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## PURCHASE GAAP ISSUES

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Purchase GAAP is currently under discussion by the Emerging Issues Task Force of FASB and that group is dealing with a number of issues. This session will give you the opportunity to learn how people who are expert in this area are dealing with these issues.

MR. HOWARD L. ROSEN: I am vice president of financial reporting for CONSECO in Carmel, Indiana. Brad Smith is a consulting actuary with Milliman & Robertson in Dallas, and Art Schneider is a CPA and a tax partner with KPMG Peat Marwick in Chicago. Our topic is purchase GAAP issues. Brad will speak about traditional aspects of purchase accounting, more or less where we have been and how we got to where we are. I will talk about changes in purchase accounting concerning amortizing the present-value-of-profits asset pursuant to Emerging Issues Task Force (EITF) issue 92-9. Art will talk about federal income tax (FIT) aspects of purchase accounting.

Purchase accounting issues for insurance companies have been around about as long as GAAP has been around (since the early 1970s). There is relatively little authoritative literature on actuarial aspects of purchase accounting. If we go back over the years and look at what we do have, the book *GAAP* was written by Ernst & Ernst, which, as many of you know, was Ernst & Young before the rash of mergers into what is now the "Big Six" of public accounting. That book was perhaps the first significant piece whose intent was to discuss GAAP for insurance companies from both the accounting side and the actuarial side. It's still used as a basic source of guidance. It's considered authoritative in some areas, and in some areas it's not.

There's also the AAA Interpretation 1-D on purchase accounting, which relates only to reserves. It offers two options, really, only one of which is currently used to any degree, but it doesn't address present value of profits (PVP). And it certainly doesn't address accounting issues. There was some accounting literature; Accounting Practices Bulletin 16 was a general piece on business combinations, so it did not address the insurance industry specifically. And because it didn't address the insurance industry specifically, it would not have addressed PVP. If one analogized the PVP asset to an inventory, it did potentially address some PVP concepts. Of course *FAS 60* and *FAS 97* discussed historic GAAP, the ongoing GAAP aspects of reserves. But they, of course, did not address purchase accounting. Now because there was little authoritative literature, practices varied over the years and, in fact, still vary across companies. If you look at ten companies that were involved in acquisitions to any degree and look at the methodology that those companies employed, you would probably find at least ten different sets of rules and at least ten different sets of procedures.

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For example, some companies set their purchase GAAP reserves equal to their historic GAAP reserves. Some companies set them equal to statutory reserves. Some companies recalculated reserves by using the actuary's best estimate of future experience as of the date of acquisition and came up with what I'll call true purchase accounting, opening balance-sheet reserves. Some companies calculated their present-value-of-profits asset for the opening balance sheet by using a risk rate of return somewhere between 12% and 18% in today's environment. Other companies used an invested asset rate, something on the order of 6–8%. Some companies wrote off deferred acquisition cost (DAC), and some companies didn't.

In recent years, the SEC and the AICPA have given purchase accounting for the insurance industry added attention. Again, there are several reasons for this. There has been an increase in acquisition activities. Certainly my company, CONSECO, has been right in the middle of that. There has been criticism of the accounting procedures by some in the industry and academia, and CONSECO has been right in the middle of that—generally on the receiving end. Also, there has been a concern about an apparent inconsistency in profits that come from companies immediately before acquisition and immediately after acquisition.

The purpose of our presentation is to discuss where we've been and where we are and perhaps take a peek at where we might be going with respect to purchase GAAP. Brad Smith will talk about where we have been with respect to the PVP asset and how we got to where we are today.

MR. BRADLEY M. SMITH: Howard's company has obviously been involved in many acquisitions, but it is also pushing the edge of the envelope, wouldn't you say? It is possibly the cause, at least, for a study by the EITF.

Let's get your hands dirty. I'll discuss actuarial aspects of issues that surrounded accounting for acquisitions of life insurance company blocks prior to the conclusions adopted by the Emerging Issues Task Force of the Financial Accounting Standards Board in November 1992.

The conclusions of the Emerging Issues Task Force contribute to the definition of GAAP. They don't have exactly the same way of pronouncement, but the practical effect is the same as the pronouncement in most circumstances. In fact, the conclusion of the Emerging Issues Task Force defined GAAP for any company that's publicly traded in the U.S. I hope, by the end of my presentation, that you will understand the issues that precipitated the need for more uniform accounting for acquired business. As Howard said, there was varying diversity of methodologies being used. Let's review a generic purchase GAAP balance sheet immediately after the acquisition of a life insurance company and/or a block of business.

For the purpose of my discussion, there is no need to differentiate between whether a block of business or a company has been purchased. You have invested assets that are equal to the net statutory liability transferred, plus target surplus established. The assets are held at market value. Value of the in-force business is equal to the discounted present value of pretax profits.

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Goodwill is a balancing item used when the purchase price paid for the business exceeds the after-tax present value of projected profits on the business. This usually occurs when a premium price is paid to reflect the new business potential of an acquired company. This typically doesn't happen when you buy a block of business.

Benefit reserves are equal to GAAP benefit reserves. For instance, for universal life or annuity business that is subject to *FAS 97*, the benefit reserves would be equal to the account value.

The deferred federal income tax is the present value of federal income tax to be paid on the business. The discount rate used in this calculation typically equals the discount rate used to calculate the value of the in-force business.

Equity equals the purchase price paid for the business plus the target surplus established on the business. It is important to remember that balance-sheet assets must equal the sum of the balance-sheet liabilities plus the equity at all times. When you establish the balance sheet, the balance-sheet assets must equal liabilities.

FASB established Issue No. 92-9 (*Accounting for the Present Value of Future Profits Resulting from the Acquisition of the Life Insurance Company*) to be considered by its EITF. The conclusions of the EITF will be discussed by Howard. Specifically, the primary issues addressed were the discount rate used to determine the initial value of in-force business, the methodology used to amortize the value of the in-force business, and the unlocking mechanisms.

The actuary was already given some guidance in determining the methodology to be used in establishing the initial value of the in-force asset. The *Actuarial Standard of Practice Interpretation* having to do with purchase accounting states, "The profit allowance used in determining the reserves should be consistent with those which apply to current new business issued by the company which will be assuming the future risk on the acquired business." Essentially, it says that a company that is acquiring the business, if it has a profit objective of a 15% return on investment, should use a 15% return on investment when discounting to determine the present value of profits. If it has a 5%-of-premium profit-margin objective, it should use a 5%-of-premium profit-margin objective.

While not explicitly directing the actuary, this has been interpreted by actuaries assigned with determining the value of the in-force asset as implying that the discount rate used in the calculation of the value of the in-force business be consistent with the return anticipated by the company in its production of new business. This is consistent with the conclusions adopted by the EITF, which stated "In establishing the risk rate of return, key factors which are considered include the yields on self-generated business, capital costs of the acquirer, that is, what its hurdle rate is, the potential impact of changes in the regulatory environment, as well as the discount rate implicit in the seller's offering price."

Let's look at a simplified example that will help us illustrate the issues (Table 1). In this example, a block of universal life business as defined by *FAS 97* was purchased. To simplify the example, the tax reserve equals the statutory reserve, which equals the account value. Additionally, no target surplus has been imputed to the line of

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business, and the purchase price was equal to the after-tax present value of profits—both gross and statutory.

TABLE 1  
PURCHASE GAAP EXAMPLE<sup>a</sup>

Year	Gross Profit	PVP @ 17%	Pretax GAAP Earnings	Deferred FIT	GAAP Equity	Aftertax GAAP Earnings	ROE
0		\$18,149		\$6,171	\$11,978		
1	\$3,400	17,835	\$3,085	6,064	11,771	\$2,036	17%
2	3,425	17,441	3,032	5,930	11,511	2,001	17
3	3,450	16,956	2,965	5,765	11,191	1,957	17
29	620	359	142	122	237	94	17
30	420	0	61	0	0	40	17

<sup>a</sup> Purchase price return objective: 17%;—FIT rate: 34%  
Present values at 7% = \$34,228; at 17% = \$18,149.

So note, I have no target surplus in this, although you could put target surplus in and it just complicates the example. And again, tax reserves equal statutory reserves, which equals the account value.

Assuming an after-tax purchase price return objective (hurdle rate) of 17% and a tax rate of 34%, which now obviously would be 35%, the present value of the gross profit stream in this example is \$18,149. The initial value of in-force business and the present value of federal income tax is \$6,171, which is set equal to the initial deferred tax liability. Therefore, GAAP equity, which is equal to the purchase price paid for the business is \$11,978, the difference between these two items. By using the level ROE approach to the amortization of the value of in-force business, its balance is redetermined each year as the prospective present value of gross profits. The pretax GAAP profit equals the gross profit plus the increase in the value of the in-force asset. The after-tax GAAP profit equals a pretax GAAP profit times 1 minus the tax rate or 1 minus 0.34. The ROE equals the after-tax GAAP profit divided by the GAAP equity at the beginning of the year. As you can see in this example, if gross profits emerge as anticipated, a level ROE equal to the discount rate used to produce the value of the in-force asset is produced. This isn't very focused, but if earnings emerge as projected, the level ROE approach produces a level ROE, which was determined by the EITF to be an aggressive approach. And it results in very little amortization of the value of in-force business in the first five years.

Table 2 uses the same example but amortizes the value of in-force business by using principles implicit in FAS 97 methodology. As you can see, the balance sheet immediately after the acquisition is the same. The initial balance of the value of the in-force asset and the deferred federal income tax liability were calculated by using the purchase price return objective of 17%. This is consistent, incidentally, with both the EITF conclusion and Actuarial Interpretation 1-D.

