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Purchase Generally Accepted Accounting Principles— Where Are We Heading?

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Summary: This panel discusses the accounting profession's attempts to codify an area that has long been subject to a wide variety of practice. The accounting profession has grappled with Accounting Principles Board Opinion 16, Emerging Issues Task Force 92-9, Statement of Financial Accounting Standards 60 and 97 in its search for guidance. Where is the accounting profession today? This session reviews the progress toward emerging new guidance and gives insights from an actuarial perspective.

Topics covered include:

- *Accounting under the various methods of acquisitions: pooling of interests, purchase of stock, assumption reinsurance, indemnity reinsurance*
- *Benefit reserve approaches under Statement of Financial Accounting Standards 60 within the context of defined-valuation premium approach vs. defined-initial reserve approach*
- *Approaches to determination of discount rate for the present value of future profits and purchase date*
- *Effect of differing levels of goodwill on earnings (accretion vs. dilution)*

Mr. Daniel J. Kunesh: There has been a lot of acquisition activity over the last several years. Along with this activity, there has been a growing amount of controversy about the accounting for business combinations. In fact, very recently, the FASB issued a new draft statement of financial accounting standards on the topic of business combinations. Our panel is going to cover that, along with a series of related topics.

I am with Tillinghast-Towers Perrin in Chicago. We are blessed today to have three very fine speakers who are knowledgeable on the topic of business combinations.

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First is James Milholland. He is a partner with Ernst and Young in Atlanta, where he has practiced for more than 21 years. Jim is very experienced in the area of buying and selling companies and in purchase accounting. Jim is going to be our teacher, so to speak. He is going to take an accounting perspective and give an overview of pooling versus purchase accounting. He will discuss topics such as price allocation and fair-value application. He will define and discuss the value of business-acquired asset, goodwill, and the emergence of earnings under purchase accounting and give you a run down on the FASB exposure draft.

Next will be Doug Kolsrud, an executive vice president and chief investment officer at AEGON, where he's been for quite a few years. As you may know, AEGON has been very active in the merger and acquisition marketplace. Doug is going to give a brief background of AEGON acquisition history. He will discuss the relationship of purchase accounting to pricing a deal. Then he will share some lessons learned about the implementation phase of purchase accounting at his company. That should be very interesting.

The final person on our program is a guest speaker, Jeff Consolino, a director at Merrill Lynch Financial Institutions Group. Jeff specializes in insurance company advisory and financial transactions. Over the last seven years he has been involved in more than 60 announced or completed assignments, which total over \$35 billion in transaction value. So Jeff is certainly no newcomer to this arena as well. Jeff has a B.S. in Electrical Engineering from Duke University. He is an MBA from Cornell University's Johnson School of Management, where he graduated as valedictorian. He will cover subjects such as the elements of an investment banker's analysis and observations from recently announced transactions. He will also take you through a real-world example and give his impressions of the newly proposed FASB requirements. So without further ado, let me turn it over to Jim.

Mr. James B. Milholland: We told you purchase accounting was changing; we just didn't realize how much. Just out of curiosity, how many of you have had to go through a purchase accounting project already? About half, of you have gone through it and the other half will at the current rate of change, undoubtedly.

It's a big topic. It's a timely topic because of the consolidation in the industry. It's a topic that affects all businesses. Many of my comments are specific to insurers, and the really good stuff is the actuarial stuff, which is the heart of this presentation.

Purchase accounting is also a controversial subject, as Dan pointed out, and it's in the news. It's been on the front page, at least the front page of business sections, that certain accounting methods are unfair and wrong and should be changed. In fact, proposed changes to the rules are part of the presentation.

There are three parts to the presentation. The first part talks about the two major accounting methods that are used for business combinations. This is where I must be careful. I tend to talk about purchase accounting, but purchase accounting is one of the methods available. In fact, there are two methods for accounting for

the combination of businesses. We're going to take a quick look at both to see how they differ.

The middle section is going to be the more actuarial. We talk about those areas requiring actuarial involvement in purchase accounting, the second of the two methods. These areas are the valuation of reserves, and the valuation of the value of business acquired (VOBA). VOBA is the acronym that I like to use for the purchase intangibles associated with the value of in-force blocks of business. It's called many different things, like present value of future profits or value of in-force. I sometimes hear it called purchase deferred acquisition cost (DAC). I don't know if purchase DAC ever makes it into a financial report, but it's apt to call it purchase DAC because in many respects VOBA operates just like DAC. It represents what the buyer has paid for the block of business.

The third part looks into the future a little bit and discusses the FASB exposure draft, in which FASB has proposed some pretty fundamental and far-reaching changes to purchasing accounting. There is no relief to actuaries as a result of those changes.

The most basic source of guidance to actuaries and others in business combinations comes from *Accounting Principles Board Opinions 16 and 17*. Remember that the APBs are the rules that were created before the formation of the FASB, but they have survived. They've been adopted by the FASB, so they remain rules until they are superseded. These two have not been superseded yet, but are about to be. *APB 16* is one that describes the two possible approaches. *APB 17* is the one that defines accounting for intangibles. Again, these are across all industries and there is very little in them that's specific to insurance businesses.

APB 16 distinguishes between two methods. The first is called pooling of interests, and the second is called purchase accounting. The first is applicable only when there's a true merger. It has the advantage that it's easier to implement.

A pooling of interest does not require changing the carrying value of the assets and liabilities. Instead, companies combine their books on their historic accounting bases. A purchase, on the other hand, requires that the buyer (and one of the two parties must be the buyer) account for the acquisition as if it were a purchase of the assets and an assumption of the liabilities. When you buy assets, you buy them at fair value, so the buyer has to record each of the assets, or pools of assets, at the current fair value. That's what generates the work is the change in the accounting basis of the assets and the liabilities.

In order to qualify for pooling of interests, there are a number of conditions that must be met.

What are the conditions for a pooling of interests? Combining companies are autonomous and independent of one another; a single transaction is completed within one year; an acquirer exchanges only common stock for at least 90% of the

common stock of the acquired; you cannot repurchase stock to consummate a transaction; and there is an absence of planned transactions.

