply. The tax benefit rule which is another factor in liquidation does not apply to life insurance companies in regard to the acquisition costs. Basically, the taxable transaction is the one that most of you are interested in because that is the one that is going to provide you with some tax benefit. When you look at the present value of the tax benefits that you can avail yourself of there is a significant benefit to you on the tax side for the acquisition.

What we put on the board will serve both for Mr. Tulin's discussion and for further exploring the relationship between the tax, the accounting, and the actuarial aspects. We are assuming that the purchase price is \$30 million. Under 338 you would be allowed to make a portion of the purchase price deductible. Now we want to determine if any is, and how much. The first part of the calculation which is not controversial is trying to determine the adjusted basis of what we bought. Once we know the adjusted basis of what we bought, then we can allocate or determine how much should be allocated to intangibles, how much should be allocated to hard assets, etc. The purchase price was \$30 million. We would have statutory reserves of \$175 million. MSVR's are \$5 million (that is not a real liability). The formula is the adjusted basis is equal to the purchase price plus liabilities assumed. The purchase price is clear.

Now we are going to look at the liabilities in case there is some controversy over what liabilities can be included. The first liability is the statutory reserve that you picked up. That is \$175 million in this case. The MSVR is not a liability so that gets added back. The tax on the policyholder surplus account is a liability. You go into a 338, and you make believe you liquidated; therefore, you have a tax on the policyholder surplus account. That tax liability gets added back. You will see that the liabilities become a very significant factor in determining the amount of deduction you will get. To the extent that you did have a tax liability on your policyholder surplus account you only get a portion of that back. The 818(c) amount is \$28 million. This is the controversial liability. There has been a lot of tax planning in order to posture a company in a position where they can determine tax benefit by assuming 818(c) business. Formal conversations with the IRS indicated that they have problems with the liability in regard to its assumption under a Mod-co 820. They said they had problems with it and the ruling was withdrawn. They did, however, indicate that on normal business and possibly on coinsurance, they really didn't see a problem with it. We were asking in regard to Mod-co and they were not about to give us a ruling in regard to Mod-co because they said no rulings were going to be issued (this was 2-1/2

years ago). They misunderstood their own restrictions on rulings because that is not what the restriction said.

In effect, the adjusted basis, which is equal to the purchase price plus the liabilities assumed, is \$230 million. Now I have to take the adjusted basis and I have to allocate all my assets to the adjusted basis. Once I allocate all my assets to the adjusted basis, then I can identify all assets, including the intangibles which would give me a tax benefit. So the next computation involves just that. I have statutory assets of \$260 million which I have to adjust to market and I have non-admitted assets of \$2 million. Bond reductions adjusting to market, mortgage adjusted to market \$25 million and real estate appreciation of \$5 million. I have a reduction to fair market value from the statutory assets of \$58 million. The fair market value of my assets now are \$202 million; these are the hard assets.

I now determine my intangible assets, and here is another controversy. If you notice, I came up with inforce business of \$21 million. I developed a value of agency force equal to \$2 million and I developed a value for goodwill equal to \$5 million, and that comes out to \$28 million, which with the \$202 million equals \$230 million in total. In this case, I have business in force of \$21 million. I would be entitled to a tax deduction over the determinable useful life of the inforce business. It might be over 10 or 12 years. How that is determined could be the difference between an accounting and a tax side. The agency force is a questionable item. The basis of the argument for allowing a deduction or not allowing a deduction is that any intangible which has a reasonably determinable useful life, can be deducted. To the extent it does not have a reasonably determinable useful life, then you can't take a deduction. Goodwill does not have a determinable useful life. In force does have a reasonably determinable useful life. The question exists does an agency force (a) have any value at all, or (b) to the extent you put a value on it, does it have a determinable useful life? I advise all clients to keep that low because you aren't going to get anything for it.

MR. TULIN: The role of the actuary in mergers and acquisitions involves everything that happens, but in a detail and numbers oriented way as opposed to the more global aspects of putting a deal together. There are three main areas in which actuaries play a very important role. Mr. Lathrop talked about two of these, actuarial appraisals and purchase GAAP accounting. The third area, which was described by Mr. Milo, is the taxable liquidation.