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TABLE 2  
PURCHASE GAAP EXAMPLE<sup>a</sup>

Year	Gross Profit	FAS 97 PVP	Pretax GAAP Earnings	Deferred FIT	GAAP Equity	After-tax GAAP Earnings	ROE
0		\$18,149		\$6,171	\$11,978		
1	\$3,400	17,617	\$2,868	5,990	11,627	\$1,893	15.8%
2	3,425	17,034	2,842	5,792	11,242	1,876	16.1
3	3,450	16,397	2,813	5,575	10,822	1,857	16.5
29	620	208	326	71	137	215	65.1
30	420	0	212	0	0	140	102.2

<sup>a</sup> Purchase price return objective: 17% gross profit ratio: 53%; FIT rate: 34%; and credited rate: 7%. Present values at 7% = \$34,228; at 17% = \$18,149.

The difference between Table 2 and Table 1 is the methodology used to amortize these initial balances. In this example, a gross profit ratio, similar to your capitalization ratio in *FAS 97*, is determined by dividing the value of in-force business, the present value of the gross profit stream using the 17% purchase-price objective, by the present value of the gross profit stream using the credited rate; the credited rate is consistent with, again, *FAS-97*-type methodology.

The retrospective deposit method, as defined in *FAS 97*, is used to amortize the value of the in-force asset, producing a faster amortization than does the level ROE method. Thus, after-tax GAAP profit is deferred into the later years, producing a nonlevel ROE, which is less than the purchase-price return objective in the initial years, increasing beyond the purchase-price return objective in the later years. One way you can think of it is, the weighted-average ROE over the 30-year period is still 17%. Just due to the accounting for the amortization of the initial asset, the ROE emerge is on a nonlevel basis, on an increasing basis.

This particular example, due to its simplified nature, is not necessarily indicative of the level of the difference between these two methodologies, or that these two methodologies will produce in the years immediately after the acquisition of the business. Just use it conceptually as an example and not quantitatively as a measure of the difference between the two.

Nonetheless, Table 3 illustrates the effect that the difference in methodology has on our example. Both of these methodologies were acceptable to the accounting profession prior to the EITF issuing its conclusions. However, this inconsistent accounting treatment of the same block of business based upon whether the business was purchased from another company or was produced directly by the company creates an unlevel playing field between those companies that produce their own business and those companies that grow through acquisition.

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TABLE 3  
PURCHASE GAAP EXAMPLE

Year	After-tax GAAP Earnings		Cumulative Additional Earnings	Percentage of Cumulative Earnings
	Level ROE	FAS 97		
1	\$2,036	\$1,893	\$144	7.6%
2	2,001	1,876	269	7.1
3	1,957	1,857	369	6.6
4	1,903	1,804	468	6.3
5	1,847	1,751	564	6.2
10	1,553	1,479	982	5.7
15	1,223	1,191	1,237	5.2
20	840	887	1,171	4.1
25	402	536	647	2.0
30	40	140	0	0.0

This inconsistent treatment affected a company's access to additional capital. The equity market's view of a company is driven largely by the level of the company's price/earnings ratio and other measurements as well as its growth in earnings per share. I don't believe that the difference in accounting treatments acceptable in each circumstance was recognized or appreciated by the capital markets. So there was no discounting, no true analysis in my mind by the capital markets going in and asking what amortization method you were using to determine the quality of the earnings.

This generated a need for a more consistent treatment among the purchase blocks of business, because there was such a diversity of methodologies being used and a difference between produced business and acquired business. This was addressed by the EITF of FASB.

The unlocking mechanisms used (when actual results deviate from expected when accounting for purchased business) were not well defined, and the approaches taken by different companies varied widely.

Tables 4 and 5 illustrate the effect on emergence of GAAP profit due to the unanticipated termination of 10% of the business in year 3.

In Table 4, the loss of business and the loss of future profit is reflected immediately at the end of year 3 through a reduction in the level of the value of in-force business. The pretax GAAP profit falls precipitously in this year, lowering that year's ROE. The ROE in following years returns to its prior level, assuming no other unanticipated events. This is analogous to what happens to companies using a GAAP factor approach for their purchased and/or produced business. So this is what actually happened. If you were using a level ROE approach, you had an unanticipated event in the third year where you lost 10% of your business. Your ROE fell in that year and then returned to its prior level in the following year, assuming that there were no other unanticipated events. That is, all bad news was reflected in the year that the

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bad news occurred. This happens when you use a factor approach for purchase business or a factor approach for produced business.

TABLE 4  
PURCHASE GAAP EXAMPLE  
10% REDUCTION IN IN-FORCE BUSINESS IN YEAR 3<sup>a</sup>

Year	Gross Profit	PVP @ 17%	Pretax GAAP Earnings	Deferred FIT	GAAP Equity	After-tax GAAP Earnings	ROE
0		\$18,149		\$6,171	\$11,978		
1	\$3,400	17,835	\$3,085	6,064	11,771	\$2,036	17.0%
2	3,425	17,441	3,032	5,930	11,511	2,001	17.0
3	3,105	15,261	924	5,189	10,072	610	5.3
4	3,038	14,818	2,594	5,038	9,780	1,712	17.0
5	2,970	14,367	2,519	4,885	9,482	1,663	17.0

<sup>a</sup> Purchase price objective: 17%; FIT rate: 34%.

In Table 5, rather than recomputing the value of the in-force asset by using a discount rate equal to the purchase-price objective, the value of the in-force asset is held at its anticipated level, and the discount rate is recomputed such that the present value of prospective gross profits equals the anticipated value of the in-force business. That is, in this example, you lose 10% of your in-force business, and you have essentially a static amortization schedule for that year. You know what the value of the in-force is, you know what your projected profit stream is. It's 10% less each year, presumably. You discount it back and solve for the discount rate. In this example it was 17% and it was reduced to 14.9%. The profit stream discounts back to this static-type balance. Thus, the loss is not entirely absorbed in the year of occurrence, but it's amortized in future years through reduction in prospective ROEs. This was acceptable prior to the EITF, issuing its conclusions.

TABLE 5  
PURCHASE GAAP EXAMPLE  
10% REDUCTION IN IN-FORCE BUSINESS IN YEAR 3<sup>a</sup>

Year	Gross Profit	PVP	Pretax GAAP Earnings	Deferred FIT	GAAP Equity	After-tax GAAP Earnings	ROE
0		\$18,149		\$6,171	\$11,978		
1	\$3,400	17,835	\$3,085	6,064	11,771	\$2,036	17.0%
2	3,425	17,441	3,032	5,930	11,511	2,001	17.0
3	3,105	16,956	2,620	5,765	11,191	1,729	15.0
4	3,038	16,442	2,523	5,590	10,852	1,665	14.9
5	2,970	15,919	2,447	5,413	10,507	1,615	14.9

<sup>a</sup> Purchase price objective: 17%; FIT rate: 34%.

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The level to which this discount rate could fall before loss recognition must occur was also an issue. I've heard strong arguments made very vehemently by different parties for the minimum acceptable ROE being the net investment rate, which is what I believe it should be and which I believe is consistent with purchase or GAAP or historic GAAP accounting for produced business. Some people make the argument that should be the credited rate. Some argue, and it's being addressed by the EITF, that the minimum discount rate should be zero.

MR. ROSEN: I want to go back and embellish a little bit more on Brad's discussion, specifically on EITF issue 92-9 and give you an example of exactly how that might work in practice. It's going to seem as if Brad and I are overlapping a little bit. But it's important that we differentiate between the variance in practice that was acceptable in the past versus a somewhat narrower measure of what's allowable going forward. Actually, the grandfather date is November 19, 1992. And that's a very important date for purchase accounting. We'll talk about that.

Industry practice has varied over the years. I mentioned briefly that there were different ways that companies established purchase GAAP reserves; there were different ways that the companies established the present-value-of-profits assets; there were different ways that companies looked at recoverability and loss-recognition testing. Some companies looked at pre- and postpurchase blocks of the same products and combined them for loss recognition; other companies looked at them separately, because in their minds, they constituted totally separate types of assets. One was an asset that was acquired in an acquisition, which would be the PVP or prepurchase block, and the other was a measure of a prepaid asset, something that you expended when you sold business and were recovering from the future profits of the block that the expense was generated to produce. That would be the DAC asset.

After the advent of *FAS 97* in 1989, practice diverged even more. Some companies ignored the estimated gross profit (EGP) and unlocking concepts of *FAS 97* products as they looked at the PVP asset. The PVP asset amortization methodology was established, and short of perhaps any loss recognition issue, the asset ran off as scheduled. Other companies analogized even before 92-9 the PVP from *FAS 97* products and the DAC from *FAS 97* products. At any rate, the procedures used did vary.

Late in the 1980s and early in the 1990s, acquisition activity did increase. The SEC began looking at acquisition activity in the insurance industry. There was some concern about the discontinuity of earnings before and after the acquisition. Even among us on the panel, I think opinion diverges. I look at the PVP asset as being totally different than a DAC asset, in that a PVP asset, or what is represented by the PVP asset, is somewhat analogous to the inventory in a manufacturing company. It represents another one of the assets that an acquiring company buys. If that acquiring company buys an asset to yield  $x\%$ , let's use 17% as an example, and if your assumptions are exactly borne out by experience, it seems reasonable to expect that asset should yield 17% on a level basis. This is not the position that they were expected to take by the SEC.

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In 1992, the SEC looked very specifically at accounting for PVP. The chief accountant of the SEC, Walter Schutz, took exception to what he perceived as the then industry practice, which was the accretion of interest on the PVP at a risk rate of return. Several issues about PVP were raised, and those issues were ultimately sent to the EITF of the AICPA for research and conclusion. Brad briefly went over those issues, but let me go over them in somewhat more detail.