Determining these conditions are met can be very difficult. They essentially say that the combination is a true merger with shareholders pooling their assets and sharing their obligations by an exchange of their shares at a reasonable exchange ratio. Any cash movement to one set of shareholders, any stock repurchase, or any spin-offs or divesting, shortly before or after the transaction, can eliminate this possibility. It is very difficult for a transaction to qualify as a pooling of interest. The test is either/or; it's not an option. Either you have a pooling of interests and meet the conditions, in which case you account for the combination as a pooling of interest, or you fail, in which case it's a purchase. Despite the onerous conditions, some major transactions have qualified for a pooling. In the insurance industry, some notable examples include the merger of American General and USLife and more recently, the UNUM-Provident merger.

Let's take an example to illustrate the difference between the two methods. Table 1 is very simple. At this point we're not going to get into actuarial issues at all. Let's take the example of Company A and Company B deciding to merge.

Table 1
Pooling Example: Balance sheets of Merging Companies

Company A		Company B	
Assets		Assets	
Investments	100,000	Investments	50,000
Liabilities and Capital		Liabilities and Capital	
Reserves	90,000	Reserves	45,000
Equity	10,000	Equity	5,000
Total	100,000	Total	50,000

Note that Company B is 50% of Company A in every respect, including income. Table 2 shows what a consolidated balance sheet looks like.

Table 2
Pooling Example: Combined Balance

Company A & B			
Assets		Liabilities and Capitals	
Investments	150,000	Reserves	135,000
		Equity	15,000
Total	150,000	Total	150,000

This is simply the addition of the various accounts. In the real world, there could be some relatively small adjustments for elimination of intercompany transactions or for conforming accounting policies, but basically it's just additive.

Table 3 shows what the pro forma income would look like.

Table 3
Pooling Example: Income Statements of Merging Companies

	Company A	Company B	Combined A & B
Revenues	16,000	8,000	24,000
Expenses	15,000	7,500	22,500
Net Income	1,000	500	1,500

Again, this is just additive. This is pro forma because nothing is ever the same after a merger, but you can think of it this way. That's simple enough.

Let's go on to consider the same two companies in a purchase. We have to describe the transaction in Table 4.

Table 4
Assumptions

A issues 500 shares to purchase 100% of shares of B		
A's shares have a market price of 20		
Purchase price is $500 \times 20 = 10,000$		
Comparative values of B's accounts:		
	Book Basis	Fair Value
Investment	50,000	52,000
Reserves	45,000	45,000

Note: Investments assumed held-to-maturity

Let's say that A buys B by giving shareholders of B 500 shares of A. These are new shares that have a market price of \$20 on the day of closing. This means that A is the buyer, and the price is deemed to be \$10,000.

To do the combination, it is necessary to know the fair value of the assets and the liabilities, so we have a comparison book and a fair value of these assets and liabilities.

In this example, again for simplicity, the only change from the book values is the value of the investments. Note that in all my examples I've assumed that the companies carry their assets as held-to-maturity, just to get the *FAS 115* complexities out. That's never the case, but it is much easier to see the principles if you assume investments are held-to-maturity.

So what did A get for \$10,000? It got \$5,000 of B's equity. It got \$52,000 of assets. Remember, A had to buy the assets at their fair value; A assumed \$45,000 of liabilities. That leaves \$3,000 of the purchase price unaccounted for.

This residual amount, the amount of the price in excess of the net assets acquired, is recorded as an asset called goodwill, a term I'm sure you're familiar with. Recording goodwill as an asset is based on the presumption that A has willingly paid the excess \$3,000 for something of value.

Nothing specific has been identified, or, if identified, it can't be measured. In other words, the residual of the purchase price is deemed to represent an unspecified intangible asset, and it's presumed to have value.

Table 5 shows what a consolidated balance sheet looks like.

Table 5
Purchase Accounting: Consolidated Balance Sheet

Company A & B			
Assets		Liabilities and Capital	
Investments	152,000	Reserves	135,000
Goodwill	3,000	Equity	20,000
Total Assets	155,000	Liabilities and Equity	155,000

This balance sheet is very different from the first example. Goodwill is an asset and must be amortized. The premium on the investments must also be amortized into income, and those two things will reduce the earnings (Table 6).

Table 6
Purchase Accounting: Consolidated Pro Forma Income Statement

Company A & B	
Revenues	23,600
Expenses	22,800
Net Income	800
Earnings difference:	
amortization of investment premium	<400>
Amortization of goodwill	<300>
	<700>

The pro forma income can be reconciled directly to the previous one by those two adjustments; namely amortization of the investment premium and the amortization of goodwill.

Table 7 shows a comparison.

Table 7
Comparison of Pooling vs. Purchase

	Pooling	Purchase
Total Assets	150,000	155,000
Equity	15,000	20,000
Earnings	1,500	800
ROE	10%	4%

This is a really dramatic difference. It's dramatic because of the circumstances that I assumed, namely that there was a significant unrealized gain and that the purchase price was pretty healthy. This is not a necessary result of purchase accounting. In fact, in a different economic environment, say, if insurance company shares are not selling for a lot, and there are unrealized losses in the portfolio, you would have the opposite result. So, driving down the ROE is not a necessary result, but it is a typical one in the current environment.

Let's just have a quick survey. Looking at pooling and purchase, which one would you deem to be distortive? A show of hands for people who think, based on these examples, that pooling would distort the financial position and results of the consolidated company? How many find pooling distortive? Not many. How many find purchase account distortive? A few more. These perspectives will be significant later when we discuss the proposed changes to the rules.

There are a couple of points we haven't covered under the existing rules. Goodwill must be amortized over a period no greater than 40 years. Purchase accounting is strictly prospective; the consolidation is as of the purchase date and thereafter. A pooling requires a restatement for the years that are shown in the financial report, as if there had been a pooling earlier.

So that's pooling and purchase. Purchase is the one that is more common, and it's the one that requires actuarial involvement. Let's focus on purchase accounting. First, a review of mega steps.

One, determine the buyer. It's not always easy. In a purchase, if a company pays cash for another company's stock, the determination is easy. In more complex transactions, determining the buyer can be difficult. Next, determine the price. Price is not always trivial. There are forms of consideration other than cash, and the consideration must be valued. That can become very complex. Third, allocate the price. That's the point at which the actuary comes in, because allocation of the price requires the actuary to set the reserves and do the VOBA calculations. Since that's where we come in, we're going to leave the first two steps to the other experts and drill down on step three and four, which are setting the balance sheet and determining how to amortize the purchase adjustments.