The actuarial appraisal itself has a long and somewhat colored history in our literature. There have been quite a number of papers written on appraisals both in the Transactions and in other actuarial literature. The basic technique of developing an actuarial appraisal is one that probably most of you are familiar with, but we can go over quickly. The concept hasn't changed that much in, say, 30 years. The application of it has changed considerably and the use of it is quite different than it was ever considered to be. The concept was that basically the value of the life insurance company could be broken down into three major components.

The first component is the one that everyone understood before GAAP accounting and before reinsurance deals. That is the statutory adjusted book value which used to be statutory surplus and things like MSVR and deficiency reserves and other kinds of appropriated liability amounts. A significant change in just that element over the past 5 to 10 years is worth a little bit of dis-

cussion because the impact of surplus relief and other planning oriented reinsurance agreements has colored the calculation of what we used to call the adjusted statutory book value and what we all used to be able to get out of a blue blank in about 5 minutes of analysis. It now takes maybe 5 days of analysis and considerable conversations with companies that publish the blue blanks in order to get any kind of intelligent flavor for what the real adjusted statutory book value is.

The second component and generally the largest is the value of the existing business or the insurance in force. The method used to determine that really hasn't changed at all in 30 years. The method involves a projection of the runoff of that business, taking into account the various actuarial assumptions that have to be made including mortality, morbidity, interest, expense, lapse, etc. What we have found is that instead of being able to do an appraisal and arrive at a range of value, maybe using different discount rates to reduce projected profits to present value, we are now asked more and more often to use the same technique but not to develop an appraisal with a range of value. Instead we are asked to develop a grid that reflects different impressions of the future based on the past and also on what we see the future bringing or what one of our clients sees coming.

Secondly, we are asked to measure the sensitivity of the value of a company to the volatility of the marketplace. The volatility of the marketplace is something that we all have to deal with. The insurance marketplace is not the stable place that it was and may never be that again. That which we have to offer and that which people want to see is no longer an appraisal or an opinion that says we think the value of this company is "X". If the value of this company in this environment is one number, then the value of the company in a totally different environment is another number. Basically what we are doing is using our skills as actuaries to bracket the reasonable valuation for an informed buyer or seller. It is ultimately up to the buyer and seller to assign their distributions to our valuations and come up with their appraisal. What used to be an appraisal is now more of a mechanical exercise that results in a large grid. This is a change that has taken place over a period of 5 years because certainly as recently as five years ago there was a considerable number of pure actuarial appraisals where there was no grid. I would say that the number of those today is very small.

The third component of value which gives rise to even a larger grid, is the value of the future business. This is where the actuaries, particularly in the literature and to a certain degree in the real world, have certainly departed from the rest of the business community. Valuing future business by projecting the profits that can emerge from it, based on reasonable assumptions as to future production, is certainly a way to quantify what everyone seems to believe is a completely intangible thing and put it into true economic terms. On the other hand, it involves a multitude of assumptions about the future, including the profit margins on products to be issued ten years from now, not to mention the mix of business from products ten years from now. The level of future production in effect becomes more of a contest in imagination than any kind of a real quantification of value. What I have seen happening is that the actuaries are asked to help to measure potential economic value by using the same techniques. The notion that the three pieces were additive, which really used to be used often to get a value of a company, is rapidly beginning to disappear.

First you have the fact that the adjusted book value which certainly is ascertainable even though it might take a little more work, is a number. Combined with the fact that it now may be added to a grid that might have 20 numbers in it and also that we used to add it to a number that now is more of a potential than an actual value, you have three numbers that are very different in terms of the solidity of them being added together. So the actuarial appraisal as such has changed from a means of valuing a company to a means of measuring the potential of a company and also what there really is in a company — the hard assets of a company if you include its in force as hard assets. It hasn't reduced the number of actuarial appraisals that are done, it has probably increased the number and has increased their usefulness to the people who use them. Nevertheless it has been a significant change in what we do.

