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Session 5PD
Purchase GAAP

Track: Financial Reporting

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Summary: This session focuses on the Generally Accepted Accounting Principles methods and standards of practice applicable to accounting for purchase of a block of business.

Topics include:

- *Initial contacts—working with investment bankers*
- *Rules of thumb for first estimates and impact on enterprise*
- *Due diligence*
- *Board presentation*
- *Determination of opening balance sheet—benefits reserves and present value of future profits*
- *Calculating and applying actuarial appraisal values*
- *Impact of synergies, management initiatives, and expense savings*
- *Projection of GAAP profits*
- *Statements of Financial Accounting Standards 60, 97, and 120*
- *Impact of marking the assets to market*
- *Applicable GAAP Actuarial Standards of Practice*
- *Impact of recent Financial Accounting Standards Board rulings.*

Mr. Michael V. Eckman: Jim Milholland is a partner with Ernst & Young in the Atlanta office. In addition to being an FSA, Jim is a CPA. After recruiting Jim to speak at the session, I found that I'd be working with him on ING's acquisition of ReliaStar. Dan Kunesh is a consulting actuary with Tillinghast-Towers Perrin in Chicago. He has participated in writing the new *Generally Accepted Accounting Principles* textbook, which includes a chapter on Purchase GAAP, and has been involved with his overseas offices on compliance with U.S. GAAP over the past seven years.

I am the appointed actuary for several of the ING ReliaStar companies, and I've participated in the consideration of many life insurance company purchases. Two of them came to fruition and required the type of purchase GAAP (P-GAAP) work that

we will be talking about today. I'm also participating in ING's current purchase and integration of ReliaStar companies. I have experience from both sides of an acquisition.

I want to start with a discussion of the roles of investment bankers because before there can be a P-GAAP calculation, there has to be a purchase. How does the purchase come about, and how does that purchase process affect the P-GAAP work that you do? I'll discuss the purchase process with emphasis on the role of investment bankers. I will use the terms target for the company to be purchased and enterprise for the company that is purchasing the target.

Investment bankers earn their fees by enabling companies to raise capital through debt or stock offerings as well as assisting companies in buying one another. In short, investment bankers are middlemen. Investment bankers have many roles in the acquisition process. I'll describe the roles and discuss how the parties can make the best use of the investment banker. I'll also mention the impact that the investment bankers have on the P-GAAP process.

Investment bankers are expensive, so you should make good use of them. The fees are approximately 1.5% of the purchase price. Some claim that there's an unspoken agreement among investment bankers to keep these fees in a tight range. The fees are paid only if the acquisition is completed. A company, however, may pay a fixed amount or a retainer to secure the services of an investment banker for a particular purpose.

Investment bankers can be compared to realtors. Like realtors, each party in the acquisition retains one. Like realtors, they may contact you with possibilities they have found. They may solicit your company as a potential sales target for another company. Investment bankers provide information about the target. One interesting aspect of negotiating a purchase is that the proposed deals have code names that are meant to hide the identity of the parties. You'll find yourself talking about your company and the target in terms of birds, presidents' wives, or some arbitrary words.

The information from the investment banker is condensed into a glossy brochure called an offering memo. It's also called the pitch book, and it has some standard parts. It contains an overview of the company being approached, the enterprise, and the reasons why the latter should look at the acquisition of the proposed target. The offering memo will discuss the strategic considerations of the proposed acquisition. There will be a valuation of the target and some information about the expertise of the investment banker.

The offering memo will contain a discussion of the enterprise and target in terms of markets, products, and sometimes personnel. Summary target financial statements, historic results, and projections will be included. These projections are important because they may be the source of P-GAAP assumptions and earnings expectations. There may be identification of expense savings that would affect your P-GAAP assumptions and identification of increased sales opportunities.

The offering memo will include a projection of combined operations. I show the increment to the enterprise plan due to a proposed acquisition (Table 1). The analysis starts with the target's plan, what the historic GAAP amortization built into that plan is, what the investment banker thinks the P-GAAP amortization would be, the effect of synergy sales, expense savings, and restructuring cost. The sum of all of these entries gives a bottom line that shows the increment to the enterprise plan. This increment could set the expectation level of management when they look at various acquisitions.

TABLE 1
PROJECTION OF INCREMENT TO ENTERPRISE OPERATIONS

P-GAAP Estimate ($Million AFIT)			
	2001	**2002**	**2003**
+ Target Plan	30.0	35.0	40.0
+ Historic GAAP Amort	48.0	50.0	52.0
- PGAAP Amortization	43.0	44.0	45.0
+ Synergy Sales	0.4	1.4	2.8
+ Expense Savings	2.0	4.0	4.0
- Restructuring Costs	1.0	1.0	0.0
= Increment to Enterprise Plan	36.4	45.4	53.8

The investment banker will do a lot of modeling for his or her clients and consider a lot of what-if situations. As the illustration here implies, they'll make a lot of assumptions about synergies, expense savings, and P-GAAP adjustments. You must compare your P-GAAP assumptions, the present value of future profits (PVFP) or value of business acquired (VOBA), and its amortization and goodwill amortization to what the investment banker illustrated.

Some investment banker is probably modeling an acquisition right now that includes your company. The investment banker goes out, creates an idea, approaches the enterprise, and sells it. The investment banker touts its ability to do these types of deals, and so it will include information on its past successes. The intention of this whole pitch book is to develop interest in the acquisition of the target and establish faith in the investment banker.

The investment banker can provide options for what to do with undesirable parts of the target. For example, if the investment banker comes to you with a company that has a line of business or a subsidiary that you don't want, they have contacts with other companies and know who might be interested. They have ideas whether another acquisition would combine with the undesirable parts and maybe make a critical mass in which you would be interested.

Investment bankers take an active role in the negotiations in the preliminary stages, and the negotiations actually occur between the investment bankers of the two companies. As the deal develops, there is contact between management of target and enterprise, but the investment banker is still involved and arranges and attends the discussions. Oftentimes you may feel at the mercy of the investment

bankers since you have to schedule everything through them and they have to be present.

Investment bankers are managers of the due-diligence process. Due diligence is an intensive review of the target involving a visit to the target or a neutral site where information is available in a data room. Due diligence is an excellent source of P-GAAP assumptions. The enterprise develops a list of required information, and the investment banker provides that list to the target ahead of time so that the information can be put together. The information is then gathered. It's housed in a data room, and the investment banker maintains that data room.

The enterprise's investment banker and the target's investment banker manage the distribution and copying of any documents. Usually at the beginning of the week the investment bankers are very tight with information, but by the end of the week everybody is so tired they will let you copy it and take it home with you. The data room is often incomplete. You will come up with a question for which the target hasn't had time to develop the information or you think of a question later as a result of the answer to a previous question. The investment banker handles those follow-up requests.