What items have to be fair-valued? For assets, tangible items include securities, mortgages, and real estate; intangibles include VOBA and other goodwill. For liabilities, you have reserves (provisions for future benefits and policyholder deposits) and claims liabilities. Another one is deferred tax liability. It is a significant one because you must record a deferred tax liability for the timing differences between the fair values of the assets and liabilities and their tax bases.

It is also important to know how the tax works; it varies with the nature of the transaction.

The example we're going to consider is the purchase of the stock of an enterprise.

There may be other intangible assets. VOBA may not be the only intangible asset that can result from a transaction, but it's the one that you and I are likely to get involved with.

The emphasis in the example is on long-duration contracts. There are purchase accounting issues with respect to short-duration contracts and claims liabilities; but let's focus on long-duration assets.

What is the fair value of liabilities? *APB 16* requires that you fair value the assets and the liabilities. Common practice for *FAS 60* contracts is to recalculate the reserves using current assumptions. This means updating the mortality, lapse, maintenance expense, and interest assumptions, including a provision for adverse deviation. If you've ever done that, you know you must pick your starting point, either selecting the net premium or the beginning reserve. Probably the most common practice on universal life (UL) type contracts and annuities is to hold the account values as the reserves, either on the presumption that account value is the fair value or the presumption that *FAS 97* defines a reserve basis, which is not changed by *APB 16*. The presumption that account values are the appropriate liability for purchase accounting of UL contracts is one that I believe is not necessarily correct.

There is very limited experience in purchases of blocks of business that are valued under *FAS 120*, although that's likely to change sometime after demutualizations are finished and transactions occur. Presumably, it would work a lot like *FAS 97*, where you either would say, because the dividend scale is adjustable, that *FAS 120* reserves are fair value, or you might argue, as I do, that that's not necessarily the case.

The second big issue is VOBA. What is it? How is it calculated? VOBA represents the buyer's willingness to accept policy obligations for which the fair value exceeds the fair value of the acquired investments funding the obligations.

If you buy a company with a block of business for which reserves have a certain value and you've made an analysis and you know the value of the assets needed to support those reserves, there is usually a difference between the reserves and the assets. The liabilities typically exceed the assets.

Why would you do that? Why would you take on a block of business where the liabilities exceed the assets? The answer is that, over time, on a net cash-flow basis, you see the profit potential, and therein lies value. So I would define the value of the business to be that difference, bringing in again the complexities of deferred taxes. The key is to identify, for each block of business, which assets you deem to support future benefits. One way to do this is to employ a standard actuarial appraisal; that's usually how a block of business is priced. You can start with the actuarial appraisal value, with assets equal to the statutory reserves and the required surplus, which form the basis for the appraisal value. VOBA is then calculated by maintaining the equation of assets to liabilities and equity, where equity is the appraisal value. This is a micro balance sheet where the equity that you would attribute to the line of business is the appraisal value.

One way to look at this is to assume that you're willing to acquire the block for the actuarial appraisal value and that VOBA is the appraisal value adjusted for the valuation differences in the assets and the liabilities. Again, the tricky part is the tax component.

Let's illustrate this with an acquisition of a company. Table 8 shows what the statutory balance sheet would look like.

Table 8
VOBA Example: Background
Acquired Company-Statutory Balance Sheet

Assets		Liabilities and Surplus	
Investments	92,920	Reserves	88,000
		Surplus	4,920
Total Asset	92,920	Total L & S	92,920
In-force business is universal life			
Investments are amortized cost classed as held-to-maturity for GAAP			
Reserves are CRVM			
Surplus equals required surplus			

This example starts with statutory because the appraisal value is typically based on statutory-basis financials. The business here is UL. Again, I assume that the investments are held-to-maturity. The discount rate in the actuarial appraisal is 12%, and the surplus is exactly the required surplus. I don't have too little or too much surplus. These again are all just simplifying assumptions.

Let's say we have a very rational basis for our purchase price. Even though prices are negotiated, you can generally relate the business to an appraisal value, and you can determine what you paid for the in-force, and what you paid in excess. As shown in Table 9, we've assumed that after we valued the various blocks of business (one in this case) we threw in an extra \$1,000 for infrastructure, potential synergies, economics, and all the usual reasons. The extra amount, if you think about it, appears to be like goodwill.

Table 9
VOBA Example: Purchase Price

Value of in-force	7,439
Regulatory surplus	4,920
Appraisal value (AAV)	12,359
Purchase premium	1,000
Total purchase price	13,359
Discount rate = 12%	
Acquisition is cash for stock	

We paid \$12,359 for the block of business. We paid an extra \$1,000 to get the company.

Table 10 shows the comparative value of the assets and the liabilities.

Table 10
Value of Assets and Liabilities

	Statutory	Sellers GAAP	Fair Value	Fair-Value Adjustments
Investments	92,920	92,920	96,833	3,913
Reserves	88,000	100,000	102,138	2,138
Amortize investment difference by effective rate method				
Amortize reserve difference to normalize expected margins				

It is necessary to show three values. The appraisal is statutory-based, but the accounting adjustments are from historic GAAP(H-GAAP) to purchase GAAP (P-GAAP). One thing that you might notice is that the fair value of liabilities is not the account value. I've used discounted cash flows as the fair-value definition. I've projected the cash flows and loaded them for profit and risk. I've also loaded them for a charge that is equivalent to what it would take to recover a typical acquisition cost. This change is the primary driver of VOBA. This cost recovery load may not survive when GAAP accounting moves to fair-value concepts.

A key assumption is the discount rate. I've used a discount rate equal to the rate on new deposits, i.e., the rate we credit new deposits. This rate is probably different from what we're crediting on existing deposits because, in most companies, interest crediting is a function of the book value of the assets and a required spread, as opposed to the fair value of the assets. So the fact that current new money rates are less than rates on existing contracts implies that we are giving in-force policies a bargain rate, which creates a difference between the account value and the fair value. If you're crediting a bargain rate, you would expect to get a fair value greater than the account value.

With these numbers, you can calculate VOBA as the excess of the price paid for the block plus the obligations, including the deferred tax, over the assets acquired at their fair value.

As shown in Table 11, the resulting \$17,407 of VOBA is brought over to calculate goodwill as the excess of the purchase price for the enterprise over the net assets acquired, which includes VOBA. The answer is \$1,000. That's a natural result of the approach we chose, and it's also an intuitively correct result. When we started, we said \$1,000 appeared to be like goodwill.