First, there was the interest accrual method: is it appropriate to accrete interest to the PVP asset at all? Should it be an interest-bearing asset?

Second, if the EITF concluded that it was appropriate to accrete interest to the PVP asset, what should the level of that interest be? What discount rate is appropriate for the accretion of interest to the PVP asset?

Third, with regard to changes in estimate, how should they be accounted for? If our original estimates as to experience going forward are not borne out, how should we take that into account in continuing accounting for the PVP? Should the current balance be locked in? Should you look back as you do for FAS 97? Should it differentiate by product type?

And finally, with regard to recoverability, how should recoverability issues for PVP assets be recognized or analyzed?

After months of research and open meetings with industry and with consultants, the EITF reached several conclusions that are now a part of 92-9. First of all, with respect to the interest accrual, one of the basic underlying concepts in 92-9 is that there was an analogy drawn between DAC and PVP. Because it was common practice in the industry to accrete interest on the DAC asset, and it was common in the industry in what I'll call the traditional approach to PVP accounting, to accrete interest to PVP, the EITF allowed it to go forward. But as far as the level of discount that was deemed to be appropriate, this is the first place where the EITF conclusions diverged from fairly common, but not exclusive industry practice.

The EITF concluded that the interest rate that was allowable for the amortization of PVP should be analogous to that which was allowable for DAC. That would then be the liability or contract rate. So this is a divergence from industry practice for those companies that established the PVP asset by using a risk rate of return, and then as long as experience allowed it, amortized that asset by accreting that same risk rate of return, something like 17%.

The EITF did not change the way the initial asset for the opening balance sheet could be established. It was still acceptable to establish the opening balance-sheet PVP by using a risk rate of return, because in many cases, that is what a company thought it was paying for the asset: a price that would yield a risk rate of return of 15-20%. So, again, it was appropriate to set up the asset by using a risk rate of return, but it was no longer appropriate to accrete that risk rate of return on the asset as it amortized.

For FAS 97 contracts, because we draw an analogy between DAC and PVP, this means that you now have unlocking entering into the amortization methodology. If

experience is materially different than originally expected, when testing for recoverability, one still has to go back and unlock assumptions and have an adjustment, a cumulative adjustment, which may be positive or negative, with respect to PVP for *FAS 97* products. Now note theoretically, when you're talking about unlocking in *FAS 97*, the gross amortization percentage comes into the picture, and there's going to be an initial difference conceptually between the gross amortization percentage that one would think would be appropriate for PVP as opposed to DAC. For DAC, a gross amortization percentage of anywhere from 40% to 70% would not be unusual. If one were to go with a pure gross amortization percentage for the concept of a PVP, which was supposed to be the fair market value of the asset, i.e., the book of business acquired, conceptually at least, the gross amortization percentage should be at or very near 100%, because what you're doing is capitalizing the value of the inventory, if you will, of policies that you've acquired.

The final question was one of recoverability. How should it be analyzed? The EITF came to the conclusion that yes, it was appropriate and necessary to look at the recoverability of the PVP asset and also to apply premium-deficiency testing. However, there are some *FAS 97* products that you are not allowed by accounting rules to establish deficiency reserves for. For *FAS 60* products, you have a PVP asset. If you look at the recoverability of that PVP asset, and your experience is not what you thought it would be and your asset is no longer recoverable pursuant to the results of your testing, the PVP asset comes down toward zero. If you're still in a loss position after bringing the PVP to zero for a *FAS 60* product, you set up an additional liability. And for some *FAS 97* products, this is true also. But for other investment products (the typical examples would be structured settlements without life contingencies or immediate annuities without life contingencies), the accounting rules are different. The accounting rules do not allow the establishment of deficiency reserves. You take your PVP asset, or DAC in the case of postpurchase business, down to zero if you perceive a recoverability problem. Once it goes down below zero, any further negative change in experience is deemed to be a period expense. No additional liability is allowed.

There was a grandfather date for 92-9. It was November 19, 1992. For acquisitions occurring after that date, the amortization methodology for PVP should be governed by the conclusions reached by the EITF.

For acquisitions completed on or before November 19, 1992, the current methodology, that is, the methodology that was used to establish the PVP when the acquisitions occurred, could be continued with one key exception. It has been common practice in the industry for many companies in the acquisition business, including the CONSECO companies that I represent, to establish PVPs by using a risk rate of return. Upon loss recognition, we were a company or a set of companies that looked at prepurchase assets separately from those for the same block of business issued after acquisition. So again, our DAC and PVP were examined separately. But if there were a recoverability problem perceived for a PVP asset, we would hold the balance sheet asset fixed but reduce the discount rate on the PVP asset until such a point where the asset became recoverable. So if we had established an asset at 19%, and two or three years down the road there were what we hope to be a temporary difference in our perception as to future experience, and it was no longer recoverable at 19% but the asset was recoverable if we projected profits and discounted them

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back at 17%, we would do that. We would fix our balance-sheet asset, but we would change the rate of amortization going forward. This was accepted and commonly used in the industry. For grandfathered transactions, the EITF recognized that this was the practice and the EITF has allowed this practice to continue, except that the floor on the interest rate or the discount rate became the then current liability rate. So if we had a block of business for which we established a PVP asset at 19% on a pregrandfathered or a grandfathered transaction, but upon later analysis we recognize that we could not recover the asset at 19%, if the liability rate were 6%, that is, if we were paying 6% on those liabilities, we could not take our PVP asset amortization rate below 6%. It could be anywhere between 19% and 6%, up or down, depending upon experience and how it changes, but it would never be higher than 19% and never lower than 6%.

Now let's see how 92-9 works in practice. There are far too many numbers, but it might be instructive to see how the numbers bear out. My example assumes a post-November 19, 1992 acquisition where the PVP comes from FAS 97 products. I've got no unlocking displayed in the example and my purpose is to show you the differences between what I've characterized as traditional accounting—I'll describe what I mean by that in a moment—and what happens pursuant to 92-9 (Table 6).

What I mean by the traditional method of PVP accounting is defined as a situation in which the asset is discounted at a risk rate of return that was deemed appropriate by the acquiring company and that going forward, that risk rate of return was accreted to the asset. It was amortized by using the expected profit stream. We're going to look at blocks of business with three differing patterns of profit recognition. So let's walk through the columns, and I will show you what's going on here.

Column one represents the undiscounted profit stream projected for this particular block of business. In this part of the example, we have a declining income stream starting out at \$21.4 million.

The second column represents the present value of that stream discounted at 17%, what the acquiring company deemed to be an appropriate risk rate of return. This is the way that the PVP asset would have run off if there were no material differences between the way that the company anticipated experience to occur and the way it actually did occur.

Now the EITF methodology requires that the company start with the same opening balance-sheet asset, amortize it over the same period of time, but instead of accreting the 17% risk rate of return, one can only accrete the liability rate. In this case, it is set at 6%, as you can see in column three.

If we were going to establish an asset at 6%, that number, instead of being \$86.8 million, would be \$153.0 million. But unless there is a huge, implied, goodwill number, you're not going to be able to discount that asset at 6%. How do you start out with a 17% asset and wind up with, effectively, a 6% asset? You would look at the ratio of the 17% PVP asset at the opening balance-sheet date, which is \$86.8 million, and take that as a ratio to the PVP asset at your liability rate, which is \$153.0. Use only these two numbers.