The enterprise's investment banker and the target's investment banker then manage the scheduling of the meetings between the staff of the target and that of the enterprise. The investment banker can also put together several formal presentations where target and enterprise management can present canned presentations to each other as to why their company is a good target or a good acquirer.

Investment bankers also act as researchers. They can help you determine what the target is worth. Since they are MBAs, they perform a lot of discounted cash-flow analysis. They look at what other similar deals have sold for, comparative multiples, earnings per share, and GAAP book value. What is the return on the purchase to the enterprise? This is where the choice of the accounting method and the way it finances comes into play. As we will see later, choosing one of the two methods of accounting will affect the return to the enterprise.

Who else is interested in the target? Usually the investment banker knows that this target is being offered to other companies at the same time, so they'll keep you appraised of who are interested. One analysis that is not often done measures the return on the purchase to the target. What rate of return are the sellers of this target going to make?

The enterprise's investment bankers will be talking to the target's investment bankers. What price will they accept? What other offers have they turned down? What offers are they considering? And what price can the enterprise financial model support? The price is dependent on how the purchase is financed or accounted for. What are the accounting options available? To date there have been only two: P-GAAP and pooling.

The investment banker provides information with respect to synergies and cost savings that help determine the price. Investment bankers can ask some pointed questions. As I mentioned, they are often MBAs and have good analytical skills, and these questions and answers will help in establishing the P-GAAP assumptions.

Similarly, investment bankers can provide solutions for problems identified in due diligence. One purpose of due diligence is to develop a list of issues that make the deal difficult, if not impossible. Based on prior experience, the investment banker may have an idea how to word purchase agreements to minimize the impact of adverse findings. Some examples would be current potential lawsuits or fears of loss of sales or personnel. You could utilize an indemnification clause if something exists after the sale, or a purchase price adjustment might be necessary to hedge the contingent risk.

Investment bankers will have ideas on the methods of payment and financing. They'll list for you the advantages and disadvantages and what the impression of rating agencies and others would be on these various options. There are basically three purchase options. A company can be purchased for stock, cash, or an earnout. The earnout would determine payments to the sellers that would provide an experience refund based on earnings of the acquired business that keeps them bearing some of the risk. For financing options, the enterprise could issue new stock, take on new debt, or reinsure part of the business. The reinsurance would not necessarily be of the newly acquired business only, but the enterprise could reinsure an existing block of business in order to raise capital to finance the purchase.

The most visible work of the investment banker is in the preparation of pro formas. These are, from a cynical point of view, pretty pictures for management and the board that prove that the deal can work. They're always in landscape form; they have color graphs; they're spiral bound. But on the serious side, it's a summary that presents the key points, key assumptions, and the key financial results. I would say that as actuaries in working through this we tend to dwell on a lot of details. Of course, the board and management are going to be interested at a higher level as to what it means when we come around to reporting financial results. In analyzing the acquisition, the enterprise needs to look at the return on equity, the impact of synergies, the impact of expense savings, and dilution accretion statistics.

The book will also contain a discussion of what can go wrong. What are the major assumptions, and what is the accounting method? This additional information indicates a need to track your actual experience relative to assumptions made at the time of acquisition. As you go through the acquisition and actual experience starts to unfold, you are going to be called upon to explain why results are different from what the pro formas showed.

One of the methods an investment banker will use is a statutory appraisal (Table 2). The statutory appraisal shows the value of the target on a present value basis at several discount rates. It starts with an adjusted statutory surplus, in my

example $150 million, the present value of book profits of existing and planned new business based on current in-force, and what the target plans to sell. If there are synergy sales because of what you plan to do with this target after acquisition, that, too, could be added. Expense savings are an important part of the appraisal. Other adjustments would be the cost of capital and federal income tax. The total present value can be compared to the purchase price to develop an implied ROI.

TABLE 2
STATUTORY APPRAISAL

Summary of Actuarial Values ($Million) 12/31/2000			
	Discount Rate		
Component	11%	13%	15%
Adjusted Statutory Book Value	150	150	150
Existing Business	145	125	100
New Business	20	1	-10
Total	315	276	240
Synergy Sales	17	8	2
Expense Savings	20	15	10
Restructuring Costs	-1	-1	-1
Grand Total	351	298	251

The next step would be a GAAP valuation, where we look at earnings per share. Table 3 shows the projected earnings per share after the acquisition. Given these estimated earnings per share and a $125 million purchase price, it implies an 8.3 to 12.5 price-to-earnings ratio. The ratios can be compared to those from similar deals to test the reasonableness of the purchase price. Of course, the higher the purchase price, the higher the multiple you're assuming. Probably the most important criterion that management and the board will be looking at is accretion and dilution of earnings per share. There are many variables to consider.

TABLE 3
ACQUISITION VALUATION (GAAP)

1999 Operating EPS		$ 10.00
2000 Estimated Operating EPS		11.00
2000 Adjusted Operating EPS		15.00
As Multiple of	**Price Range ($Million)**	
	125	175
1999 Operating EPS	12.5x	17.5
2000 Estimated Operating EPS	11.4x	15.9
2000 Adjusted Operating EPS	8.3x	11.7

In Table 4, I show the purchase price across the top, the method of financing going down, how much debt or preferred financing you have, the enterprise stock price, and the amount of annual cost savings. This chart shows the various accretion and dilution amounts given different purchase prices and percentages of debt. Not surprisingly, the lower the purchase price and the more debt you take on, the higher the accretion.

TABLE 4
2001 EPS PRO FORMA ACCRETION/DILUTION

Debt or Pref. Financing	**Purchase Price ($Million)**				
	100	**125**	**150**	**175**	**200**
20%	1.2%	0.4%	-0.3%	-0.9%	-1.6%
50%	2.3%	1.5%	0.8%	-0.1%	-0.5%
70%	2.6%	1.8%	1.1%	4.0%	-0.2%
90%	3.5%	2.7%	2.0%	1.3%	0.6%
Enterprise Stock Price			$50.00		
Cost Savings ($Million)			20		

Table 5 is a little different as it assumes 50% debt but makes the expense savings a variable. It is clear that the lower the purchase price and the more the expense savings, the more accretion there's going to be. In this simplified example I have looked at accretion for one year (2001). A company may look out two or three years. The enterprise may be willing to take dilution in the early years for a sufficient amount of accretion two or three years down the road.

TABLE 5
2001 EPS PRO FORMA ACCRETION/DILUTION

Pre-Tax Expense Savings $Million)	**Purchase Price ($Million)**				
	100	**125**	**150**	**175**	**200**
0	-1.3%	-2.0%	-3.0%	-3.4%	-4.1%
5	-0.5%	-1.3%	-2.0%	-2.5%	-3.2%
10	0.3%	-0.2%	-1.0%	-1.6%	-2.2%
15	1.3%	0.4%	0.0%	-0.7%	-1.4%
20	2.3%	1.5%	0.8%	-0.1%	-0.5%
Enterprise Stock Price			$50.00		
Debt or Preferred			50%		

Table 6 shows one measure that I mentioned earlier and that I have seen only once in an acquisition: the return to the target. If you do know what the seller's initial investment was when they made that investment and can look at the various sales prices, you can determine the annual return. This is interesting to see, and it can make you envious of very successful people, but it's not often going to turn a deal off.