Table 11
VOBA and Goodwill Calculations

	VOBA	Goodwill
Purchase price	12,359*	13,359**
Plus obligations at fair value	102,138	102,138
Deferred taxes	<257>	<257>
Investments Acquired	96,833	96,833
VOBA	17,407	17,407
Goodwill		1,000
* amounts related to acquired contracts and required surplus		
** amounts relate to total acquired company		

In fact, Table 12 is the balance sheet.

Table 12
GAAP Balance Sheet

Assets		Liabilities & Equity	
Investments	96,833	Reserves	102,138
VOBA	17,407	Deferred Tax	<257>
Goodwill	1,000	Equity	13,359
	<u>115,240</u>		<u>115,240</u>

The deferred tax is actually a deferred tax debit, which is not unusual.

If you were to project the earnings of this block on a closed block basis for selected years, (1, 2, 5, and 10), the GAAP earnings would look something like Table 13.

Table 13

Earnings Emergence Closed Block				
	Year 1	Year 2	Year 5	Year 10
GAAP Net Income	1,548	1,673	1,671	1,581
Equity	13,359	14,591	16,399	15,073
Roe W/ Goodwill	11.97%	11.13%	9.57%	10.49
Roe W/O Goodwill	13.25%	12.22%	10.36%	11.22%

Note: Equity reflects dividend payments equal to distributable earnings; i.e., statutory profits less increase in required surplus.

The GAAP equity is based on statutory required surplus, plus the GAAP adjustments, so the equity is reduced by the distributable earnings, which is statutorily based. The ROEs are less than 12% because of goodwill amortization. If you were to take out goodwill by removing it from equity and take goodwill amortization out of earnings, you would get ROEs that hover around 12%. These ROEs are also intuitively appealing because the actuarial appraisal was at 12%.

We believed we brought the business to have an internal rate of return (IRR) of 12%, and if you look at the ROEs in the last row, they confirm this.

If we were to use a more traditional approach, we would calculate VOBA as discounted P-GAAP margins and keep reserves equal to funds. We wouldn't fair-value the liabilities. With a 12% discount rate, you would have a balance sheet that looks like Table 14.

Table 14
Alternative Method
Balance sheets of Merging Companies

VOBA = Discounted P- GAAP margins, 12% Discount Rate Reserves = Funds			
Balance Sheet			
Assets		Liabilities And Equities	
Investments	96,833	Reserves	100,000
VOBA	16,807	Deferred Tax	281
Goodwill		Equity	13,369
Total	113,640	Total	113,640

For the same purchase price, there is no goodwill. In fact, when we did the calculations, we started with negative goodwill and had to reduce the VOBA until we eliminated it. This approach is sometimes called the ROI approach, because it results in a 12% return on VOBA, not on equity. The earnings emergence is reflected in Table 15.

Table 15

Alternative Method Earning Closed Block				
	Year 1	Year 2	Year 5	Year 10
Earnings	1,553	1,549	1,444	1,594
Equity	13,359	14,471	15,901	14,626
ROE	11.16%	10.44%	9.08%	11.12%

Note: Equity reflects dividend payments equal to distributable earnings; I.e., statutory profits less increase in required surplus.

The ROEs are consistently under 12% for the block of business. That's because, under this approach, what felt like goodwill got jammed into VOBA, and it's dragging the ROEs.

The difference in methods can be significant, if, for example, you are concerned about dilution. You have less potential for dilution under the actuarial appraisal method than you do under the ROI method in the given set of circumstances. When the ROI method is used, what is often done in practice is simply to increase the discount rate to get the VOBA to be something that feels right. The reason I like the actuarial appraisal method is that it gives the answer that feels right for a reason that is rational and tied to the way we price blocks of business.

Now that we're into the third phase, we're going to review the FASB's exposure draft. You have until some time in December to make comments. After listening to this, you may be inspired to do that.

The exposure draft is a result of the dissatisfaction by some, notably the SEC, with the pooling of interest method and with accounting for goodwill. It's also intended to be a step toward harmonizing US GAAP and international accounting standards. The big change is that there will no longer be pooling of interest. Recall that the consensus view of this group was that a pooling was less distortive than a purchase. This is not the view of FASB. Goodwill accounting will be different.

Goodwill is still the residual of the purchase price allocation. There is still the requirement that you identify all the intangibles that can be measured and value them. Then you calculate goodwill. Goodwill amortization will be limited to 20 years. That, by itself, is a very significant difference to expected earnings. Goodwill will have to be reviewed for impairment and potential write-off; this is not a change.

Negative goodwill sometimes results, and when it does, certain assets, mostly the intangibles, must be reduced to try to eliminate the negative goodwill.

If, after that process, there is still some negative goodwill, you record an extraordinary gain on the acquisition date. You no longer amortize negative goodwill into income.

The exposure draft (ED) addresses intangible assets. Remember VOBA is the big one, but there might be others. The ED addresses intangible assets, whether created in the course of operations or whether acquired in a purchase.

Internally developed intangibles are expensed; that is, they do not create an asset. Purchased intangibles must be valued, and the value must be amortized systematically according to the expected life and benefits. There is a presumption that intangibles will have a life no longer than 20 years. For long-duration insurance contracts, 20 years is a short period. But this is what accountants will call a "rebuttable presumption." You can make a case, based on projected cash flows with appropriate demonstration, that there is value after 20 years. If you make that case, you are allowed to use a longer amortization period.

In fact, there may be some intangibles that have an indefinite life. VOBA would not be one. If an intangible has an indefinite life, and there is a market for the intangible, you may not have to amortize it at all. There is never an amortization expense unless there is a write-down because of an impairment.

If adopted, the new rules will probably be effective for accounting periods starting sometime in the year 2000. I believe it's likely to go through as it stands. The ED provides that accounting for existing intangibles will not be changed, so there's not going to be any catch-up adjustment.

That's the theory. I think you're now ready for the practice section, and Doug is going to do that.

Mr. Douglas C. Kolsrud: Dan gave a brief overview of my background. He introduced me as the chief investment officer at AEGON USA, but I'm not here to talk about investments. I've been the corporate actuary at AEGON USA since 1989, and until recently, I held that title. Some people would argue that I hadn't done the job for the last couple of years, but I've been pretty active in the acquisition side of AEGON USA over the last decade.