TABLE 6  
EXAMPLE OF THE IMPACT OF THE EITF METHOD ON PVP AMORTIZATION  
DECLINING INCOME

Year	(1) Gross Profit	(2) Traditional PVP @17%	(3) PVP @6%	(4) Adjusted Gross Profit	(5) "EITF" PVP	(6) Inc Recognition Trad Method	(7) Inc Recognition EITF Method	(8) Income Impact	(9) % Impact on Inc of EITF Method	(10) Cumulative Impact
1	\$21,400,000	\$86,844,008	\$153,026,054	\$12,144,741	\$86,844,008	\$14,763,481	\$14,465,900	(\$297,582)	-2.02%	(\$297,582)
2	20,300,000	80,207,489	140,807,617	11,520,478	79,909,908	13,635,273	13,574,116	(61,157)	-0.45%	(358,739)
3	18,600,000	73,542,762	128,956,075	10,555,709	73,184,024	12,502,270	12,435,332	(66,938)	-0.54%	(425,676)
4	17,100,000	67,445,032	118,093,439	9,704,442	67,019,356	11,465,655	11,416,719	(48,937)	-0.43%	(474,613)
5	15,700,000	61,810,688	108,079,045	8,909,927	61,336,075	10,507,817	10,470,238	(37,579)	-0.36%	(512,192)
6	14,200,000	56,618,504	98,863,788	8,058,660	56,106,312	9,625,146	9,507,719	(117,427)	-1.22%	(629,619)
7	12,900,000	52,043,650	90,595,615	7,320,895	51,414,031	8,847,421	8,663,947	(183,474)	-2.07%	(813,093)
8	11,900,000	47,991,071	83,131,352	6,753,384	47,177,978	8,158,482	7,977,295	(181,187)	-2.22%	(994,280)
9	11,000,000	44,249,553	76,219,233	6,242,624	43,255,273	7,522,424	7,352,693	(169,731)	-2.26%	(1,164,011)
10	10,100,000	40,771,977	69,792,387	5,731,864	39,607,965	6,931,236	6,744,614	(186,622)	-2.69%	(1,350,633)
11	9,400,000	37,603,213	63,879,931	5,334,606	36,252,580	6,392,546	6,240,549	(151,997)	-2.38%	(1,502,630)
12	8,600,000	34,595,759	58,312,726	4,880,597	33,093,129	5,881,279	5,704,991	(176,288)	-3.00%	(1,678,918)
13	8,000,000	31,877,038	53,211,490	4,540,090	30,198,119	5,419,096	5,271,797	(147,299)	-2.72%	(1,826,218)
14	7,400,000	29,296,134	48,404,179	4,199,583	27,469,917	4,980,343	4,848,612	(131,731)	-2.65%	(1,957,949)
15	6,900,000	26,876,477	43,908,430	3,915,828	24,918,528	4,569,001	4,479,284	(89,717)	-1.96%	(2,047,666)
16	6,300,000	24,545,478	39,642,936	3,575,321	22,497,812	4,172,731	4,074,548	(98,183)	-2.35%	(2,145,849)
17	5,800,000	22,418,209	35,721,512	3,291,565	20,272,360	3,811,096	3,724,776	(86,319)	-2.26%	(2,232,168)
18	5,400,000	20,429,305	32,064,803	3,064,561	18,197,137	3,472,982	3,427,267	(45,714)	-1.32%	(2,277,883)
19	4,900,000	18,502,287	28,588,691	2,780,805	16,224,404	3,145,389	3,092,659	(52,730)	-1.68%	(2,330,612)
20	4,500,000	16,747,676	25,404,013	2,553,801	14,417,063	2,847,105	2,811,223	(35,882)	-1.26%	(2,366,494)
21	4,200,000	15,094,780	22,428,253	2,383,547	12,728,286	2,566,113	2,580,150	14,037	0.55%	(2,352,457)
22	3,800,000	13,460,893	19,573,949	2,156,543	11,108,436	2,288,352	2,309,963	21,612	0.94%	(2,330,845)
23	3,500,000	11,949,245	16,948,385	1,986,289	9,618,400	2,031,372	2,090,815	59,443	2.93%	(2,271,402)
24	3,200,000	10,480,616	14,465,289	1,816,036	8,209,214	1,781,705	1,876,517	94,812	5.32%	(2,176,590)
25	3,000,000	9,062,321	12,133,206	1,702,534	6,885,731	1,540,595	1,710,610	170,015	11.04%	(2,006,575)
26	2,700,000	7,602,916	9,861,198	1,532,280	5,596,341	1,292,496	1,503,500	211,004	16.33%	(1,795,570)
27	2,500,000	6,195,412	7,752,870	1,418,778	4,399,841	1,053,220	1,345,212	291,992	27.72%	(1,503,578)
28	2,300,000	4,748,632	5,718,042	1,305,276	3,245,053	807,267	1,189,427	382,160	47.34%	(1,121,418)
29	2,100,000	3,255,899	3,761,125	1,191,774	2,134,481	553,503	1,036,295	482,792	87.22%	(638,626)
30	2,000,000	1,709,402	1,886,792	1,135,023	1,070,776	290,598	929,224	638,626	219.76%	0

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The ratio of these two numbers represents the ratio by which column one, the gross profits, needs to be "haircutted," to amortize an asset initially established at 17%, with 6% interest starting out at the same place and ending at the same place over the same period of time. So that adjusted gross profit stream, column four, is exactly what we have. It is the ratio of \$86.8 over \$153.0 times column one. That will be the new gross amortization amount—undiscounted gross amortization—in every year.

Column five represents the EITF amortization of PVP for this transaction. As you can see, we're starting out at the same place, \$86.8 million, and we're ending up at the same place at the end of 30 years, which is zero. But we are accreting 6% and amortizing column four.

Now the income recognition as between those two methods, except by sheer coincidence, will be different. And in general, as Brad mentioned, the asset pursuant to the EITF method will run off faster. In this particular example, the income impact is negative for the first 20 years, starting out at about 2% less than what the traditional method would allow in this case, then dipping a little bit before it increased to a relative worst case in the 12th year, where the difference was 3%. That is, the EITF income would be 3% less before it declined back to zero and turned positive in the later years. That is where the EITF method generated higher profits than the traditional method. That has to happen. That has to happen because we are playing with a zero sum game. We are amortizing \$86 million one way or the other, and if it runs off faster in the early years, it has to run off slower in the later years, because we're playing with a zero sum game.

But again, another important point that you'll see on the next two pages of the example, is that the underlying pattern of profits for the block of business before any amortization whatsoever will really determine the impact that the EITF method has on your income statement.

Now let's look at what would happen under a level approach (Table 7). Keep in mind that in this case, we have a declining income pattern and we have a difference that starts out at about 2% and goes to 3% before it turns around. What happens if your income pattern is level and the EITF methodology is used? Now look at the difference. The relative difference is greater. In the early years, we're talking about an income stream, which under the EITF method is about 6.5% lower in the first year. It goes to about 9.5% in about the 13th or 14th year before it turns around and gets significantly better. But again, we're talking 20 years out. And of course, instead of a declining underlying pattern of income, we have a level pattern of income. What happens if we have an increasing level of income as some blocks of business, such as flexible premium deferred annuities (FPDAs), might generate?

There is a pattern of income increasing at 2% a year in this case (Table 8). And now we have an even more significant difference from the impact of 92-9. There is a 9% difference in the initial year; it increases to almost 13% in years 13-14 before it turns around. Ultimately, it's 3.33 times as great under the EITF method.

TABLE 7  
EXAMPLE OF THE IMPACT OF THE EITF METHOD ON PVP AMORTIZATION  
LEVEL INCOME

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	
Year	Gross Profit	Traditional PVP @17%	PVP @6%	Adjusted Gross Profit	"EITF" PVP	Inc Recognition Trad Method	Inc Recognition EITF Method	Income Impact	% Impact on Inc of EITF Method	Cumulative Impact
1	\$21,400,000	\$124,748,938	\$294,567,387	\$9,062,875	\$124,748,938	\$21,207,319	\$19,822,062	(\$1,385,258)	-6.53%	(\$1,385,258)
2	\$21,400,000	124,556,257	290,841,430	9,062,875	123,171,000	21,174,564	19,727,385	(1,447,178)	-6.83%	(2,832,436)
3	\$21,400,000	124,330,821	286,891,916	9,062,875	121,498,385	21,136,240	19,627,029	(1,509,211)	-7.14%	(4,341,647)
4	\$21,400,000	124,067,061	282,705,431	9,062,875	119,725,414	21,091,400	19,520,650	(1,570,750)	-7.45%	(5,912,397)
5	\$21,400,000	123,758,461	278,267,756	9,062,875	117,846,064	21,038,938	19,407,889	(1,631,049)	-7.75%	(7,543,446)
6	\$21,400,000	123,397,399	273,563,822	9,062,875	115,853,953	20,977,558	19,288,363	(1,689,195)	-8.05%	(9,232,641)
7	\$21,400,000	122,974,957	268,577,651	9,062,875	113,742,316	20,905,743	19,161,664	(1,744,078)	-8.34%	(10,976,720)
8	\$21,400,000	122,480,700	263,292,310	9,062,875	111,503,980	20,821,719	19,027,364	(1,794,355)	-8.62%	(12,771,074)
9	\$21,400,000	121,902,419	257,689,849	9,062,875	109,131,344	20,723,411	18,885,006	(1,838,405)	-8.87%	(14,609,479)
10	\$21,400,000	121,225,830	251,751,240	9,062,875	106,616,351	20,608,391	18,734,106	(1,874,285)	-9.09%	(16,483,764)
11	\$21,400,000	120,434,221	245,456,314	9,062,875	103,950,457	20,473,818	18,574,153	(1,899,665)	-9.28%	(18,383,429)
12	\$21,400,000	119,508,039	238,783,693	9,062,875	101,124,610	20,316,367	18,404,602	(1,911,765)	-9.41%	(20,295,193)
13	\$21,400,000	118,424,405	231,710,714	9,062,875	98,129,212	20,132,149	18,224,878	(1,907,271)	-9.47%	(22,202,464)
14	\$21,400,000	117,156,554	224,213,357	9,062,875	94,954,090	19,916,614	18,034,371	(1,882,243)	-9.45%	(24,084,707)
15	\$21,400,000	115,673,168	216,266,159	9,062,875	91,588,461	19,664,439	17,832,433	(1,832,005)	-9.32%	(25,916,713)
16	\$21,400,000	113,937,607	207,842,128	9,062,875	88,020,894	19,369,393	17,618,379	(1,751,014)	-9.04%	(27,667,727)
17	\$21,400,000	111,907,000	198,912,656	9,062,875	84,239,273	19,024,190	17,391,482	(1,632,708)	-8.58%	(29,300,435)
18	\$21,400,000	109,531,190	189,447,415	9,062,875	80,230,755	18,620,302	17,150,971	(1,469,332)	-7.89%	(30,769,766)
19	\$21,400,000	106,751,492	179,414,260	9,062,875	75,981,726	18,147,754	16,896,029	(1,251,725)	-6.90%	(32,021,491)
20	\$21,400,000	103,499,246	168,779,116	9,062,875	71,477,755	17,594,872	16,625,791	(969,081)	-5.51%	(32,990,572)
21	\$21,400,000	99,694,118	157,505,863	9,062,875	66,703,546	16,948,000	16,339,338	(608,662)	-3.59%	(33,599,234)
22	\$21,400,000	95,242,118	145,556,215	9,062,875	61,642,884	16,191,160	16,035,698	(155,462)	-0.96%	(33,754,695)
23	\$21,400,000	90,033,278	132,889,588	9,062,875	56,278,582	15,305,657	15,713,840	408,183	2.67%	(33,346,512)
24	\$21,400,000	83,938,935	119,462,963	9,062,875	50,592,423	14,269,619	15,372,671	1,103,052	7.73%	(32,243,460)
25	\$21,400,000	76,808,554	105,230,741	9,062,875	44,565,093	13,057,454	15,011,031	1,953,577	14.96%	(30,289,883)
26	\$21,400,000	68,466,008	90,144,585	9,062,875	38,176,125	11,639,221	14,627,693	2,988,472	25.68%	(27,301,412)
27	\$21,400,000	58,705,229	74,153,260	9,062,875	31,403,817	9,979,889	14,221,355	4,241,466	42.50%	(23,059,946)
28	\$21,400,000	47,285,118	57,202,456	9,062,875	24,225,172	8,038,470	13,790,636	5,752,166	71.56%	(17,307,781)
29	\$21,400,000	33,923,588	39,234,603	9,062,875	16,615,808	5,767,010	13,334,074	7,567,064	131.21%	(9,740,717)
30	\$21,400,000	18,290,598	20,188,679	9,062,875	8,549,882	3,109,402	12,850,118	9,740,717	313.27%	(0)