TABLE 6
ANNUAL RATE OF RETURN TO INVESTORS

Initial Investment ($Million)	50		
Date of Initial Investment	01/01/1995		
Sale Date	**Sale Price ($Million)**		
	100	**150**	**200**
06/30/1999	17%	28%	36%
12/31/1999	15%	25%	32%
06/30/2000	13%	22%	29%
12/31/2000	12%	20%	26%
06/30/2001	11%	18%	24%

With all of this the investment banker brings credibility to the presentation to management and the board. They have experience in many deals and direct contact with the target's investment banker. They've reviewed our work, and they will weigh in with an opinion on the fairness of the deal. Investment bankers can be viewed as cheerleaders and problem solvers. They want to bring the deal to fruition because that's the way they get paid. If there's any hope at all, an investment banker will be persistent.

Investment bankers appear to believe that any problem can be solved by the application of enough time and money. If you feel that not everything is for sale, and time is a nonrenewable quantity, you will be at odds with your investment banker. The investment banker does, however, want repeat business, so he does not want to mislead you. Investment bankers are under time pressure. They always want to move onto the next deal. If you've ever worked with them, you know that they're always working on more than one deal at a time.

Last, but not least, the investment banker provides a closing dinner and a tombstone. This is an expensive party at the enterprise's and target's expense to celebrate the successful completion of the deal. The tombstone preserves the deal and the investment banker's name in Lucite to keep on your desk.

Just to review, investment bankers have many roles. They act as realtors, matchmakers, analysts, negotiators, intermediaries, and salesmen. Although the deals could be done without the investment bankers, many companies would not pursue some acquisitions without their prompting. The investment banker's pro formas are important because they often become the benchmark against which subsequent projections and actual results are compared. Therefore, the investment bankers often set the expectations on these deals. They help put together the P-GAAP assumptions, particularly through the due diligence process. And, as I mentioned earlier, one of them is probably looking at your company right now.

Mr. James B. Milholland: I wonder if there's a meeting going on in New York right now of investment bankers talking about deals, and one of them is saying that he really likes to do insurance company deals because you get to work with actuaries.

If you go back to Table 2 of Mike's presentation and look at the statutory appraisal, it is a nice segue to what I'm going to be talking about: goodwill. You can see there that he has several components of the total, and the total would probably relate like something to the purchase price of the company in a purchase. In the first two lines the adjusted statutory book value in the existing business structure would be what we would call the tangible value of the company. Anything you pay above that would be intangible value. Keep that in mind as we switch from the statutory basis of the pricing to the GAAP accounting; at this point in time the deal's been done. The investment bankers are gone. The actuaries are left to do the heavy lifting to get the accounting of the books restated.

Goodwill: How good is it? My presentation is intended to be purposely not technical but to give a sense for what creates goodwill and why it is more or less than you might expect in a given situation.

This presentation is taken from a speech I gave for a group of insurance investment analysts, not investment bankers, who become confused when they see deferred acquisition cost (DAC) go away, and then there's PVFP, and there's some goodwill. This presentation was an attempt to bring them out of the confusion. Judging from their questions after the presentation, I don't know that I succeeded. I thought I'd try again.

I begin with a question: What is it that Americans love that the Dutch don't like at all? I give you three choices: baseball, American beer, or goodwill. The answers are American beer and goodwill. It's no surprise that there's not a lot of beer exported from the U.S. to Holland, but goodwill may surprise you. I think the point is that we think of goodwill as an asset. Whether it should be an asset or not may depend on your perspective. As Dan will point out, perspectives change. In Holland

right now they're thinking about changing Dutch accounting, and while they're thinking about changing it, one of the possible changes is to record goodwill as an asset. While that's going on there's also an effort to generate an international set of accounting rules, and that may become the basis for all of European, maybe all of the world's, accounting at some point in the not too distant future. There will be some resolution of the issue of what to do with goodwill for international accounting.

The definition of goodwill—and this comes from the accounting literature—is the excess of the cost of the acquired company over the sum and the amounts assigned to identifiable assets less liabilities assumed. Remember that in that sense identifiable assets include some intangible assets. It includes those assets, such as the VOBA and the PVFP, proprietary databases, trademarks, patents, and brand names, that you can specifically identify and put a value on and determine a reasonable life for the amortization of that value.

By implication, goodwill is all the things that you can't identify. You haven't identified enough things to bring it up to the purchase price. Why would you pay more than what you could identify? There's obviously something of value that's driving the market price, and so you pay for it, the synergies and the economies that Mike mentioned. There may be other reasons. It may be just simply a function of the fact that you want to make the acquisition, and you have to pay a certain amount to close the deal. The residual is goodwill. The question is "Is it an asset?" and the answer under U.S. GAAP accounting today is "Yes." In a purchase situation you record the residual as an asset on the balance sheet and amortize it over its life, not to exceed 40 years.

The purchase accounting process looks something like this; we will take the example of a purchase. (The other alternative is a pooling. Pooling does generate goodwill, and pooling is probably not going to be around as an option for much longer. The more common situation, one Mike is dealing with now, is a purchase.) Step #1 is to determine the purchase price. That's not always trivial if the consideration is not all cash. If the consideration is cash, you know what was paid. If the consideration is stock, there's a question of valuation. And if the stock is moving around between the time the deal was agreed to and the time the deal was closed, there could be valuation issues.

The intent of purchase accounting is to get the acquired assets and the liabilities on the basis that the acquirer bought them, or assumed them in the case of liabilities, and this is the fair value. Step #2 is to eliminate retained earnings and record the purchase price as contributed capital. The retained earnings are the retained earnings of the seller. The buyer doesn't have any retained earnings yet. That's all in the future. The retained earnings are eliminated, and the purchase price is contributed capital. As you analyze the purchase, you see that the acquisition is consolidated and there would only be consolidated equity.

The purchase price gets allocated by assigning a fair value to all the assets. Probably the first step is the tangible assets. For insurance companies it's mostly

their investments and their properties, a subject that's dealt with at length in the accounting literature and generally doesn't require actuarial involvement. Next comes the fair value of liabilities. The big liabilities on an insurance balance sheet are the reserves, and there are some issues around whether you can use fair value. For example, Financial Accounting Standard (FAS) 97 reserves are normally account values. The answer is that there seems to be an evolving school of thought that says maybe the fair value on a purchase situation is not equal to the account value. It's another interesting subject that we're not going to deal with directly.

Then you fair value the intangible assets. That's the VOBA. You have to get the deferred tax liability because you have a new set of timing differences between the the tax basis and the GAAP book basis.