I've broken my presentation into three sections. First, I'll provide a brief historical background of acquisitions at AEGON USA during the last decade. AEGON USA was formed January 1, 1989. It was the combination of three insurance subsidiaries of a Dutch holding company. At that time, the U.S. operation made up about 20% of AEGON worldwide. We currently make up between 50% and 60% of AEGON worldwide. So you can see, we've grown quite a bit faster than the organization as a whole, mostly through acquisitions. Second, I'll talk about how we price deals and the evolution of how we've priced deals over the last ten years and relate that to how we've set up purchase accounting for those deals over the last ten years. Finally, I'll talk about some of the lessons we've learned over that period in implementing the P-GAAP process.

We've been active in the acquisition market this decade. Early in the decade, we were primarily involved in buying blocks of business. We bought a few home-service blocks. One was from Washington National, which also had some distribution attached to it. We did an exchange of blocks with Reliable Life. We also bought a mutual fund/variable product complex called Western Reserve Life, based out of Florida, and the credit card business of American Express, which was a closed block that had no distribution attached to it. An interesting acquisition was in 1993. We took over the pension operation from Mutual of New York. As we took over the block, we reinsured all the existing business back to Mutual of New York; we then got all premium that came on the books after the date of close. Everything up until the date of close was Mutual of New York's; whereas everything after the date of close was ours. We then have a deferred purchase formula that will buy Mutual of New York out of the deal in the year 2002. The reason I'm going into some of these details is to give you some of the flavor for the different P-GAAP challenges we've had, because we've tended to have pretty complex deals and thus have some interesting accounting challenges.

As we entered the last half of the decade, we've done two joint ventures in Mexico with Banamex, a large Mexican company. We're 49% owners, and we've put together a structure where there's a down payment for the business up-front and an earn-out formula that will true up the deal at the end of ten years with some complexities in the interim ten years.

The two largest acquisitions we've done have been in the last two-and-a-half years. First, we bought the insurance operations from Providian Corporation for about \$3 billion with the banking operations continuing as Providian Corporation. The

Providian acquisition resulted in almost a doubling of our size at that time, going from about \$23 billion in assets to about \$40 billion in assets. This year, we announced the acquisition of Transamerica Corporation, a stock/cash for stock deal. We own 100% of Transamerica Corporation, and it again about doubled our size. So you can see we've undergone a lot of change in the last ten years, particularly the last two-and-a-half years.

A common thread over the decade is that we've used the traditional actuarial approach to price the businesses. Some of that is tied to having a heavy actuarial influence within our organization, but also having a Dutch parent. Whereas, in Europe, you tend to have more reliance on an actuarial appraisal value to determine what the business is worth. We've used much of what Jim described earlier: a discounted value of future distributable profits for both the existing and future business. If we paid anything on top of that, for the surplus or goodwill, we would add that in.

Just drilling down a little bit into some of the specifics, we generally used a discount rate based on our after-tax cost of capital, which admittedly has decreased pretty dramatically over the last ten years as interest rates have fallen and price/earnings (PE) ratios have increased. When we started doing deals, our ratio was in single digits. At the beginning of the year, we had a P/E ratio of about 40; currently, we're about 35. During the entire decade, we've included the cost of holding required surplus in the distributable profit stream. Early in the decade, I think that was more the exception than the rule. I think now you see it as fairly typical of being included in appraisals, and it's more the norm than not.

Finally, as a reminder, in order to pay anything for new business, the pricing IRR has to be in excess of the discount rate. For nonactuaries, it's not easy to go to management and say, "We think that the new business is not worth anything or might have a negative value unless we can take some corrective action." Many times, the value of new business, especially with the discount rates in the early part of the decade, had negative value or zero.

Through the whole decade, we've also taken a look at GAAP, realizing that from the seller's perspective, many times they're looking at the GAAP book value, whether it would be a block of business or a company. Many times their expectations are that they're not going to take a GAAP loss on the business. However, we've tended not to do much due diligence on the GAAP numbers, which inherently have lot of problems. By looking at GAAP numbers, you can get a lot of different answers. We have been more interested in understanding the seller's point of view. As we've gotten more into making stock purchases in the last couple of years, market capitalization and multiples have been much more important as senior management and the board of directors of the target company are looking at their market capital and multiples. They typically provide a benchmark of what the seller expects you should pay, plus some premium on top of that. Jeff will talk a lot more about that when you get into the investment banking approach. Typically, investment bankers deal with industries other than

insurance business where actuaries are very active in the acquisition process. You tend not to look at some of these other measures as many industries do.

Moving on to the topic of purchase accounting, we have typically tried to align the purchase accounting framework with the economics of the deal. We have used the same formula presented by Jim whereby we tie the value of the insurance in-force, the VOBA as he called it, to the purchase price and segment the goodwill as a separate item. We've used this approach through the decade. But as we got into the Provident deal, we actually brought Jim in to talk about the approach we were using, and to ensure that we were going to be ok from an accounting perspective, especially with the materiality and size of the deal. Luckily, his approach generally followed the approach we've been using for five or ten years, so that we didn't have to go to someone else besides Jim to confirm what we were doing. But much of what he said is what we do. It's pretty much the same approach.

Mr. Milholland: Actuarial appraisal.

Mr. Kolsrud: Actuarial appraisal method. One of the methods that was being considered for mutual companies back in the mid 1980s was a level ROI method, which is actually sort of an appraisal approach method that's done every year. What happens with that method is you calculate the value of the business every year and, if all your assumptions are realized, you get a level ROI, unlike the methods that Jim talked about earlier. Early on, we used the level ROI method but the *Emerging Issues Task Force 92-9* has disallowed this approach; you must now follow methods consistent with either *Statement of Financial Accounting Standards (SFAS) 60* or *97*. As Jim demonstrated, by their very nature, other methods create nonlevel ROEs over time and the methods themselves create different ROE patterns as *SFAS 60* releases profit as a percentage of premium and *SFAS 97* releases profit as a percentage of gross profits.

So we do spend quite a bit of time trying to understand the level of ROEs that are going to emerge as GAAP ROE is a major thing that we look at. You have to understand not only the impacts of the accounting methods you're using, but also what assumptions you're making in your GAAP process, what provisions for adverse deviation that you're making, and the very structure of the product. So we do spend quite a bit of time trying to understand those relationships. They can move, not dramatically, but materially based upon some of the assumptions you make. We tend not to like ROEs that start off high and go down low, especially for those of us that plan on being around for awhile.