**TABLE 8**  
**EXAMPLE OF THE IMPACT OF THE EITF METHOD ON PVP AMORTIZATION**  
**INCOME INCREASING 2.0% ANNUALLY**

Year	(1) Gross Profit	(2) Traditional PVP @17%	(3) PVP @6%	(4) Adjusted Gross Profit	(5) "EITF" PVP	(6) Inc Recognition Trad Method	(7) Inc Recognition EITF Method	(8) Income Impact	(9) % Impact on Inc of EITF Method	(10) Cumulative Impact
1	\$21,400,000	\$140,339,905	\$366,273,625	\$8,199,537	\$140,339,905	\$23,857,784	\$21,620,858	(\$2,236,926)	-9.38%	(\$2,236,926)
2	\$21,828,000	142,797,689	366,850,042	8,363,527	140,560,763	24,275,607	21,898,119	(2,377,489)	-9.79%	(4,614,415)
3	\$22,264,560	145,245,297	367,033,045	8,530,798	140,630,882	24,691,700	22,171,615	(2,520,085)	-10.21%	(7,134,500)
4	\$22,709,851	147,672,437	366,790,467	8,701,414	140,537,937	25,104,314	22,440,714	(2,663,601)	-10.61%	(9,798,101)
5	\$23,164,048	150,066,900	366,088,044	8,875,442	140,268,799	25,511,373	22,704,734	(2,806,639)	-11.00%	(12,604,740)
6	\$23,627,329	152,414,225	364,889,279	9,052,951	139,809,485	25,910,418	22,962,947	(2,947,471)	-11.38%	(15,552,211)
7	\$24,099,876	154,697,314	363,155,306	9,234,010	139,145,103	26,298,543	23,214,572	(3,083,971)	-11.73%	(18,636,182)
8	\$24,581,873	156,895,982	360,844,749	9,418,690	138,259,800	26,672,317	23,458,771	(3,213,546)	-12.05%	(21,849,728)
9	\$25,073,511	158,986,425	357,913,560	9,607,064	137,136,697	27,027,692	23,694,649	(3,333,044)	-12.33%	(25,182,771)
10	\$25,574,981	160,940,607	354,314,863	9,799,205	135,757,835	27,359,903	23,921,246	(3,438,657)	-12.57%	(28,621,429)
11	\$26,086,481	162,725,529	349,998,774	9,995,189	134,104,100	27,663,340	24,137,537	(3,525,803)	-12.75%	(32,147,231)
12	\$26,608,210	164,302,388	344,912,220	10,195,093	132,155,157	27,931,406	24,342,427	(3,588,979)	-12.85%	(35,736,211)
13	\$27,140,374	165,625,584	338,998,743	10,398,995	129,889,373	28,156,349	24,534,742	(3,621,607)	-12.86%	(39,357,818)
14	\$27,683,182	166,641,559	332,198,293	10,606,975	127,283,741	28,329,065	24,713,231	(3,615,834)	-12.76%	(42,973,652)
15	\$28,236,846	167,287,442	324,447,009	10,819,114	124,313,790	28,438,865	24,876,559	(3,562,307)	-12.53%	(46,535,958)
16	\$28,801,582	167,489,461	315,676,984	11,035,497	120,953,503	28,473,208	25,023,296	(3,449,912)	-12.12%	(49,985,870)
17	\$29,377,614	167,161,087	305,816,020	11,256,207	117,175,217	28,417,385	25,151,921	(3,265,464)	-11.49%	(53,251,335)
18	\$29,965,166	166,200,858	294,787,367	11,481,331	112,949,523	28,254,146	25,260,807	(2,993,339)	-10.59%	(56,244,674)
19	\$30,564,470	164,489,838	282,509,443	11,710,957	108,245,164	27,963,272	25,348,222	(2,615,050)	-9.35%	(58,859,724)
20	\$31,175,759	161,888,640	268,895,540	11,945,176	103,028,916	27,521,069	25,412,318	(2,108,751)	-7.66%	(60,968,475)
21	\$31,799,274	158,233,950	253,853,513	12,184,080	97,265,475	26,899,771	25,451,123	(1,448,649)	-5.39%	(62,417,124)
22	\$32,435,260	153,334,447	237,285,450	12,427,762	90,917,323	26,066,856	25,462,538	(604,318)	-2.32%	(63,021,442)
23	\$33,083,965	146,966,043	219,087,317	12,676,317	83,944,601	24,984,227	25,444,324	460,097	1.84%	(62,561,345)
24	\$33,745,644	138,866,306	199,148,591	12,929,843	76,304,960	23,607,272	25,394,099	1,786,827	7.57%	(60,774,519)
25	\$34,420,557	128,727,934	177,351,862	13,188,440	67,953,415	21,883,749	25,309,322	3,425,573	15.65%	(57,348,945)
26	\$35,108,968	116,191,125	153,572,417	13,452,209	58,842,180	19,752,491	25,187,290	5,434,799	27.51%	(51,914,146)
27	\$35,811,148	100,834,648	127,677,794	13,721,253	48,920,502	17,141,890	25,025,125	7,883,235	45.99%	(44,030,912)
28	\$36,527,371	82,165,391	99,527,314	13,995,678	38,134,479	13,968,116	24,819,761	10,851,645	77.69%	(33,179,267)
29	\$37,257,918	59,606,137	68,971,582	14,275,592	26,426,870	10,133,043	24,567,939	14,434,895	142.45%	(18,744,372)
30	\$38,003,076	32,481,262	35,851,959	14,561,103	13,736,890	5,521,815	24,266,186	18,744,372	339.46%	0

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The conclusion that I would draw from this is that the slower the underlying pattern of income runs off, the more significant the EITF impact. In fact, if you have a block of business in which the profit stream is running off very quickly, as perhaps in a block of A&H business, you may have a pattern that is exactly the opposite of this. That is, the EITF method may be beneficial in the early years and detrimental in the later years.

We've talked about the actuarial adjustments to PVP that must be made under purchase accounting. Brad touched upon the FIT adjustments. It's time now to hear more about the impact of federal income taxes on purchase accounting.

MR. ARTHUR C. SCHNEIDER: As Howard mentioned, my subject will be accounting for income taxes in purchase GAAP situations. As you probably know, accounting for income taxes in purchase GAAP situations is governed by *FAS 109*, which was issued by the FASB a couple of years ago and has been adopted by every company that's issuing GAAP financial statements. In order for the deferred tax accounting for purchase GAAP situations to make any sense to you, I think it's first going to be necessary to spend time on the basic principles of accounting for income taxes under *FAS 109*.

As you may know, *FAS 109* puts a balance-sheet focus on accounting for income taxes. That is, deferred tax assets and liabilities are established relative to the differences between the GAAP carrying value of assets and liabilities, and their respective tax bases. In addition, deferred tax assets may be established for tax net operating loss and tax-credit carryforwards.

The income statement effect is then measured by the change in the net deferred tax asset or the net deferred tax liability from the beginning of the year until the end of the year. Under *FAS 109*, the measurement of deferred tax assets and deferred tax liabilities is based on the enacted tax rates, which are currently 34% or 35%. The 34% tax rate may still be relevant because the 35% rate doesn't kick in until income exceeds \$10 million in a particular year.

However, the FASB has decided that in the case of a small life insurance company that may be eligible for the 60% small life insurance company deduction, that deduction cannot be anticipated in setting up deferred tax liabilities. This means that a small life insurance company has to set up deferred taxes at, let's say, a 34% rate, even though it knows that it's actually going to pay a much lower rate of tax when that income is reported on the tax return. Conversely, if that company has deferred tax assets, it probably would have to set them up at a lower tax rate because a valuation allowance might very well be appropriate in that case. I'll discuss the concept of a valuation allowance in just a moment.

The differences between the GAAP carrying value of assets and liabilities and their respective tax bases are referred to as temporary differences. Temporary differences result either in future taxable income or future tax deductions when they are recovered or settled. For purposes of the deferred tax computations under *FAS 109*, it's assumed that recoveries of assets and settlement of liabilities is going to occur at their GAAP carrying values.

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As I'll discuss more in a few minutes, it's important to note that goodwill that arises in purchase GAAP situations is not a temporary difference if it's not amortizable for tax purposes.

With limited exceptions, *FAS 109* requires that deferred tax liabilities be established with respect to all temporary differences that result in future taxable income. There are two important exceptions to this rule, relating to the potential liabilities for Phase III taxes for stock life insurance companies and also for the GAAP basis in excess of the tax basis in stock of subsidiaries. As a general rule, no deferred taxes are provided with respect to these items unless it's clear that those taxes are going to occur in the foreseeable future.