The second thing that we do which is important in the pre-acquisition stages, is these pro formas or projections of purchase GAAP consequences assuming that the deal that is contemplated is a purchase. There the evolution is not yet finished and certainly hasn't developed to the degree that it has on the actuarial appraisal side. There is tremendous demand to know what the earnings consequences in terms of GAAP earnings will be after acquisition. Since you don't know what the purchase price is, you don't know really what purchase GAAP is and you are not at all sure what the taxation will be. Nevertheless, deals won't move forward without these pro formas. The major complication today is that the guidelines to purchase accounting that are in our literature and are published in the Academy's guidelines are so flexible they make virtually any earnings projection appear to be reasonable or at least defensible with assumptions that can legitimately be made. Secondly, the accounting profession really never did understand or buy what it is that we put in the Academy's guidelines and is working on its own set of guidelines for purchase accounting. It is not completely independent; there is some actuarial input to what the accountants are doing. The truth of the matter in purchase accounting is that the AICPA Task Force has been going on at least three years and hasn't come close to anything that makes sense or reduces the flexibility of purchase accounting.

There are two things we do. The first is bring to a buyer's and often to a seller's perspective the view that the earnings can be very different depending upon what the objective of a new owner is going to be. If your objectives are to achieve rapidly growing earnings regardless of performance, that can probably be achieved. If your objective is to avoid dilution, which is simply a reduction in the earnings per share, that can be achieved by getting a very high base, probably at the cost of future growth and earnings. What we have tried to do is show reasonable ranges where reasonable people might go in setting assumptions under purchase accounting.

The basic principles of purchase accounting are that you restate both the assets and liabilities to fair market value using current assumptions. One of the great frustrations for the actuary of the company that has been acquired (for the first time) is when the accountants will come to you some day and say we want the liabilities of this company restated to fair market value at current assumptions. When you go to think about that, you realize that what you have is one equation with two unknowns. You always have the net premiums that work at issue where the concept is that the present value of future benefits is equal to the present value of future net premiums and you fund for this over a level period. If you look at a policy in the fifth year, how do you determine what the present value of future net premiums is without making some assump-

tion about the relationship of the net premium to the gross premium? That is one of the major variables in this whole thing, and it is one of the reasons why the answer can be a lot of different things. From an actuary's perspective within the company it is something he will want to become more and more familiar with as more and more companies go through Purchase GAAP. My hope is that some time within the next five years the AICPA and the Academy's committee will get together to come up with something that cuts down a little on the flexibility and arrives at some sensible guidelines for purchase accounting.

The third thing that the actuaries are called on to do is work with the tax people in developing a valuation of insurance in force for taxable liquidations. The technique that is used is basically an outgrowth of the technique that is used for valuing the existing business in the three-part actuarial appraisal. The assumptions often are similar. The discount rate has to be one number since you are now not trying to develop a range. This leads to some interesting discussion and some interesting assumptions and you can't do the flexibility test or the grids that we used to do. So for now for valuing a block of business for tax purposes you are left with trying to arrive at a number or a point within this great grid of yours. The one other thing that is slightly different is that which we discount to get the present value. In the actuarial appraisal you discount the projected statutory earnings because they reflect true economic value in the sense that they determine solvency. They also determine the capacity of paying dividends to shareholders and things that really relate to cash for the insurance industry.

For developing the value of the insurance in force, what we really are discounting is the stream of future tax-basis gains before special deductions. Whether or not the IRS agrees with that or whether or not the IRS even accepts the notion that an actuarial appraisal of the existing block of business based on quantitative techniques as opposed to global techniques makes sense is something that nobody really knows yet. Nevertheless, every liquidation that I am familiar with has gotten an actuarial appraisal and has used it largely as the basis for assigning value to insurance in force before the allocation process begins. They have used an actuarial appraisal as the basis for determining the value of insurance in force and that actuarial appraisal has typically been developed on the classical basis with the one exception that it is based on a new tax balance sheet. It includes the release of the 818(c). You can change your timing difference on 818(c) to a permanent difference. The reason that you do that is that in effect by putting it onto the new balance sheet and by making it a part of the value that you are going to write off, you no longer write it off, because as your timing difference is realized and the 818(c) comes back again into income in Phase II, you get a deduction for it for the value of business. You recognize the benefit before and it becomes permanent after because you are matched. Whether or not that stands no one knows yet. The other thing that is different is in the establishment of an interest assumption for valuing the insurance in force. Since the balance sheet gets restated to market value, the interest assumption that you use for crediting interest on reserves in your valuation or insurance in force is reasonably one that is based on the market value of the assets. The interest assumption has, in today's environment at least, been a much higher interest rate than the Exhibit 2 portfolio rate of a company that was just acquired. Those are the major differences.