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Introducing a New Practice Note on Purchase GAAP Accounting

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In early April, the Life Financial Reporting Committee of the American Academy of Actuaries released an exposure draft of a practice note titled, "Treatment of VOBA, Goodwill and Other Intangible Assets under PGAAP." Depending on the extent of comments received in April and May, the final practice note should be released about the time this issue reaches your mailbox.

The practice note consists of five parts:

A. Background
B. Calculation of Value of Business Acquired, Initial Measurement
C. Tax Considerations in the Calculation of Initial VOBA
D. Other Items on the PGAAP Balance Sheet
E. Subsequent Measurement

And four appendices:

I. Distributable Earnings and VIF
II. Additional Tax Issues
III. Summary of Formulas
IV. Glossary of Abbreviations and Acronyms

As implied by its title, the practice note addresses only intangible assets; it does not address the normal GAAP liabilities, which are typically valued under other accounting standards (FAS 60, FAS 97, etc.) even after a purchase.

PART A. BACKGROUND

The practice note begins with some of the history leading to current standards in accounting for business combinations, commonly called purchase accounting, purchase GAAP or simply PGAAP. It then answers some of the fundamental questions involved in accounting for a business combination, including:

- When is PGAAP applied?
- How is a business defined for purposes of PGAAP?
- What is the objective of PGAAP with respect to measurement of assets and liabilities at the acquisition date?

PART B. CALCULATION OF VALUE OF BUSINESS ACQUIRED, INITIAL MEASUREMENT

Fundamental to accounting for any business combination involving insurance operations is the value of

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business in force at the time of purchase. Among the various terms used by actuaries, the practice note uses "value of business acquired" (VOBA) to represent this value.

Under the accounting standards, VOBA is defined as the difference between the GAAP book value (GVL) and the fair value (FVL) of the liabilities at time of purchase. The practice note recognizes two common methods for determining VOBA:

1. Determining VOBA from the value of future distributable earnings; and
2. Determining FVL as a value of future liability cash flows, and then subtracting FVL from GVL.

Recognizing that most actuaries concerned with PGAAP are also dealing with business combinations subject to U.S. statutory accounting and tax laws, and that such requirements are key drivers of distributable earnings, the practice note includes significant reference to U.S. statutory and tax accounting, beginning with the determination of an appraisal value of the in-force business. This section then lays out basic formulas for the calculation of PGAAP's initial VOBA from a statutory appraisal value.

After a brief note on the equivalent result that could be expected under the two methods, this section proceeds to address several considerations in the second method's direct calculation of FVL. The section ends with a note that there can be no VOBA associated with business for which GAAP liabilities are already carried at fair value.

PART C. TAX CONSIDERATIONS IN THE CALCULATION OF INITIAL VOBA

Though GAAP (including PGAAP) valuation of assets and liabilities is on a pre-tax basis, it is tied in some way to prices, and prices take into consideration the tax characteristics of assets or liabilities. Taxes, therefore, affect VOBA.

In the United States, taxes depend on the purchase price, the nature of a purchase, and certain options that are available in the tax code. Among the considerations:

- Is the business included as part of the purchase of a legal entity or is it purchased without acquiring the company?
- Is the business subject to section 848 of the tax code (DAC tax)?
- What options are available under the tax code?

Tax and GAAP specialists sometimes use different terms for similar concepts. To minimize confusion that can arise when communicating across specialties, the practice note preserves the language of both and ties them together.

Since GAAP defines fair value from the perspective of a market participant, calculation of VOBA needs to consider taxes from that point of view, which might differ from the specific tax situation of any particular transaction.

This section looks at various tax situations that are commonly encountered in the purchase of insurance business in the United States and untangles the interdependence between purchase price and taxes. New terms are introduced as appropriate for each situation, and specific variants of Part B's general formulas are provided for each situation.

To preserve a connection between general formulas and specific formulas for different situations, the specific variants preserve the same general formula numbers, using unique subscripts for each variant. For example, variants of Part B's general formula 3 for calculating VOBA appear in Part C as formulas 3.s, 3.a, 3.a.i, 3.a.ii and 3.a.iii. In most cases, the specific formulas appear simpler than the general formula but the simplifications vary from one tax situation to another.

PART D. OTHER ITEMS ON THE PGAAP BALANCE SHEET

This section addresses the initial calculation of GAAP goodwill and briefly addresses other intangible assets that might be encountered in a business combination.

PART E. SUBSEQUENT MEASUREMENT

Different intangible assets are subject to varying requirements subsequent to the date of acquisition. This section addresses amortization of VOBA and other amortizing intangible assets. It addresses goodwill and other intangible assets that do not amortize. It also addresses loss recognition and impairment testing of the various intangible assets.

APPENDICES

Appendix I goes into greater detail about some of the finer points involved in a statutory appraisal of in-force business and two common approaches to measuring it, starting with either discounted distributable earnings or with discounted statutory book profits. Among the items considered here: book profit; options and guarantees; required capital; and discount rate.

Appendix II provides additional information about some of the more complex tax situations addressed in Part C—purchase of a company when the buyer and seller agree to an Internal Revenue Code section 338(h)(10) election; and purchase of a business that does not also involve the purchase of a company (typically involving reinsurance of the in-force). It also includes examples illustrating the development of a PGAAP balance sheet under different situations and interpretations of the accounting guidance.

Appendix III lists all formulas introduced in Parts A through E of the practice note. Formulas are grouped according to the conditions to which they apply and reference is made to the place where each formula is introduced.

Appendix IV is a glossary of all abbreviations and acronyms introduced in Parts A through E of the practice note. As with formulas, reference is made to the place where each is introduced. ■