Similarly, at least initially, deferred tax assets are established for all future deductible temporary differences and for any tax-return-net-operating-loss carry forwards or tax-credit carryforwards that the company might have. But these potential deferred tax assets have to be reduced by a valuation allowance if it's more likely than not that some portion of those deferred tax assets won't be realized. The key factor in determining the realizability of deferred tax assets and, therefore, the level of the valuation allowance, is the amount of taxable income that's available to offset these future tax deductions. There are three sources of taxable income to look to for this purpose. First is taxable income in the current year and the two prior years; that's available for carryback. Second is taxable income that will result in the future from the reversal of existing temporary differences. Third is future taxable income resulting other than from the reversal of existing temporary differences. It's in allowing consideration of this last category of taxable income that *FAS 109* differs from its predecessor and allows a much more liberal standard for companies to establish deferred tax assets.

The taxable income that offsets these future tax deductions has to be of the proper character; meaning that if the future deduction is going to result in a capital loss, then the taxable income has to be capital in nature as well.

It should be noted that the amount of the valuation allowance can range from zero to the full amount of the potential deferred tax asset; it's not limited merely to the net of the deferred tax asset as reduced by any deferred tax liability. Thus, a company could, before the valuation allowance, be in a net deferred-tax asset position, yet be in a deferred-tax liability position after applying the valuation allowance.

Tax-planning strategies must be considered in determining the amount of the valuation allowance. Tax-planning strategies are actions that management could take and would take, if necessary, to prevent the expiration of a net operating loss or a tax-credit carryforward. Here are a few examples of tax planning strategies: accelerate taxable income or deductions; change the character of taxable income or deductions; switch from tax-exempt to taxable investments; and elect to file a life-nonlife consolidated tax return.

I will next cover the determination of deferred taxes and transactions that are accounted for as purchase business combinations. Let's first consider allocations of GAAP purchase price in a situation in which there's positive GAAP goodwill resulting

from the acquisition. As I go through this, remember that nonamortizable goodwill is not a temporary difference.

When there's positive goodwill resulting from an acquisition, the allocation of GAAP purchase price is done in a six-step process, which I'll illustrate with an example in a moment. First of all, fair-market values are assigned to the identifiable assets acquired and liabilities assumed in the acquisition. The identifiable assets for this purpose include all intangibles other than goodwill. The second step is to compute temporary differences by comparing the values that were assigned in step one to the tax bases of the respective assets and liabilities. The third step is to set up deferred tax assets and deferred tax liabilities on those temporary differences. Four, deferred tax assets are set up with respect to any net operating loss carryforwards and tax-credit carryforwards that the company might have. Fifth, the valuation allowance is set up, if appropriate, on the deferred tax assets. This would be the point where, if there are purchased net operating losses (NOLs) or tax credit carryforwards, a consideration would have to be given to the tax law limitations on the postacquisition utilization of those credits and carryforwards. The sixth step is to set up goodwill for the residual amount that's remaining after the allocations have previously been made.

Table 9 is an illustration of an allocation of purchase price in a situation where there's positive goodwill. In this example, Company A acquires Company B for \$200 million. The identifiable net assets of Company B total \$175 million, consisting of \$150 million in bonds, \$50 million of value of in-force business, and \$25 million of reserves.

TABLE 9  
EXAMPLE  
ALLOCATING PURCHASE PRICE—POSITIVE GOODWILL

● Company A acquires Company B for \$200,000,000			
	<u>Fair Value</u>	<u>Tax Basis</u>	<u>Temporary Difference</u>
Bonds	\$150,000,000	150,000,000	-0-
Value of insurance in force (VIF)	50,000,000	10,000,000	40,000,000
Reserves	<u>(25,000,000)</u>	<u>(25,000,000)</u>	<u>-0-</u>
Identifiable net assets	<u>175,000,000</u>	<u>135,000,000</u>	<u>40,000,000</u>
● Company B has no loss or tax-credit carryforwards for tax purposes			
● Allocation of purchase price:			
Bonds			\$150,000,000
Value of insurance in force			50,000,000
Reserves			(25,000,000)
Deferred tax liability			(14,000,000)
Goodwill			<u>39,000,000</u>
Purchase price			<u>\$200,000,000</u>

The tax basis of the acquired assets also is \$150 million for bonds, and for the value of the in-force business it is \$10 million (this tax-basis value of in-force business might, for example, result from acquisition costs that have had to be capitalized under Section 848 of the Internal Revenue Code (IRC), or perhaps from a ceding

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commission that had to be capitalized for tax purposes from a reinsurance transaction). Although it's unlikely, I'll assume that the tax reserves are also \$25 million. So there's a \$40 million temporary difference here, resulting from the value of insurance in force. This company has no tax-credit or tax-loss carryforwards, so the allocation of the purchase price is made \$150 million to the bonds, \$50 million to the value of the in-force business, and \$25 million to the reserves. A deferred tax liability of \$14 million is set up representing 35% of the \$40 million temporary difference on the value of the in-force business. The residual \$39 million is then allocated to the goodwill.

This \$39 million basically represents the excess of the \$200 million purchase price over the \$175 million of identifiable net assets prior to the deferred tax computation, plus an additional \$14 million to offset the deferred tax liability. In other words, the entry that was made to set up the deferred tax liability was to debit goodwill by \$14 million and to credit deferred tax liability for \$14 million.

Now let's assume that there has been a bargain purchase, and that there's negative goodwill. Negative goodwill is an excess of the fair market value of the identifiable net assets over the purchase price. *FAS 109* requires that negative goodwill be allocated to reduce the assigned values of noncurrent assets.

The problem with negative goodwill is that it creates a loop in the purchase-price allocation. First, negative goodwill is allocated to reduce the assigned values of the noncurrent assets. The reduction in assigned values changes the temporary differences. The change in the temporary differences changes deferred taxes. The change in the deferred taxes changes negative goodwill and so on.

Fortunately, this process can sometimes be cut short by using a simultaneous equation to solve for a factor, which can be applied to the temporary differences to determine the appropriate amount of deferred taxes. The formula that's set forth here, with the 35% tax rate, produces a factor of 0.5384615. Table 10 illustrates how that factor would get applied.

In this example, A has purchased B for \$18 million, and the fair value of the net assets of B before the deferred tax calculation is \$22 million. So initially, there's \$4 million in negative goodwill. The factor from the simultaneous equation is applied by subtracting the tax basis of the net assets acquired, which is \$15 million, from the purchase price of \$18 million, and then multiplying the remainder by 0.5384615 to get an adjustment of \$1,615,385.

Now in this example, the adjustment affects the asset for value of in-force business, which in the final allocation is going to be \$5,615,385, consisting of the \$8 million initial fair value, less the \$4 million of negative goodwill, plus the \$1,615,385 deferred tax adjustment. The deferred tax liability that results (\$1,615,385) represents 35% of the \$4,615,385 temporary difference between the final GAAP value of the in-force business and its \$1 million tax basis.

The point regarding the interaction of the acquired and acquiring companies' tax positions is that the deferred tax asset that's established for the acquired company at the date of acquisition may be affected by temporary differences or tax-loss or tax-credit

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carryforwards of the acquiring company. Presuming that these companies are going to file a consolidated tax return, either initially or somewhere down the road, these items must be considered in setting up the deferred taxes for the acquired company at the date of acquisition.

TABLE 10  
EXAMPLE  
ALLOCATING PURCHASE PRICE—NEGATIVE GOODWILL

● Company A purchases Company B for \$18,000,000			
	<u>Fair Value</u>	<u>Tax Basis</u>	<u>Difference</u>
Bonds	\$34,000,000	34,000,000	-0-
VIF	8,000,000	1,000,000	7,000,000
Reserves	<u>(20,000,000)</u>	<u>(20,000,000)</u>	<u>-0-</u>
Net assets acquired, excluding deferred taxes	<u>\$22,000,000</u>	<u>\$15,000,000</u>	<u>\$7,000,000</u>
● Assume no valuation allowance required			
● Apply factor from simultaneous equation			
Purchase price		\$18,000,000	
Tax basis of net assets required		<u>15,000,000</u>	
Initial net temporary difference		\$3,000,000	
× Factor	x	<u>0.5384615</u>	
Adjustment necessary		<u>\$ 1,615,385</u>	
● Allocation of purchase price			
VIF		\$5,615,385 <sup>a</sup>	
Bonds		34,000,000	
Reserves		(20,000,000)	
Deferred tax liability		<u>(1,615,385)</u>	
Purchase price		<u>18,000,000</u>	

<sup>a</sup>\$8,000,000 fair value less 4,000,000 negative goodwill plus 1,615,385 adjustment.

Subsequent recognition of carryforwards is an important concept relating to accounting for income taxes in purchase GAAP situations. At the date of acquisition, if the acquired company has to establish a valuation allowance, because it's more likely than not that some portion of the future tax benefits of deductible temporary differences or tax net operating loss or credit carryforwards won't be realized, then when those benefits are subsequently recognized, the benefit does not go to the income statement, but instead first reduces goodwill and other noncurrent intangible assets related to the acquisition. Only after those items have been reduced to zero does the benefit go to the income statement.

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Now the reason why goodwill is credited upon subsequent recognition of these carryforwards is that goodwill would have been credited at the date of acquisition if the deferred tax asset could have been recognized at that time. Therefore, the subsequent credit to goodwill more or less restores things to the way they would have been from the start, if the tax asset could have been recognized at the date of acquisition.