One of the things Dan asked me to talk about a little bit was earnings accretion. In general, we try to look at deals that are accretive to earnings. This is a very complex issue, but it always merits some understanding when you're pricing the deal. We look at this issue when we're pricing the deal, but not when we put the P-GAAP process together. It really does depend on a lot of things, including how much you are going to allocate to VOBA versus goodwill, and what amortization methods and time periods you're going to use. The reduction in the goodwill amortization from 40 to 20 years will have a material effect on the ability to

produce accretive deals. Eliminating pooling might have an impact on technology deals going forward but perhaps not as much of an impact on life insurance deals.

As we've gotten into public stock deals, the amount of accretion in a deal depends on the deal structure, how much of the deal you're doing in stock versus cash. Accretion also depends on the relationship of the P/Es between the two companies. As mentioned earlier, we have tended to have a relatively high P/E for the insurance business, currently in the 30s. I think the industry is probably down around 20. As we've done deals with companies that have P/Es in the teens, it has been much easier for us to have an accretive deal when we exchange stock for the stock.

Another thing you have to understand as you get into the stock deals is price collars, because the price is a moving target based upon how you put the collar together. A typical one that we've used, for the period between the date of announcement and the date of close, is the value attributed to the deal at the announcement date. This amount stays frozen within the collar, and the number of shares exchanged will float accordingly as our stock price and that of the acquirer moves. We then may have another collar outside of that, where the number of shares and the price both move at the same time. Outside of the collar, the deal can actually be called off or renegotiated.

The last thing I'm going to cover relates to some of the practical issues and lessons we've learned during the implementation process over the last ten years. For complicated deals that involve a lot of different business units, it's important to identify a core group early. Typically, at the core group level, we'll have the corporate actuary, chief financial officers and controller and some key people from the business units. P-GAAP is a huge process, and it's important to do a lot of planning and really make sure all the things keep moving. Lately, we've realized how important it is to have project management skills on the team. With the Transamerica deal, we put a project manager as a key person on the team to make sure all the processes keep moving, as they do need to come together fairly quickly after the date of close. You can't waste a lot of time. It's important to get the auditors involved early. You don't want to be doing a lot of different things and find out three or four months down the road that your auditors aren't going to accept what you've been doing. So we tend to bring our auditors in the process fairly early on.

Realize that some early decisions will have to be revisited, whether it be the allocation of a purchase price to different blocks of business or the market value of the assets. You have to make some decisions early and move on and then come back. It's an iterative process where you'll be fine-tuning the steps as you advance throughout the project. If the acquisition involves multiple business units, bring the business units on-board early. We've tended to get our business units involved early because they're going to have to live with the results, and you want to have accountability at that level. Have them believe that this is actually their value of the business, as you don't want to be cramming something down their throat from the corporate level.

Finally, always look for ways to simplify. Don't spend a lot of time on immaterial issues trying to get them refined to the third decimal point. Simplify where you can. We've tended to do that where we can. Finally, remember that no two deals are the same. I think that from each deal, not only do we learn something about how to price the deal, but also how to put the accounting together.

Mr. Joseph E. (Jeff) Consolino: I work for Merrill Lynch in their Investment Banking Department, and I do nothing but work on insurance company matters. Dan challenged me to go beyond the concept of P-GAAP and the multiples that Jim and Doug talked about and get into how accounting really influences the whole transaction process. So that's what I'm going to try to do.

This will be an investment banker's perspective on what financial information is important during transaction negotiations. I want to start by describing what investment bankers actually do in purchase transactions, and what it is that we're doing in the first place. From my perspective, as an investment banker, what is important is setting the price for a transaction. I'll try to crystallize this by going through a recent case study of an acquisition of a life company that was announced earlier this year. Then I will close with some informed speculation as to what impact accounting has on transactions, referencing things that Jim identified as the change in the way acquisitions are accounted for under US GAAP.

What the investment banker typically does is represent either the buyer or the seller. Up front, our work is to identify potential merger partners or acquisition targets. Then our technical advice turns to helping with the valuation and how to structure the transaction, whether it is a purchase or a "pooling of interests." Then we help to set up a negotiating strategy to get the transaction done. Then, finally, as evidence that we are actually there, we provide a fairness opinion, which gives explicit comfort to the company and its board of directors that the value that is being paid is fair, from a financial point of view.

An investment banker's financial analysis really can be broken down into a couple of different buckets. I would characterize the first as relative measures of value or benchmarks. This is where you go out and seek similar companies or similar businesses and compare their values with that for the company you represent. One source of these benchmarks is the public markets. There is no shortage of publicly traded life insurance companies, where prices are set every day by investors. We tend to look at multiples of stock price to earnings or, more specifically, earnings excluding realized capital gains and other nonrecurring items. We also look at multiples to book value. Another set of benchmarks that we evaluate is the price, relative to earnings and book value that has been paid for companies and similar lines of business in other transactions. These are all the valuation benchmarks. They are viewed as multiples, and they are a starting point.

In contrast to this relative set of valuation measures, we also look at the intrinsic value of the business. Often, but not always, intrinsic value is embedded in an actuarial appraisal. What an appraisal seeks to measure is the present value of distributable cash flows from the business under a reasonable projection scenario

and at a realistic discount rate. Discounted cash flow should set the value of the company.

The last area of financial analysis really isn't valuation per se, but an assessment of the financial impact of the business combination on the combined companies. Here I want to focus my comments on GAAP accounting, rather than statutory accounting. What you really are looking at is the effect of the transaction on the combined companies and their future profit and loss accounts. You are seeking to measure the effect of the transaction on the combined companies' financial position and balance sheet.

A buyer, when setting the price for a target company, might want to look at all of these strategic measures—the relative measures of value; what purchase price multiples might be paid; cash returns; and the effect on the company's consolidated reported financial results, especially when the acquisition is a public company. In a case of public companies, there is a real desire to only undertake transactions that they can get something out of i.e., transactions that will result in an increase in the reported GAAP earnings per share (earnings accretion). Clearly, there is a lot of resistance today to doing transactions that would have a material diminishing effect on a public company's reported GAAP earnings because that spills over into their stock price. Thus, in analyzing a transaction in a number of ways, the need to apply purchase accounting (versus pooling accounting) really can be a constraining factor on the value that an acquirer is willing and able to pay.