There may be some iterations or simultaneous solutions required because some of these things depend on each other. The VOBA depends on the deferred tax, and the deferred tax depends on the VOBA. And then when you get all that done, you do the calculation of the excess of the purchase price from Step #1 over the net of the assets acquired and the liabilities assumed, and you come up with goodwill, which is usually positive but not necessarily so.

There's no specific guidance for the calculation of VOBA, and we're going to step through some nontechnical, high-level examples of how goodwill falls out of calculations. The examples are going to use the actuarial appraisal method. The value of the existing contracts translates into VOBA. The purchase premium, what you pay above that, translates into goodwill.

We're going to do the examples where a company, XYZ, buys a company, ABC. In the examples, H-GAAP refers to the seller's historic cost basis that is going away. H-GAAP will be replaced by P-GAAP, which is the buyer's purchase accounting basis. To keep it simple, we're not dealing with any valuations of stock to get to the purchase price. We'll just say we know the purchase price. As XYZ enters into this transaction, XYZ is performing all of its calculations on the expectation that it ought to get a 15% internal rate of return. It is pricing the acquisition, and pricing an acquisition is a lot like pricing a product, with a 15% expectation.

Table 7 is the balance sheet of ABC on the purchase date. I've made some simplifying assumptions. I've assumed that the investments are held to maturity. That's almost never the case. But unwinding FAS 115 and then winding it back in just adds complications that don't help support the concepts or shine any extra light on the subject. I'll just keep it simple. The investments are held to maturity. I've said it was a purchase of stock with cash. We're not doing any pooling; we're doing a purchase situation. The tax rate is 35%, and, again, just to keep it simple, the only tax and book difference is the deferred acquisition cost. The deferred tax liability is 35. The company has equity of 165 that is made up of contributed capital, 50 from years ago and retained earnings accumulated over the years of 115.

TABLE 7
XYZ BUYS ABC LIFE INSURANCE COMPANY
H-GAAP Refers to Seller's Historic Cost Basis
P-GAAP Refers to Buyers Purchase Accounting Basis
Assume- Purchase of Stock with Cash
XYZ Expectation is 15% I.R.R

ABC Life H-GAAP Balance Sheet-Purchase Date			
Assets		**Liabilities and Equity**	
Investments	1,000	Reserves	900
DAC	100	Deferred Taxes	35
		Equity	165
		Contributed Capital 50	
		Retained Earnings 115	
Total Assets	1,100	Total Liabilities and Equity	1,100

Scenario 1 is shown in Table 8. The target company, the company being bought, is getting a return on equity of 15%. It's already meeting the buyer's expectation. And just by coincidence, the fair value of the investments would not change. There would be no mark to market adjustment. And the same thing would be true in this example of the liabilities. We have no changes required to the investment valuation on liability, and by skillful negotiation we are able to buy the company for its book equity. Again, it is a totally unrealistic scenario but intended just to illustrate the point.

TABLE 8
XYZ BUYS ABC LIFE INSURANCE COMPANY
Scenario 1
ABC's ROE is 15%
Fair Value of Investments=H-GAAP Basis(i.e., No Change)
Fair Value of Liabilities=H-GAAP Book Basis
Purchase Price=H-GAAP Equity

ABC Life P-GAAP Balance Sheet-Purchase Date			
Assets		**Liabilities**	
Investments	1,000	Reserves	900
DAC	0	Deferred Tax	35
VOBA	100	Equity	165
Goodwill	0	Contributed Capital 165	
		Retained Earnings 0	
Total Assets	1,100	Total Liabilities and Equity	1,100

What happens here is that the equity is the same because the equity reflects, as the buyer, my basis or what I put into it, which is 165, but it's all contributed capital, no retained earnings. There's no DAC. DAC is the seller's basis in the contracts. My basis is VOBA that is 100 because I've linked VOBA to the purchase price. I used an internal rate of return of 15%. The company's getting 15% ROE. The VOBA is going to come out to be very close to DAC.

Now, if I pay 250 (Scenario 2 in Table 9), everything else being the same, my equity is bigger, 250 instead of 165, and I have 85 of goodwill. Deferred tax

doesn't change because this is a purchase. I did not do a step-up in basis tax, and under FAS 109 VOBA is the timing difference. My goodwill is not. I have goodwill, but I don't have any deferred tax effect from that.

TABLE 9
XYZ BUYS ABC LIFE INSURANCE COMPANY
SCENARIO 2

ABC's ROE is 15%
Fair Value of Investments=H-GAAP Basis
Fair Value of Liabilities=H-GAAP Basis
Purchase Price=250
ABC Life P-GAAP Balance Sheet-Purchase Date

Assets		**Liabilities**	
Investments	1,000	Reserves	900
DAC	0	Deferred Tax	35
VOBA	100	Equity	250
Goodwill	85	Contributed Capital 250	
		Retained Earnings 0	
Total Assets	1,185	Total Liabilities and Equity	1,185

In Table 10 we're dealing with a company that's an underperforming company by the buyer's expectation. Its ROE is 10%. I wouldn't buy a company to get 10%; I'd demand 15%. But I've still had to pay 250 to get the company. Fair value in investments doesn't change; fair values of liabilities doesn't change. The purchase price is 250. My investments don't change. My DAC is eliminated. Reserves don't change. The company's underperforming. When I do my VOBA calculation, I would say that since the business is underperforming, I wouldn't pay as much for it. I do my purchase price allocation. I come up with a VOBA that's less than the historic DAC. The result of that is there's more goodwill. In order to justify a 250 purchase price in this situation I had to assume more than what was on the balance sheet—an infrastructure or business capacity or synergies or whatever—than I did in the other situation because there wasn't as much value in the acquired business.

TABLE 10
XYZ BUYS ABC LIFE INSURANCE COMPANY
SCENARIO 3

ABC's ROE is 10% with Little Room for Improvement
Fair Value of Investments = H-GAAP Basis
Fair Value of Liabilities = P-GAAP Basis
Purchase Price=250
ABC Life P-GAAP Balance Sheet-Purchase Date

Assets		**Liabilities**	
Investments	1,000	Reserves	900
DAC	0	Deferred Tax	25
VOBA	70	Equity	250
Goodwill	105	Contributed Capital 250	
		Retained Earnings 0	
Total Assets	1,175	Total Liabilities and Equity	1,175

Scenario 4 (Table 11) is one in between. It's getting 10%, but under my skillful management it's going to do better than that. I can make it perform better. As I do the calculation now with the VOBA I can anticipate those improvements and allocate a bigger value to the business. In this case it comes out to be 85 for the same purchase price, a VOBA of 85 and a goodwill of 95. In the last three scenarios you see three different situations. Where it's performing up to my expectations, we get a certain VOBA and goodwill; where it's not performing, that creates a lower VOBA and a bigger goodwill. In many respects what the purchase accounting comes down to is the play between VOBA and goodwill.