Table 11 is an example of the accounting for subsequent recognition of goodwill. In this example, A acquired B for \$21 million. The identifiable net assets of B have a fair value of \$20 million and a tax base of \$18 million, so there is a \$2 million temporary difference. Company B also has a tax-net-operating-loss carryforward of \$3 million. If it's decided at the date of acquisition that the tax net operating loss should be recognized as a deferred tax benefit only to the extent of Company B's \$2 million future taxable temporary difference, the purchase price would be allocated \$20 million to the identifiable net assets and \$1 million to goodwill. There would be no net deferred tax asset or liability, because the \$700,000 deferred tax liability on the \$2 million temporary difference would be offset by the \$700,000 deferred tax asset on \$2 million of the \$3 million net-operating-loss carryforward.

**TABLE 11**  
**EXAMPLE**  
**SUBSEQUENT RECOGNITION OF CARRYFORWARDS**

● Company A acquires Company B for \$21,000,000			
	<u>Fair Value</u>	<u>Tax Basis</u>	<u>Temporary Difference</u>
Identifiable net assets acquired	\$20,000,000	\$18,000,000	\$2,000,000
● Company B has a tax NOL carryforward of \$3,000,000			
● If it is decided that the tax benefit of the NOL should be recognized only to the extent of Company B's \$2,000,000 future taxable temporary difference, purchase price would be allocated as follows:			
Identifiable net assets	\$20,000,000		
Net deferred tax liability		-0 <sup>a</sup>	
Goodwill		<u>1,000,000</u>	
Purchase price		\$21,000,000	
● The following year, Company B has \$4,000,000 of pre-tax income, and completely utilizes its NOL carryforward, so its current tax liability is \$350,000 ((\$4,000,000 less \$3,000,000) × 35%). Company B makes the following entries to record its tax provision:			
DR Current tax expense	350,000		
CR Current tax liability			350,000
DR Deferred tax expense	700,000		
CR Deferred tax liability			700,000
DR Charge in lieu of tax expense	350,000		
CR Goodwill			350,000

<sup>a</sup>\$700,000 deferred tax liability net of \$700,000 deferred tax asset.

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Now the following year, assume that Company B has \$4 million of pretax income, so it's able to completely utilize its net operating loss carryforward. Its current tax liability is \$350,000, that being it's \$4 million of income less the \$3 million NOL carryforward times 35%. Company B in that case would set up a \$350,000 current tax expense and current tax liability, a \$700,000 deferred tax expense and deferred tax liability, and it would credit goodwill for \$350,000, representing 35% of the previously unrecognized net operating loss carryforward of \$1 million. The offset to the credit to goodwill would be a charge to an income statement account that is called a "charge in lieu of tax expense." The \$700,000 deferred tax liability that exists after these entries equals 35% of the \$2 million temporary difference on the acquired net assets other than goodwill, so the company has gotten back to the proper point its deferred tax accounting.

Table 12 is an example of a similar rule that applies in case of subsequent recognition of so-called "purchased excess tax basis." This is a situation that arises when the tax basis of assets exceeds the GAAP value that's assigned in the purchase. If a valuation allowance is initially recognized for the tax benefit related to the purchased excess tax basis, then, as in the previous example, the subsequent recognition of that benefit is first credited to goodwill and not to the income statement.

TABLE 12  
EXAMPLE  
PURCHASED EXCESS TAX BASIS

●Company A purchases Company B for \$900,000			
●Company B's only identifiable asset is a mortgage loan			
	<u>Fair Value</u>	<u>Tax Basis</u>	<u>Temporary Difference</u>
Mortgage Loan	\$700,000	\$1,000,000	\$(300,000)
●Assuming a valuation allowance is established for the full amount of the potential deferred tax asset, purchase price is allocated as follows:			
Mortgage Loan		\$700,000	
Net deferred tax asset		-0-	
Goodwill		<u>200,000</u>	
Purchase price		<u>\$900,000</u>	
●The following year, the remaining principal balance of the mortgage loan (\$1,000,000) is prepaid. Company B makes the following entries to record its tax provision:			
DR Current tax expense		-0-	
CR Current tax liability			-0-
DR Charge in lieu of tax expense		\$105,000	
CR Goodwill			\$105,000

Let's move on to talk about taxable purchases. So far the examples have dealt with purchases that didn't affect the tax basis of the assets, such as where the acquisition is a straight purchase of the stock of the acquired company. In a taxable purchase, the purchase price is allocated to the tax basis of assets and liabilities as well as to the GAAP basis of assets and liabilities. Probably the most common example of the

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way this happens these days is a stock acquisition in which the buyer and the seller agree to treat the acquisition as a purchase of the target company's assets. This is referred to in tax parlance as a Section 338 (h)(10) election. Now you might think that there shouldn't be any deferred taxes in these situations, because the same purchase price is being allocated both for GAAP and tax purposes. But remember that, first of all, values assigned to individual assets and liabilities for GAAP and tax purposes may differ, thereby creating temporary differences. And even if temporary differences do net to zero, *FAS 109* requires that deferred tax liabilities be established for all future taxable temporary differences, but a deferred tax asset isn't necessarily established for all future deductible temporary differences. Therefore, there might not be a complete netting. Second, as I mentioned before, nonamortizable goodwill is not a temporary difference, so the temporary differences won't necessarily net to zero.

Prior to enactment in 1993 of Section 197 of the IRC, the major tax issue in a taxable purchase was normally whether the values assigned to intangible assets should be amortizable for tax purposes. Many companies took aggressive tax-return postures with respect to this situation, hoping for favorable settlement with the IRS or in the courts. *FAS 109* requires that the deferred tax calculations in these types of situations should be made on the basis of the expected outcome, and Table 13 shows an example of how this accounting would be made. I'm not going to cover the example, because it's really applicable only in the historical context these days.

**TABLE 13  
EXAMPLE  
AGGRESSIVE TAX POSITIONS IN TAXABLE PURCHASE**

<ul style="list-style-type: none"> <li>● Company A acquires Company B for \$100,000,000 in a taxable purchase</li> </ul>			
	<u>Fair Value</u>	<u>Aggressive Tax Basis</u>	<u>Probable Tax Basis</u>
Net assets other than intangibles	\$80,000,000	\$80,000,000	\$80,000,000
Identifiable intangible asset	10,000,000	10,000,000	-0-
Goodwill	10,000,000	10,000,000	20,000,000
<ul style="list-style-type: none"> <li>● Deferred taxes at the date of acquisition are based on probable tax basis, so purchase price is allocated as follows for GAAP purposes:</li> </ul>			
Net assets other than intangibles		\$80,000,000	
Identifiable intangible asset		10,000,000	
Deferred tax liability		(3,500,000)*	
Goodwill		<u>13,500,000</u>	
Purchase price		<u>\$100,000,000</u>	
<ul style="list-style-type: none"> <li>● As the identifiable intangible asset is amortized on the tax return, a cushion is set up in the current tax liability and the deferred tax liability is correspondingly reduced.</li> <li>● For example, after 40% of the asset has been amortized on the tax return:</li> </ul>			
Current tax liability		\$1,400,000	
Deferred tax liability		<u>2,100,000</u>	
		<u>\$3,500,000</u>	
<ul style="list-style-type: none"> <li>● If a tax deduction is ultimately sustained, the reduction of the tax liability is credited to goodwill rather than income tax expense.</li> </ul>			

\*35% of \$10,000,000 of GAAP basis of identifiable intangible asset over probable tax basis.

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The 1993 tax law will affect the computation of deferred taxes in situations involving taxable purchases. The reason for this is that the 1993 Tax Act added Section 197 to the IRC. This section generally allows a tax deduction for amortization of purchased intangibles, including goodwill and going-concern value. The amortization is allowed over a 15-year period and is done on a straight-line basis.

However, deferred taxes still are not established with respect to GAAP goodwill that's nonamortizable for tax purposes. Nonamortizable goodwill could arise in a taxable purchase if the GAAP goodwill exceeds the tax-basis goodwill. So under *FAS 109*, in situations in which goodwill is amortizable for tax purposes, goodwill must be separated into two components for purposes of calculating deferred taxes. The first component is the lesser of goodwill for GAAP purposes, or tax-deductible goodwill, and the second component is the remainder of any goodwill for GAAP or tax purposes.

Any basis difference related to this first component that arises in future years because of different methods of amortization is going to create a temporary difference for which a deferred tax asset or liability is recognized in those future years. A simple example is if there was a \$3 million purchase price and all of the value was assigned to goodwill, both for tax and GAAP purposes, with the GAAP amortization occurring over 30 years and tax amortization occurring over 15 years. In this case, there wouldn't be any deferred taxes that would be established at the date of acquisition, because there is no difference at that point between tax-basis and GAAP-basis goodwill.

However, after one year the GAAP basis would have been amortized by \$100,000 down to \$2.9 million and the tax basis by \$200,000 down to \$2.8 million. And at that time, a deferred tax liability of \$35,000 would be set up on that \$100,000 excess of GAAP over tax basis. This makes sense because at that time, there has also been a \$35,000 current tax benefit relating to the excess of tax amortization over GAAP amortization.

With respect to the second component of goodwill in these situations, no deferred taxes are ever recognized. If the second component of goodwill is an excess of tax-deductible goodwill over GAAP goodwill, however, the tax benefit for that amortization is recognized when it's realized on the tax return. However, that tax benefit is first recognized as a reduction of goodwill and other noncurrent intangible assets related to the acquisition before it can be reflected as an income-tax-expense benefit.