Just to drive that home, I will focus on the life insurance sector and press releases about some acquisitions that were recently announced, including the AEGON/Transamerica transaction. Typically, these announcements contain a paragraph describing what the deal is and a couple paragraphs describing the strategic fit and the terms of the transaction. These announcements always seek to explain the effect of the transaction on the GAAP earnings of the acquirer. Certainly the intent is to announce that the transaction is going to add to their GAAP earnings. They feel they at least need to announce that the transaction won't have a significant negative effect on their earnings after the acquisition.

All that said, let's get into an actual case study. This is a situation where Merrill Lynch represented the seller, American Heritage Life, a company based in Jacksonville, Florida. This discussion of the case study has been drawn from the proxy statement filed for the transaction. So, if you find my case study so compelling that you want to read more, I encourage you to log onto Edgar. You can download the background, the elements of our valuation work and more of the transaction's details.

American Heritage Life, (AHL or Heritage) had a market value of about \$750 million. AHL is a very, very fine company with a unique and strong distribution system. It has a decade-long history of increasing earnings and increasing dividends. The company has demonstrated a 15%+ ROE year in and year out, with similar top-line and bottom-line performances.

Allstate, the acquirer, needs no introduction. It is the largest publicly held personal insurance company in the U.S. It is also the 13th largest life company in the U.S., measured by assets at year-end 1998. Allstate announced its intention to acquire Heritage back in July of this year, in a cash and stock transaction valued at \$1.1 billion. Allstate follows a multichannel, multiproduct, multibrand strategy. The Heritage opportunity gave them access to a work-site marketing channel based on high growth and access to a management team that was expert in pursuing this market.

Heritage, for its purposes, was interested in accessing Allstate's vast resources, including Allstate's distribution networks and financial resources that accompany Allstate's greater size. Heritage started thinking about strategic partners early in 1998. They evaluated their alternatives for about a year before engaging the services of a financial advisor. Merrill Lynch has had a long history with this company, but as we became involved, we visited them and got more current on their thinking, strategies, and financial projections.

Then we started doing the work that I identified up front. The first element was helping them identify potential partners that might have an interest in acquiring them and participating in the work-site business. The second was financial analysis, which started with an analysis with management as to what price it might expect in a change of control. Typically, for a public company, a change of control is done where the acquired company receives a premium on their shares. Over a long period of time, this premium has averaged 2545%.

We determined that for large life companies with differentiated distribution networks and a strong record of profitability, recent data suggests a price of about 20 times GAAP earnings. That became a benchmark of value for Heritage. Then we looked at the company's financial projections, trying to derive what cash flows would be released and what distributable surplus would be created from their business plan. Using present value techniques, another benchmark was defined; that is, what the company might expect to realize if it were sold. Specifically, combining all of these facts for a company currently trading in the low 20s, we concluded that the stock price might be as high as \$30 in an acquisition scenario. So we provided the company a preliminary view on value in that range.

Next, we looked at purchase accounting factors and tried to gain a sense of value for a purchase transaction and who might have an interest. This last item is seeing whether somebody can afford to acquire this company at that value. Often an acquisition tends to dilute the acquirer's earnings per share. Thus, another piece of the analysis involved going through each of the possible acquirers to determine whether they had the financial capacity to acquire a company this size, the price they could likely afford before the acquisition became overly dilutive to their financial results.

At about the time that these initial views surfaced and values were laid out (May 1998), Heritage was engaged specifically in a discussion with Allstate on a possible business combination. The discussions were compelling enough that by June

Heritage was willing to pursue a combination on an exclusive basis, which led to the announcement in July and an October closing.

Going back to valuation, this transaction was announced at \$32.25 per share. That represented a premium to a stock price of about 33% at the time the crisis struck and 20% over the price the day before the transaction was announced, which was at an all-time high. Before describing the valuation process, let me make one quick caveat. Pricing of the transaction was based on Merrill Lynch's final determination of value, which was delivered to the board. The fairness opinion letter and all details of the valuation are available on Edgar.

Our valuation work indicated that AHL, relative to other public companies, would be worth in the range of \$18 to \$31 per share. Let me explain how we got there. Relative to acquisitions of other life companies, we derived a range of \$16 to \$26 per share. On an intrinsic value basis, looking at management's projections, we concluded that the value of the company's future cash flows on a stand-alone, per-share basis, was probably \$23 to \$28 per share, if no acquisition took place. If you include potential synergies like incremental sales growth and cost savings, the stock could be worth as much as \$27 to \$33 dollars per share in the hands of the right acquirer. All of that is relative to the \$32.25 price that we realized in the transaction.

The price that was paid represented 21 times projected GAAP earnings in 2000 for AHL, and approximately 2.8 times book value. In referencing other comparable companies, we analyzed nine publicly traded life insurance companies. Obviously, no two companies are ever perfectly comparable. However, it was felt that these nine companies were comparable enough to suggest a market value multiple for Heritage. For these nine companies, we looked at the ratio of price-to-GAAP earnings and price-to-GAAP book value, as well as other statistics like their earnings growth rate and their ROE. Then, applying the range of multiples to Heritage's actual financial data, we were able to derive a range of value from \$18 to \$31.

Similarly, because there has been no shortage of acquisition transactions in the industry, we selected 23 transactions in the life insurance sector that we thought were relevant. I had earlier stated that for companies with good distribution, good growth prospects, and good profitability, the underlying theme is for a value of around 20 times GAAP earnings and two times GAAP book value. The median for this broader set of companies was actually about 17 times GAAP earnings and 1.4 times GAAP book value. Applying these ratios to Heritage's financial data gives us the \$16 to \$26 value range.

These are only relative benchmarks. We clearly would have argued on behalf of our client. They deserve to be on the high end of that range, which is where they usually end up. This is often more constraining for a buyer with some financial discipline, like Allstate or AEGON.

What was the true value of Heritage's business? We looked at it in two ways, based on management's business plan and on how much distributable cash flow the

company would produce over the projection horizon. Without any synergies or merger benefits, the value is \$23 to \$28 per share. However, upon combination, Allstate and Heritage could demonstrate additional profitability, leading to an increase in the value of the stock from approximately \$27 to \$33 per share.

Finally, let's look at the effect on Allstate. Allstate announced that they expected the transaction to only minimally dilute their earning per share over the next two years. Our calculations indicated that on a purchase accounting basis, Allstate would experience less than 1% dilution to its reported GAAP earnings per share in 2000 and 2001. This indicated to us that Allstate priced the deal right up to the point where they would experience breakeven GAAP earnings in the near term and hope to benefit from the merger over the longer term.