TABLE 11
XYZ BUYS ABC LIFE INSURANCE COMPANY
SCENARIO 4

ABC's ROE is 10% - XYZ Sees Opportunity for Improvement
Fair Value of Investments = H-GAAP Basis
Fair Value of Liabilities=H-GAAP Basis
Purchase Price= 250
ABC Life P-GAAP Balance Sheet - Purchase Date

Assets		**Liabilities**		
Investments	1,000	Reserves		900
DAC	0	Deferred Tax		30
VOBA	85	Equity		250
Goodwill	95	Contributed Capital	250	
		Retained Earnings	0	
Total Assets	1,180	Total Liabilities and Equity		1,180

Scenario 5 (Table 12) has some more noise. This is more the typical situation. Fair value of the investments is greater than under the old H-GAAP basis, and that would not be a typical scenario today because interest rates have just gone up a little bit. It might have been more typical a couple years ago. In this situation the investments are higher. Now, with a higher investment rate I have a lower yield rate when I recalculate my reserves, and either you have to assume that these are FAS 60 reserves or you have to go along with the idea that you fair value accumulated deposits in FAS 97 contracts. If you assume lower yields and roll that into your reserve calculation, you get a higher reserve. My investments have gone up by 80; my liabilities have gone up by 70. I have some play in the VOBA and goodwill calculations. At the end of the day my VOBA is based on how I valued the business. I said I bought the business to get 15%, and I'll look the actuary in the eye and say, Value the business to get 15%. The VOBA comes out 75 in this example, and the goodwill is 95. Most of that investment difference goes to reserves, and I think you'd find that that's a typical situation.

TABLE 12
XYZ BUYS ABC LIFE INSURANCE COMPANY
SCENARIO 5
ABC's ROE is 10% - XYZ Sees Opportunity for Improvement
Fair Value of Investments = 80 More than H-GAAP
Fair Value of Liabilities = 70 More than H-GAAP
Purchase Price = 250
ABC Life P-GAAP Balance Sheet - Purchase Date

Assets		**Liabilities**		
Investments	1,080	Reserves		970
DAC	0	Deferred Tax		30
VOBA	75	Equity		250
Goodwill	95	Contributed Capital	250	
		Retained Earnings	0	
Total Assets	1,250	Total Liabilities and Equity		1,250

Note: Other VOBA methods may have some of the fair value differences affecting goodwill.

How does an acquisition affect earnings prospects? There's some cynicism about purchase accounting that says that people do deals to juice their earnings, but there's really a lot that goes on after the purchase that affects earnings. There are short-term cash-flow effects and long-term cash-flow effects in purchase accounting. Short-term cash-flow effects are mainly the transition costs, the cost of consolidation and transition, which can be considerable, particularly when you're moving people and moving systems. The reason I call these cash-flow effects is because the cash-flow effects are obvious. The accounting effects may be less obvious. If the cash flows are just the expenses as they're incurred, then the short-term effect of a deal is usually an increase in expense and reduction of earnings and a potential for dilution, which is a no-no when you're the investment banker trying to justify the deal, but it happens.

Purchase accounting does allow that some expenses can be accrued and counted as part of the purchase price. That means they just roll through to goodwill and get amortized over 40 years. You get 1/40th of the effect each year, and you can mitigate a lot of the chance for dilution. There are certain kinds of costs that you can accrue, and there are certain kinds of costs that you cannot accrue. The rules are fairly complex, and it's something I just can't do off the top of my head. I do know, for example, that if in my example XYZ buys ABC, and ABC has a business unit that's very similar to XYZ's, then the costs of closing ABC's unit down, moving the systems, and moving the people can be accrued. If you go the other way, if XYZ says, well, I like ABC's ability to manage this kind of business better, I'm going to close down my shop and move my people out there—you can't accrue for that. So the rules are not intuitive and funny in some respects.

The long-term cash-flow effects are those things that Mike pointed out are ways to justify a big premium on the purchase price, increased revenue through product distribution leverage. XYZ can sell more product through ABC's distribution. ABC can sell more product through XYZ's distribution. There may be things they can do together that they couldn't have done before. That's something that always

comes into these analyses by investment bankers. When you're trying to look after the fact to see how you're doing on your purchase, it can get really muddy.

It's really hard to know if you're getting those synergies except by a process of inference, and the synergy may not come through the acquired company. The benefits of the synergy may come through some of the business units of the acquiring company. To go back and try to figure out whether you're getting a 15% ROE on the whole purchase may be an impossible task.

Improved pricing simply refers to the fact that if you buy a competitor, you've achieved some market share dominance; there may be an ability to either charge a higher price or pay a lower commission because you have a stronger market position. Companies often find that combined companies have a larger mass in their investment portfolio, and there may be opportunities to enhance yield, so there may be opportunities to do more effective risk management strategies to the benefit of the cash flow. And, finally, the obvious point: You can usually cut costs as a result of a purchase.

It was obvious from the presentation that a lot of the effect of a purchase on the balance sheet was the play between goodwill and VOBA. Goodwill is amortized straight-line for a period of up to 40 years. The popularity of 40 years has changed over time. It used to be popular. The SEC started snapping at some companies asking, "How can you justify a period of up to 40 years?" Their real concern was high-tech companies. For example, if you bought a dot-com company that had a lot of goodwill, over how long of a period would you amortize it? It would be more like six months. But the insurance companies would respond that insurance business has been around for 150 years. Our products are essentially the same as 150 years ago. Granted, our distribution is revolutionized. Our customer base is steady. We'll be here for another 150 years. Forty years is awfully short. We're going to go to the max.

VOBA works like DAC. VOBA amortization is just like DAC amortization, that's one of the clear rules, which means it's going to tend to be amortized over 20+ years. It's not going to have much effect after 20 years, and in the early years you're usually going to have a faster VOBA amortization than goodwill amortization. To the extent that you have some play between goodwill and VOBA, and if you put more in goodwill, you will have higher early earnings. If you're worried about earnings dilution, you have a bias to put value in goodwill rather than VOBA.

Even if VOBA is close to DAC, DAC is amortized over the remaining life of the business that is set on FAS 60 in particular. You may have on average 15 years of life remaining for DAC amortization. One day it's no longer called DAC, it's called VOBA, and you get to start over: you may decide it has 30 years remaining. That change alone is going to produce a VOBA amortization expense lower than the DAC amortization expense. It would give you an earnings benefit that might be more apparent than real.

There is some ability, to the extent that you have to make assumptions about maintenance costs in either the FAS 60 reserves or the FAS 97 DAC amortization, to put a pattern of expense rates that anticipate that expenses are going to be high for a year or so and then come down until you get to the run rate that you anticipate to be associated with the acquisition. There's a mitigating effect on the expense because you essentially reserve for that expense. That's something you have to do very carefully because you have to be able to support that those assumptions are based on an analysis consistent with the way you view operating expenses and direct cost for maintenance. Those expense rates that have the smoothing effect probably fall way short of the total expense of doing a consolidation. Nonetheless, there's some ability to again mitigate the potentially diluting effect of a purchase.