Tables 14-16 deal with this much more complex situation, in which there are two components of goodwill, and the second component is in excess of tax-basis goodwill over GAAP goodwill. This example is based on an example that was published in *FAS 109* at paragraph 263. I'm not going to go through it, because it's long and complex, but it does show how GAAP goodwill is affected in future years as the benefit of the second component of goodwill is realized on the tax return.

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TABLE 14  
EXAMPLE  
ACQUISITION WITH TAX-AMORTIZABLE GOODWILL

●Assumptions:

- Goodwill at date of acquisition equals \$600 for GAAP purposes and \$800 for tax purposes.
- Tax goodwill is amortized straight line over two years.
- GAAP goodwill is amortized straight line over four years.
- Income before amortization of goodwill and income taxes in each of years 1-4 is \$1,000.
- At the purchase date, goodwill is separated into two components:

	<u>GAAP Basis</u>	<u>Tax Basis</u>
First component	\$600	\$600
Second component	-0-	200
	<u>\$600</u>	<u>\$800</u>

- A deferred tax liability is recognized at the end of years 1-3 for the excess of GAAP over tax basis for the first component of goodwill.
- A deferred tax asset is not recognized for the second component of goodwill; but the tax benefit is allocated to reduce goodwill.
- This allocation produces a deferred tax benefit by reducing the taxable temporary difference related to the first component of goodwill.
- So total tax benefit (TTB) allocated to reduce first component of goodwill is the sum of the realized tax benefit plus the deferred tax benefit from reducing the deferred tax liability related to goodwill.

$$\begin{aligned}
 \text{TTB} &= \text{Realized Tax Benefit} + (0.35\text{TTB}) \\
 &= 35 + (0.35\text{TTB}) \\
 &= 53.84615
 \end{aligned}$$

TABLE 15  
ACQUISITION WITH TAX-AMORTIZABLE GOODWILL

●GAAP goodwill for years 1-4 is:

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>
Beginning balance	600	396.15	210.25	105.125
Amortization:				
600/4 years	(150)			
396.15/3 years		(132.05)		
210.25/2 years			(105.125)	(105.125)
TTB allocated to reduce goodwill	<u>(53.85)</u>	<u>(53.85)</u>	<u>-0-</u>	<u>-0-</u>
Ending balance	<u>396.15</u>	<u>210.25</u>	<u>105.125</u>	<u>-0-</u>

●Deferred tax liability for first component of goodwill and related deferred tax expense (benefit) for years 1-4 is:

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>
GAAP goodwill at end of year	396.15	210.25	105.125	-0-
Tax basis of first component of goodwill	<u>300.00</u>	<u>-0-</u>	<u>-0-</u>	<u>-0-</u>
Temporary difference	96.15	210.25	105.125	-0-
Deferred tax liability:				
End of year	33.6525	73.5875	36.79375	-0-
Beginning of year	<u>-0-</u>	<u>33.6525</u>	<u>73.5875</u>	<u>36.79375</u>
Deferred tax expense (benefit)	<u>33.6525</u>	<u>39.935</u>	<u>(36.79375)</u>	<u>(36.79375)</u>

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TABLE 16  
ACQUISITION WITH TAX-AMORTIZABLE GOODWILL

●GAAP income for years 1-4 is:				
	Year 1	Year 2	Year 3	Year 4
Income before amortization of goodwill and income taxes	\$1,000.00	\$1,000.00	\$1,000.00	\$1,000.00
Amortization of goodwill	<u>150.00</u>	<u>132.05</u>	<u>105.125</u>	105.125
Pretax income	<u>\$ 850.00</u>	<u>\$ 867.95</u>	<u>\$ 894.875</u>	<u>\$ 894.875</u>
Income tax expense (benefit):				
Current	\$ 210.00	\$ 210.00	\$ 350.00	\$350.00
Deferred	33.6525	39.935	(36.79375)	(36.79375)
Charge in lieu of taxes	<u>53.85</u>	<u>53.85</u>	<u>-0-</u>	<u>-0-</u>
Total	<u>297.5025</u>	<u>303.785</u>	<u>313.20625</u>	<u>313.20625</u>
Net Income	<u>\$ 552.4975</u>	<u>\$ 564.165</u>	<u>\$ 581.66875</u>	<u>\$ 581.66875</u>
Effective rate of total tax	35%	35%	35%	35%

MR. BRUCE R. DARLING: You defined the tax basis of value of insurance in force. I missed what that was. I know what the fair value of insurance in force is for GAAP purposes, but I'm not really sure what that means for tax.

MR. SCHNEIDER: Well I guess I shortcut the description. I think you could have basis in a block of business for tax purposes in two ways. First is, if you looked at DAC that was capitalized under Code Section 848, that could be considered basis in a block of business. Second, if you had a ceding commission in a reinsurance transaction that had to be capitalized and amortized for tax purposes, that could give you a tax basis as well.

MR. DARLING: OK, except for the DAC tax, wouldn't you normally have run into that earlier?

MR. SCHNEIDER: That's generally true.

MR. ROSEN: Art, with respect to 338(H)(10) elections, is it true that the amortizable value more or less becomes a plug; that is, the difference between the purchase price, the liabilities and surplus? In the past, for 334(B)(2) and 334-type elections, when you looked at the amortizable value in the tax return, didn't it used to be more or less an actuarial calculation?

MR. SCHNEIDER: That's somewhat true, Howard. I think you could broaden that to say that the plug is for all intangibles. The way the allocation will now work under Section 338 is that you basically allocate tax basis to all assets other than intangibles, and then intangibles will be the residual amount that will be amortized under new Code Section 197. Some have questioned whether it's even necessary to break out the various values of intangibles, because they're amortizable under the same tax section and they're all amortizable. The answer is probably yes. First of all, it probably will have to be done for financial-statement purposes. As I mentioned in the example I gave, different amortization periods are going to give different values that could produce temporary differences. There are also some tax rules relating to the disposition of assets acquired under Section 197 that may make it necessary to have basis allocated to various assets. And then finally, probably most importantly, is that

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from a tax standpoint, when business is acquired that's subject to capitalization under Section 848, the capitalization that's required under Section 197 for that value of in-force is only the excess of the amount that normally would be capitalized under 197 over what has to be capitalized under the DAC rules. To figure out the DAC rules, you must come up with an imputed premium. To get an imputed premium, you're probably going to have to have a value that you would back off from reserves to get the assets that are deemed transferred.

MR. ROSEN: Brad, has 92-9 had any impact on your clients with respect to their acquisition activity, accepting the fact that it will have an impact on earnings per share?

MR. SMITH: Obviously, it should conceptually. What should be clear from both of our presentations is that you can't use the level ROE approach anymore. Obviously, if you make an acquisition and your hurdle rate is 17%, the earnings aren't going to emerge on a level-ROE-type basis. They're going to typically emerge on an increasing basis. I guess your question is, does this accounting treatment stop the mergers and acquisition business? Quite frankly, I think most people are viewing it as the accounting benefit that you got was just kind of an incremental benefit. It wasn't what was driving the acquisitions. Personally, I've seen a tremendous increase in mergers and acquisitions in the last three to four months. It was kind of depressed last year, because of the capital structures that people had to put together and the leverage transactions. The banks weren't lending money as freely, and the decline of the subsidiary debt market has forced people to put more common equity into the deals, which has resulted in a lower return. Where as before, the common equity people were getting a return of 30-40% on the common equity piece, because they were only putting in 5% or 10% of common equity into the capital structure. Now they're having to put in 25-40% in as common equity, thereby lowering the return on equity. So many of the highly leveraged players are no longer in the game. But to answer your question directly now, if anything, I've seen an increase in merger and acquisition activity, possibly due to other mitigating reasons like risk, companies divesting because of risk-based capital (RBC) and things like that.

Howard, I might make the point, which is interesting, of the difference between the EITF adoption of these rules and a FASB pronouncement. If you'll remember back when *FAS 97* was adopted, companies had to go back and restate their balance sheet based upon what the balance of DAC should have been based upon the *FAS 97* methodologies. Now, because a pronouncement wasn't made, one of the small differences between a pronouncement and a conclusion adopted by the EITF is that companies did not have the benefit of bringing down their PVP or DAC on acquisitions. For *FAS 97*, you weren't allowed to take down DAC through equity. DAC still has to come down through income, which is a minor difference but is still a significant difference. Also, the advantage that I talked about and that you had touched on is the companies that were aggressive previously in their accounting, using a level ROE approach, given the fact that they can continue that approach, are still reaping the benefits of that prospectively.

MR. ROSEN: I look at my companies on the left end of the page as being slightly to the left of average.

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MR. SMITH: I don't think I said left or right. I think I said pushing the edge of the envelope, whatever side of that envelope it was.

MR. ROSEN: If you meant the right side, my absolute apologies. I'm not sure you did.

MR. EDWARD P. MOHORIC: What date is meant by the November 19 date? Is that the date of the agreement or sale? There's often a string of dates involved in an acquisition.

FROM THE PANEL: Right. I believe that it's the effective date of the acquisition, not the definitive agreement, but the effective purchase price date.

FROM THE PANEL: I think that's right. For instance, Ed, if you closed the transaction on December 1, 1992, but it was effective as of July 1, 1992 and you wanted to amortize by using a level ROE approach, I think you could make that case. Isn't that your interpretation?

FROM THE PANEL: What's really important about 92-9 is that it is not retroactive. Companies do not have to change their methods and procedures with the exception of that one item that I mentioned, which was companies that had as a normal matter of practice reduced their discount rates when those things were indicated by recoverability. But for companies whose transactions predated November 19, actually November 19 and prior, there's no change. It's only for subsequent transactions.

And like I said, there's no opportunity to take down that excess DAC through equity as opposed to through income. Eventually, you have to take it down through income.