Let's step back from all this for a moment and try to crystallize the lesson we can take away from this exercise. Looking only at relative values, it's pretty easy to gain a sense of where Heritage ought to have been priced. However, that is only based on a couple ratios and intensive multiple points. The true value of the company, which Allstate was able to pay, was much more closely aligned with the value of their own business, as it stood, with its own growth prospects. Plus, a possible increment to Heritage's value is derived from the additional sales and additional cost savings that can result from a combination with a company with Allstate's reputation. So the true value of this business is then the sum of all these developments.

From Allstate's perspective, there were a number of constraints, not the least of which was what could they afford to pay before tantalizing their earnings per share and possibly their stock price. So the negotiation really took place around the range that incorporates, on one hand, the value of the target company and, on the other hand, what the acquirer can afford without impairing its own earnings.

Let's turn to the proposed changes in the accounting for business combinations. Jim took you through the background and indicated that the FASB has endorsed eliminating pooling. Any new accounting standard will likely become effective at the beginning of 2001. Thus, only transactions that are announced before the January 1, 2001 date can still use a pooling approach.

The FASB is arguing that there's really no economic difference between a purchase and a pooling; therefore, there shouldn't be two different ways to account for it. The reality is, however, that from a reported GAAP basis, there is a significant difference, as Jim had demonstrated. The fact is that many significant transactions in this industry have been structured as poolings. It is evidence on its face that acquirers prefer not to burden their earnings with goodwill charges, which they view as fictional charges and not actual expense.

We think that, over time, investors will get used to analyzing their earnings by excluding the goodwill charge because it's not a true cost of business. On Wall Street, this is referred to as "cash earnings per share" or EPS excluding goodwill charges. However, it is a transition that'll take time. It won't be something that

people will get used to on day one, although the FASB, by allowing companies to show per-share earnings excluding goodwill, will certainly be helping that transition. This is just a supporting schedule. Most of the larger transactions in the insurance business have been structured as pooling transactions, including whether it's Travelers, Sun America, or Provident. The near-term implications of diminishing pooling is that companies that want to pursue acquisitions on a pooling basis will probably accelerate their plans. Companies with high P/E multiples will probably try to get one or two more pooling transactions in before this window disappears. On behalf of potential sellers, we believe the FASB's efforts will accelerate their plans to sell within this window period because they realize that a higher value can be obtained under a pooling transaction. Also, in the period after pooling goes away, acquirers might be more reluctant to issue stock, and, as a result, sellers might lose the benefit of tax-free transactions in a stock-for-stock transaction.

Over the longer term, the elimination of pooling will shift the balance of power for buyers from companies with high P/E multiples to companies with "big" balance sheets. Companies that can fund an acquisition entirely with cash or largely with cash will succeed. That means a lot of the foreign buyers because they tend to be much larger financial institutions than the companies making acquisitions in the U.S. It may also mean larger financial services conglomerates will form as financial deregulation takes place.

Finally, over the long term, we believe cash EPS or EPS excluding goodwill will be the dominant factor for people looking at stock valuations. This will require a transition period to get used to cash EPS. It already exists in sectors of business such as the cable business, the telecom business, and industrial businesses. Analysts are conditioned to look at cash flow rather than EPS. That's not yet the case for the financial services sector, so there will be an adjustment period.

Finally, over the long term, research does seem to give evidence that high-performing companies and companies that grow quickly and have high financial returns and consistent profitability have higher valuations in the market, regardless of how they have accounted for their acquisitions. After a transition period when people can get used to looking at earnings on a consistent basis, excluding goodwill, we believe acquisitions, perceived to be strategically smart and not overpriced, will result in an increase in shareholder value. Whereas, no matter how the accounting is structured, acquisitions that are overpriced will damage stock prices for these acquirers.

Mr. Frank E. Knorr: I was wondering if you could briefly discuss what the difference is between P-GAAP when you're dealing with a block of business versus purchasing a company outright? Also, what kind of implications are there with P-GAAP when you're dealing with an insolvent company in which the transaction is between a purchaser and a guarantee association?

Mr. Milholland: The first question I thought about. The second one, I have not previously given any consideration to. In my view, there are no conceptual differences in purchase accounting between the purchase of a block of business and

a company. There are differences, but they are not conceptual differences. Their tax situations are very different. The accounting and valuation are going to be different because the transaction must recognize the different tax situations of acquiring a block of business versus a company.

I think the accounting approach is the same. You would not use a discounted GAAP margin approach with the purchase of a block of business. You can start with an actuarial appraisal value. In fact, I've demonstrated to my own satisfaction that, when you calculate the value of the acquired business, it is simply the "fill" because you're going to defer only the purchase price. You are not allowed to have a gain or loss on the underlying reinsurance transaction.

You can get that same answer by using the actuarial appraisal method, if the price relates reasonably to an actuarial appraisal of the acquired block. That's a big "if." If the price is rational, then I don't think there is any significant difference.

I am not sure in the situation of an insolvency. My first thought is that it's the same. However, the price paid may be low and there may be a big contribution of capital. You would have to factor that into the formulation. That's just my quick reaction.

Mr. Hans J. Wagner: You mentioned that one of the FASB's reasons for eliminating pooling was to coordinate with international standards. French regulators have recently moved towards permitting pooling, so the US and the rest of the world may find once again that they are "two ships passing in the night," instead of coordinating the standards.

Mr. Charles M. Underwood, II: This is for Jim Milholland on his illustration of the appraisal method. You had \$100,000 of reserves for the selling company, which under *SFAS 97* would be account value plus unearned cost of insurance or something like that. Your appraisal value was \$102 and change. Since *SFAS 97* applies to the purchasing company after the purchase, how do you justify changing the value of the reserve?

Mr. Milholland: One, I justify it on the basis that the rule we're trying to apply is *APB 16*, which says you fair-value the assets and the liabilities. In my view, when you have a bargain interest rate, the account value is not the fair value; some other number is. The fair-value basis at purchase becomes your new cost basis and you have to amortize the difference over some period of time, probably five to seven years. After that period, you're back to account value.

From the Floor: Would it be more appropriate to amortize that difference the same way you amortize VOBA?

Mr. Milholland: No, I would amortize it to normalize my spreads. Those are very good points though.