I hope you understand P-GAAP better now, and that you have a little better understanding of what a balance sheet looks like after an acquisition. What does it mean when you see a lot of goodwill, and what does it mean when you don't see much goodwill at all? Low goodwill probably means that the acquisition was more of an industry consolidation—an expense play—that the buyer didn't see a lot of infrastructure or capacity, but he wanted the business to consolidate with his. Certain questions may come up, such as does the buyer have a long-term strategy for organic growth? Does this acquisition add to this plan? In other words, if you're growing through acquisitions, what happens when you run out of acquisitions? Are these acquisitions actually helping you build some kind of infrastructure for organic growth, or are you dependent on acquisitions to continue your growth?

If you are, are there enough opportunities out there that you can buy at these bargain rates, or do you end up paying ever-increasing premiums in order to grow, putting goodwill on the books even though your purchase strategy is just to acquire more business to keep costs down? If that is the case, does that mean that you become over time not a buyer but a target yourself? We've certainly seen that in the industry. Plenty of times we've seen the big fish swallowing the small fish, only to be swallowed by the even bigger fish. It happens all the time.

High goodwill generally means that the buyer sees something strategic, usually that it is aiming toward market dominance. The buyer can justify the goodwill based on all the positive results of being not just a player but also a dominant player in some important markets. Certain questions might come up. Can the buyer continue to hurdle a rising bar, a rising bar created by goodwill and amortization, considering the purchase price as access to capital and the ability to effectively merge operations? And even for a company striving for market dominance, at some point you have to put together an operating company. Does the buyer have a vision and talent to succeed as a dominant company?

Mr. Daniel J. Kunesh: I will talk about three topics today. The first is rather brief and regards the Actuarial Standards of Practice that relate to purchase accounting. The second, where I'm going to spend most of my time, will be about the proposed standard of practice from the FASB on business combinations and goodwill. I will

round up my portion of this panel with a quick discussion about the treatment of reinsurance and expenses in a P-GAAP situation.

In looking at what standards of practice apply, I was hard-pressed to find much, to tell you the truth. In fact, there are no Actuarial Standards of Practice (ASOPs) that deal directly with purchase accounting aside from an old interpretation, 1(d), that came out many years ago. There has been very little actuarial literature published on purchase accounting other than in discussions like this. I'm going to talk about three concepts that can be helpful to you as a practicing actuary.

ASOP 10 deals with accounting methodology and assumptions. It provides guidance in establishing methods and assumptions used in GAAP reporting. Now, admittedly, while the standard expressly excludes purchase situations, it's my belief that the guidance is largely still applicable. It provides guidance in assumption setting: the establishment of provisions for adverse deviation and methodology. It also addresses communications and disclosures required of the actuary whenever he or she is involved in the process of financial reporting on a U.S. GAAP basis. The standard is currently being updated but only in a very minor sense to recognize SFAS 120 and AICPA SOP 95-1.

ASOP 21 concerns the actuary's responsibility to auditors in connection with the preparation and review of an audited financial statement. It defines and discusses the roles of the preparing actuary and the reviewing actuary. For the preparing actuary, it covers disclosure requirements about assumptions and actuarial methodology, and it provides general guidance on the selection of those assumptions and methods. ASOP 21 calls for the reviewing actuary to have a written plan of audit and addresses the concepts of confidentiality, documentation, and actuarial reports.

ASOP 23 on data quality is broadly applicable to all forms of actuarial practice. It provides guidance for selecting data, for reviewing data for propriety, reasonableness, and comprehensiveness, and for making disclosures about that data. ASOP 23 also discusses materiality, consistency, and reliances.

SEC Staff Accounting Bulletin '99 cautions that in ascertaining materiality of a given accounting situation, quantitative guidelines alone should not be used. Instead, qualitative indicators that could influence an investor's reading of the financial statements and investor decisions must also be considered. As you go forward, you can no longer rely upon the old rules of thumb such as 5% of total earnings to define materiality. You have to look further than that. And you want to have a close interaction with your accounting friends, your chief financial officer, and the auditors in this regard. ASOP 23 also covers data selection, the treatment of biased and imperfect data, and disclosure.

How many of you have heard about the new FASB standard that's coming out on business combinations? Only two or three? The proposed new standard was originally intended to come out by the end of this year. However, because of strong opposition from various industry sectors and the U.S. Congress, it is now

expected to be released next year. It covers business combinations and the treatment of goodwill.

The definition of goodwill that Jim gave you probably will not change in the new standard of practice. Thus goodwill will continue to be the balancing item, representing the excess of the net assets acquired (the fair value of all assets, including all tangible and identifiable intangible assets, less the fair value of all liabilities) over the purchase price of the acquired entity. The purchase price becomes the opening equity position of the acquired entity. This will not change.

The item most likely to change is the amortization of goodwill. Currently goodwill is to be amortized over its so-called useful lifetime, not to exceed 40 years, on a straight-line basis. It's been my observation that fewer than 40 years are used in most cases. In recent years 20–25 years have been used.

What is the status of this project? In August 1996 the FASB took on a project to reevaluate the accounting for business combinations. This was at the behest of the SEC because the commission found that it was spending more and more of its time answering questions regarding purchase business situations, especially pooling of interest matters. They were putting patches on top of patches, so to speak, on an already creaking system. They instructed the FASB to take a look at this whole topic and come up with a new standard if necessary.

A draft standard finally came out in December 1999 after over three years of deliberation. It is now believed that the new standard will amend APB 16, not replace it, and supersede APB 17, the existing standard on goodwill. This draft standard has been the subject of great controversy; it is probably one of the most controversial proposed standards in quite some time, particularly among high-tech firms and banks. You'll hear why in a minute. As I said earlier, it was hoped that this new standard could be released this year, but for political and other reasons and to make sure the subject is thoroughly investigated, it is now expected to come out some time in 2001.

What are some of the key areas of this proposed statement? I will investigate with you several of the decisions made to date. The new standard will redefine business combinations. For this purpose a business combination is a transaction through which an enterprise acquires all or part of the net assets that constitute a business, or the equity interests of one or more enterprises, and obtains control over those enterprises. Note that this definition would accommodate reinsurance or indemnity reinsurance much more cleanly than does the current definition in APB 16.

It should be noted that this new definition clarifies that a business combination really is an exchange of one business for another. It does not apply to not-for-profit organizations. Perhaps the most significant decision to this point, which many believe is cast in stone, is that the pooling of interest method (which is simply bringing the two balance sheets together at their current book value) will be eliminated for all transactions. We'll talk more about this later, particularly the reasoning given by both sides of the argument.

The new standard will also redefine the treatment of negative goodwill and will establish a new accounting basis for both identifiable intangible assets (for example, VOBA) and unidentifiable intangible assets (goodwill).

