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Session 50TS
The New Purchase Accounting

Track: Financial Reporting

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Summary: The Financial Accounting Standards Board (FASB) introduced two pronouncements during 2001 that materially change the way in which companies account for purchase transactions, both retroactively and prospectively. While no longer required to amortize goodwill, the measurement of a company's recoverability has changed. In addition, the list of intangible assets to be identified, valued, and recognized over their useful life has grown. Actuarial, accounting, and merger & acquisition professionals introduce the new requirements.

MR. JASON A. MORTON: I'm a partner with Deloitte and Touche. As a consulting actuary who works within an accounting environment, we deal with these accounting issues all the time, as I'm sure you all do from a consulting and insurance perspective. This is one that has been kicked around for a long time, just as all the FASBs tend to be in this day and age. Some of the things I'm going to go over are a summary of the new standards, insights into the measurement of the company's goodwill and impairment testing—probably the most important thing for actuaries that comes out of this. I'll also touch on an awareness of some of the nonactuarial aspects of these FASBs. I think that's important to know. Then we'll touch briefly on the implications of the new standards.

We're going to start with basic purchase GAAP (PGAAP) principles. I'm going to focus on the new things in FASB 141 and 142, but it is important just to talk briefly on the PGAAP process because not only do FASB 141 and 142 deal with PGAAP, but they also talk a little bit about the methodologies that you have to employ in the goodwill testing. I'll talk about some of the key features of FASB 141 and 142, then a little bit about the identification of intangible assets in general, then go into the goodwill testing and spend a few minutes on the im pact.

We'll start with the basic PGAAP principles. The acquirer will set the acquired assets and liabilities to market value, fair value, which for some assets is pretty straightforward. For a lot of the actuarial items, it's fairly complex, mostly because there's subjectivity, and there's lack of authoritative guidance, which we'll touch on. The excess of the purchase price over these net assets and liabilities acquired, which are on fair value basis, becomes the intangible we know as good will. In addition, there are other identified intangibles like the value of the business that you acquire (VOBA), and now with the new FASBs, even more intangible assets are identified than before, but the solved-for item is still goodwill as it has been.

Some of these intangibles are amortized into income. There's a change. It used to be that they all were and now certain ones aren't, which we'll touch on. The equity of the acquired company is the purchase price. What is the process? Once you've agreed on a purchase price, the acquirer needs to allocate that purchase price. What does that mean? First of all, you start with the assets. You assign the fair value to the hard assets that you have, then do the PGAAP reserves, effectively fair value to liabilities, but put the GAAP reserves on a PGAAP basis. Then you eliminate all of the other intangibles, including deferred acquisition costs (DAC) and VOBA, that were on the acquiree's balance sheet at time of acquisition. Then you determine the VOBA asset, that's the largest, most significant intangible for the actuaries. Make sure you top that up with deferred tax liabilities or assets as needed and so forth. Assign the fair values to other intangibles, and that's what we'll talk about a little bit later in the section named "Intangible Assets." Then you solve for the goodwill and allocate that down to the reporting units.

Before we get too far, let's talk about negative goodwill. Remember this formula; we'll rephrase it a few times. We'll have a couple of examples to really hammer it home, but it's a simple formula. I'm going to abbreviate goodwill as GW. The formula is GW = PP – (FVA - FVL). It's just the excess of the purchase price, PP, over what's commonly referred to as the net assets acquired—fair value of the hard assets less the fair value of the liabilities.

Until FAS141 and 142 came along, you could have negative goodwill. It was unusual to see it for insurance companies, at least, but if you did, you could leave it on the books as negative. That will change. If you do see a negative goodwill, the first reaction is, "Maybe I did something wrong; I better double check the calculations." You don't expect a negative goodwill, even in a bargain basement price. If you do get a negative goodwill and it looks like the calculations are correct, the first thing you need to do is go to all of your other intangibles including VOBA and pro rata them down until the goodwill goes to zero. If you've written off all of your other intangibles, and goodwill is still negative, you take that into income as an extraordinary gain. That probably shouldn't happen for insurance companies.

There is a live example of one insurance company buying another that will show you how the purchase price allocation process works. The company that was acquired held some of their assets at held-to-maturity. The acquirer said, "No, I'm going to hold everything at available-for-sale." So assets held-to-maturity got reclassed available-for-sale. The other adjustments are marking the target's assets to market value. Of course, the target's DAC gets written off, so does its previous VOBA and goodwill from prior acquisitions. You put new ones back on the books. You're marking the liabilities and the assets of the target to market.

You do the same thing with the liabilities. You make PGAAP adjustments, using today's assumptions, best estimate instead of at issue and so forth. The equity becomes, effectively, the purchase price. You net out the summation of all the asset and liability adjustments that you've done marking the balance sheet to market. It's always a good step to look at the summary of all the fair value adjustments and just summarize them all. What's shown here is not called goodwill; it's cost in excess of net assets acquired. You can see a reconciliation of the total cost of the acquisition and how you arrived at it. You started with their actual equity, made the fair value adjustments, and then you get down to the total cost.

This process when you do it in reality is a lot more onerous, with a lot more details and so forth, but this is the process that you need to go through when you do a deal. Also, when you do the goodwill impairment testing, you'll need to allocate the goodwill, and then you'll need to allocate the purchase price that you will come up with for each of the reporting units in this sort of fashion.