Now let's look at some of the decisions in greater detail. The pooling of interest method will be or is likely to be eliminated. The two industries that have been most against this are high-tech industries and banks, because some fairly substantial prices have been paid in recent transactions, and if these companies were forced to use a purchase basis of accounting, you might see some dastardly looking earnings results going forward. I'm sure there are other reasons, but those two industries have been the most vocal, to the point of soliciting their congressmen to help try to delay, eliminate, or change the pooling decision.

Goodwill will continue to be reported as an asset on the balance sheet because it meets the definition of an asset in Concept Statements 5 and 6. Concept Statement 5 is called "Elements of Financial Statements." Concept Statement 6 is called "Recognition and Measurement of Financial Statements of a Business Enterprise."

Acquired identifiable intangible assets are to be amortized, as in the past, over their useful economic lifetimes and reviewed for impairment in accordance with SFAS 121. This requirement is new. In a very direct sense the current proposal discusses reviewing the recoverability of intangible assets by reference to another existing accounting standard. The problem with this reference is that the most significant identifiable intangible asset of an insurance company is VOBA, and I really don't think SFAS 121 applies to VOBA. In many ways the VOBA of an insurance company is similar to the DAC asset, and DAC is already included as an exception. Some clarification will be needed to say that the value of business acquired in a purchase business combination should also be excluded from the provisions of SFAS 121 and that loss recognition testing as currently defined under FAS 60 should continue to apply, in accordance with existing practice

Identifiable intangible assets should be separately recognized only if they are "separable or if control over future economic benefits is obtained through contractual or other legal rights." By separable, the FASB means that they are capable of being divided from the entity or, at least theoretically, sold, transferred, or exchanged. This adds a new dimension to the process of splitting the total excess purchase price between identifiable intangible assets and goodwill. Given this definition, one could ask if the value of future new business expected to be sold by the acquired company's existing agency force qualifies as an identifiable intangible asset like VOBA. The answer is, I'm not 100% certain, but I think the answer is no. This is something that needs clarification and has been brought forward before the board for clarification in the final standard.

If the lifetime of the asset is indefinite and supported by clearly identifiable cash flows and with an observable market, then it is possible (and this is relatively new) that no goodwill amortization will be required at all. Let me just say that even

though amortization may not be required, all goodwill will still be subject to impairment testing. Goodwill with a finite lifetime must be amortized over its useful lifetime, over a period not to exceed 20 years. The 40-year rule used in the past is out.

Initial impairment testing must occur within the first two years after acquisition if certain conditions exist. There are four conditions. One is that if the carrying amount of net assets of the reporting enterprise is more than its market capitalization at the balance sheet date, then impairment testing is required. This could happen in a down market. Second, if there has been a significant decrease in the stock price since the acquisition date and the chance of impairment has increased, then impairment testing would be required. Third, if the probability of occurrence of an assumed event critical in setting the purchase price has changed significantly from the time the price was set, then an impairment test may be triggered.

Finally, if an unfavorable change in the status of, or expectations about, one or more of the underlying elements of goodwill has occurred, then impairment testing is required. As you can see, a new set of rules has been defined, with the FASB actually looking at three possibilities, that is, you amortize, you don't amortize, or you use a mixed approach.

There may be no amortization of goodwill if there is an indefinite lifetime and observable market. The goodwill then would be carried at the lower of the carrying value that is the initial amount set-up or fair value. Fair value for this purpose would be based on an observable market price, if one exists. It seems that if an observable market does not exist, you wouldn't meet the first definition, and you would have to amortize the goodwill. However, to carry on the definition of fair value where there is no observable market, a discounted cash-flow model could be used.

If there is no observable market, as I indicated earlier, then amortization is required over a period not to exceed 20 years. Goodwill is to be presented as a separate item on the balance sheet, as in the past, with the change disclosed on a net-of-tax basis on the income statement on a separate line preceded by the subtotal of after-tax income before goodwill charges, discontinued operations, and extraordinary items. Thus, you will have to disclose all regular income items, a subtotal, goodwill charges, discontinued operations, extraordinary items, and a final total for income after all these items.

Another recent decision relates to the possible disclosure of both fair values and book values in a transaction. The FASB decided that only fair values of the purchased assets and liabilities by category will have to be disclosed. Something else of interest is that certain pro forma reporting requirements are now necessary. Surprisingly, certain information about the acquired company will need to be shown for the two comparative periods *prior* to the purchase date as if the companies had combined at that earlier comparative date. If the acquired entity is a U.S. company, disclosure would be on the Form 10K. If a foreign entity, disclosure is on

the 20F filing. Many believe this is a silly requirement. However, it appears that the requirement will survive and continue forward. The information that you would have to show includes revenue, income before extraordinary items, net income, and earnings per share. Questions have come up about the accounting basis for disclosure. It seems that the old historic GAAP basis would continue to apply for most items other than the actual amortization of the purchased intangibles themselves and certain other items such as the pension benefits.

The FASB is continuing its research on various methods available for the impairment review of goodwill. This is quite important. Actually, several accounting firms have recently approached the FASB with the concept of a "residual income valuation" model. This model would include all intangible assets and would not consider goodwill as a wasting asset. A wasting asset is one that is to be written off over time. If the acquiring entity continues to invest in the acquired business to sustain its value, then it could use this model. Thus, goodwill would be viewed as expected profitability in excess of the required return on the net tangible assets, hence the term "residual income."

The impairment review would include an assessment of the feasibility of the company's financial plan for obtaining the profitability rate needed to achieve the projected results from period to period. Goodwill would be considered to be impaired if this rate is permanently below that needed to sustain the original acquisition value. The test would apply to all elements of goodwill. Clearly it seems that the test would also apply to VOBA.

Earlier I mentioned that negative goodwill is to be taken as an extraordinary gain in the year of purchase. To derive negative goodwill, you would first allocate a portion of the negative goodwill to intangible assets for which there is no observable market, then to acquired depreciable nonfinancial assets, and then to items like VOBA. If there is any left over, you have to take it as income in the current year. Generally it is unusual to have negative goodwill, occurring in rare cases like the takeover of a troubled company or a company that is in liquidation.

I now would like to outline the arguments for and against eliminating the pooling of interests method. Those in the industry who favor this method believe that poolings are appropriate for the merger of equals. In fact, the American Council of Life Insurance's position is just that. Strong opposition to eliminating pooling comes from banks and high-tech firms. Many have raised the so-called public policy argument, where it is believed that the far-reaching and detrimental effects of eliminating pooling could affect the entrepreneurial spirit of the technological community and various technological innovations of recent years. It is believed that the elimination of pooling will dampen the consolidation in the banking sector and create other inconsistencies and harm.

Opponents argue that this is not the role of accounting. They believe that the purchase method makes it difficult to compare companies that have grown through business combinations with firms that develop through internal growth. They also believe that eliminating poolings will not solve another fundamental weakness of the

purchase method, the treatment of knowledge assets and their value in a transaction. Finally, they say, "All right, if you have to change the pooling method, let's just change it." Don't eliminate it. Just correct those situations to reduce the abuses that have occurred in the past.

The FASB's arguments seem to be quite strong, to the point where I feel that they will prevail in the end. The pooling method, according to the FASB, provides investors with less relevant information than the purchase method does. It believes that the pooling method ignores the values that are exchanged in a business combination; that is, if a pooling combines the financial statements at book value, while a purchase method recognizes the fair value at the time of combination, under a pooling, according to the FASB, the reader of the financial statement cannot tell how much was really invested in the transaction, nor can they track the subsequent performance of that investment. The FASB believes this is a very serious flaw.

The availability of two different methods can make it very difficult for investors to compare companies. Companies using the pooling method have avoided the earnings penalty associated with the purchase method and have often paid too much for transactions. This can lead to dilution of equity interests of the shareholders of the acquiring entity and is often evidenced by owners selling their shares shortly after a transaction so that they can capture the gains. There are many, many other arguments along these lines.

It has also been argued that goodwill should not be amortized at all. Even though its research is looking at a variety of approaches, the FASB feels very strongly that at least a portion of goodwill has strong elements or significant elements of a wasting asset and should be amortized, and this is where much of the dilemma comes from. The FASB believes that many companies have paid too much in many of the recent transactions and that this overpayment should be written off. It's going to be interesting to see what finally comes out on the issue of a permanent goodwill and whether or not it can be amortized.

Let me make a couple of quick comments on goodwill impairment testing. The question in my mind is, for an insurance company, does SFAS 121 really apply? I think not. SFAS 121 applies to long-lived assets and the goodwill associated with long-lived assets. For an insurance company, there are no long-lived assets in respect of the value of the insurance business in force. Most assets of an insurance company are held in support of accrued policyholder liabilities. They are not associated with VOBA, goodwill, or any other identifiable intangible asset.

Further, it would be very easy for an insurance company to demonstrate goodwill recoverability under SFAS 121. Under SFAS 121 the test is to compare the carrying value of goodwill with the undiscounted present value of future cash flows. Because life insurance company cash flows go out 10, 20, 30, or more years, the test would be fairly easy to pass. The problem is that if the test is ever failed, then the company has to restate goodwill at the fair market value of the future cash

flows, which is based on a risk discount rate. This can cause a very, very large hit to earnings in the year that the problem occurs.

What else exists? Actuarial Practices Bulletin (APB) 17. Staff Accounting Bulletin 100 references other methods in addition to the undiscounted approach, including market capitalization and a discounted cash-flow approach. Clarification is truly needed in this area. The problem that I have with the new standard is that it provides little definitive guidance to insurance companies, much like the old APB 16 and 17. It doesn't tell you how to calculate the VOBA, for example, and there are still going to be many questions left wide open after the new standard comes into being.

Let me wrap up with a couple quick comments on the treatment of expenses in a purchase business combination and reinsurance. The question is, Can you include overhead expense? Clearly, to do so would be more in line with the pricing of the deal, but existing guidance like SFAS 60 would say no. I think it's decided on a case-by-case basis, and accountants will look at the nature of the expenses you wish to include. Certainly inclusion reduces the VOBA and increases goodwill. That can provide a good answer earnings-wise, as Jim indicated.

Regarding reinsurance, there are two basic types: assumption and indemnity. Assumption treaties are not that common simply because they require policyholder approval or novation. Generally it is believed that assumption treaties can be handled in the same manner that a company acquisition would be handled under purchase accounting, but without any goodwill. For indemnity treaties, your friendly accountant would generally direct you to SEC Regulation S-X, item 210.11-01d. This item provides the criteria as to what is a business combination for purposes of treatment under P-GAAP. Generally most indemnity treaties in which a block of business is actually being sold would appear to qualify for treatment under P-GAAP. In reality, there are very few differences between the two approaches anyway.

Mr. Edward C. Jarrett: A couple times during the remarks a comment has been made about fair valuing the account balances for UL or for annuity-type contracts in doing your P-GAAP accounting. My question is, How prevalent is acquiring companies using something other than the account value as a benefit liability on purchase GAAP?

Mr. Milholland: I haven't seen a survey and haven't conducted a survey, but in my experience, which includes numerous acquisitions, I would say, probably less than half have used the fair value of liabilities.

Mr. Kunesh: I probably haven't see more than one or two myself. It's definitely less than half in my experience.

Mr. Jarrett: Just a follow-up question. It seems like whatever way you do it, it's just going to be different in the presentation?

Mr. Milholland: I think the big difference is on the earnings emergence, because if you fair value the liabilities, you normalize your margins.

Mr. Brian C. Campbell: You talked a bit about what would happen if you had to P-GAAP a block that already had been P-GAAPed. You said something about the FASB saying that VOBA is not divisible. If a company purchased a company or a block of business that had already been purchased in the past, what would GAAP require?

Mr. Kunesh: Whether or not the block of business was previously acquired makes no difference. You would eliminate the old VOBA amount and calculate at the current best estimate assumption. What is the current value of business acquired according to the terms of the current transaction and according to the current required risk discount rate. That's been my experience.

Mr. Milholland: I agree. VOBA #1 is the first buyer's basis, and then it gets eliminated; and VOBA #2 is the new buyer's basis, and the exercise is just as if old VOBA was DAC.

Mr. Kenneth A. LaSorella: It seems that these ASOPs are fairly precise, they have a lot of detail, and they're useful, but they come out about a year or so after they're needed. We're still waiting for an ASOP on demutualizations, and in the meantime there have been several demutualizations taking place. Likewise, now that these demutualizations have been completed, we're going to see a lot of acquisitions, including blocks of business, involving these companies. Is there going to be any forthcoming guidance from the FASB that deals with actuarial calculations on VOBAs and similar actuarial values?

Mr. Kunesh: Ken, I agree with you that guidance is needed from the FASB. However, I think that the FASB does not want to come out with industry-specific guidance for any of their standards, at least on something as broad as this. That's what the Committee on Life Insurance Financial Reporting was told in a recent effort to clarify this issue. The FASB intends to avoid the single-industry, very narrow focus in coming out with new standards. I think we are going to have to live with the status quo going forward. As you know, this can lead to a continuation of the earnings arbitrage that has taken place in the past because of the varying interpretations made by different companies. I don't think you're going to see a lot of change. I see this new guidance doing not much more than eliminating the pooling method, which was one of their primary goals. But it's not going to give us any guidance with respect to how to calculate the initial amount of VOBA, the discount rate to use, and things like that. All these issues will remain the same as they currently are, and the current lack of guidance will still be there.

Mr. Milholland: The FASB is on the track of fair value for financial instruments, and most of its energy is going into how to develop fair value concepts and guidance for fair value. Under fair value there won't be any DAC, and there won't be any VOBA, and I think that with their preoccupation on trying to come up with something that

will be appropriate for fair value, they're just not going to go back and even think about some of the old accounting kind of issues.