MR. JIM TOOLE: I really want to clarify the use of the terminology "fair value" because of all the discussions on the international accounting standards. It's my understanding that you're setting them at GAAP reserves using FAS 60 and FAS 97, which do not necessarily translate to fair value.

MR. MORTON: Right. We'll talk a little bit more later. Right now in the United States, fair value doesn't mean what it does around the world, and even around the world there's not a consensus on a definition of fair value, especially for actuarial liabilities. Fair value, whatever that is, is going to evolve, but you still would use the current interpretation of fair value when you mark this thing to market.

That's just some background on PGAAP, and we'll talk about this later on as we sprinkle it in with how to apply the new FASBs. Let's summarize the key features of FASB 141 and 142 introduced in 2001, effectively replacing the prior authoritative guidance, which was APB 16 and 17 and also FASB 38. Even with these new FASBs, there's still a lot of work to be done. They're fairly thick. They're thicker than most of the FASBs, and as the years go by, each of the FASBs gets thicker and thicker. Back in July 2001, the AICPA finally formed a task force to address some of the practical application and issues around PGAAP. They formed a task force, and they started in. They put it on hold until FASB 141 and 142 were done and adopted.

They'll pick it up again soon, but that whole concept they're referring to is business combination Phase II. You should hear more about that coming soon. That's going to look more at the practical applications of these sorts of things, the typical issues that come in. Fair value is one example. You have FAS 97. You have UL business. For HGAAP, historical GAAP, we always use account value. That's the definition that we use for the GAAP reserve, but now there's some talk about maybe that's HGAAP, maybe that's what GAAP tells you to do, but it's not fair value. If you came up with something different than account value for universal life reserves, what would you do on day two when you're supposed to follow normal HGAAP? There are practical issues that need to be addressed, and this group is going to look into them.

There's a lot of history here. It's been going on for over 30 years from when APB 16 and 17 came out. Immediately, there were questions and implications that have been addressed piecemeal throughout. For example, one of my accounting folks told me that as the merger and acquisition (M&A) landscape has changed, there have had to be approximately 70 different little tweaks to the accounting guidance in various forms to help keep APB 16 and 17 in line with what's been happening in the marketplace. After a while you just have to redo it. As I just mentioned, even after redoing all that, you still end up with work to be done in this Biz Com II.

But there has been a lot of controversy over PGAAP, particularly in the 1990s. One of the reactions was this emerging issues task force to look into some of these things, and all they came up with was about a three-quarter-page standard that just says basically: however you come up with your initial VOBA, you amortize just like you would DAC. That's basically all it says. It doesn't tell you anything—how to get the initial VOBA, what methods to use, how to come up with a discount rate or anything like that. So it really didn't solve much. The SEC had problems with pooling, and there was abuse. They needed to get rid of it. They thought we might as well take advantage of what's going on in the rest of the world and harmonize our accounting standard for PGAAP with the rest of the world. You'll find out they didn't really get there. So they went ahead and issued the FASBs. That's what they're telling the world. What's the real story from industry?

Basically, goodwill has just been the solved-for, and there's been a lack of rigor around determining goodwill. One of the reasons for that, people believe, is that in 1992 and prior there was a tax code that really made you focus on an appropriate determination of goodwill because it really impacted your taxable income. So people did a very diligent job in calculating the goodwill. Once that went away, companies got a little sloppy with it. The FASB also was trying to do the industry a bit of a favor, though, with this issue of ending the double dilution of earnings. What that means is if you're a company and you spend advertising and other costs to build up your company to add value to sell future business and so forth, those get expensed immediately in your income statement. If subsequently you become acquired, you have goodwill on the part of the acquirer and then you have to amortize that into income as well. It just seems to be a double hit to earnings. As we'll find out when we talk about the main features of FASB 141 and 142, we won't be amortizing goodwill any more.

As for the desire to improve transparency of financials, pooling wasn't very good at doing it, but even under PGAAP, you still don't really get there. This was intended to be a step in the right direction. The last point is that the FASB has been trying to move, albeit slowly, the industry to think more about fair value than cost recovery. This is just another step in that direction. You've had FAS 107 with fair value liabilities. You've had FAS 115, with the unrealized gains and losses flowing through equity. You've had FAS 133, with recognizing the embedded options in products. With international accounting standards, that's an even stronger step toward fair value, so this is just trying to move us along.

What are the key provisions? No more pooling—PGAAP only. Any deal after June 30, 2001 has to be PGAAP. But if you've done a deal before that and it was a pooling, two mutuals that merged, you don't have to go back and do anything with those other than one transition thing that we'll talk about. You don't recharacterize those as PGAAP or anything; you can preserve that pooling.

It talks a little bit more about allocating the cost of the acquired entity and then talks about what is and what is not a business combination. There are the obvious ones—the purchase of the stock of another company, for example—but also it goes to acquiring blocks via reinsurance. That's also considered a purchase.

The last one is a bit controversial. If you read the FASBs, it looks like merger of mutuals is excluded. Biz Com II is going to have them included. The only problem is, how do you apply PGAAP to a merger of mutuals? There are issues there, so that's one that is kind of in development at this point.

What is not a purchase? I think the key here for insurance companies is joint ventures. More and more companies are getting into joint ventures. There are a lot of definitions in the FASB about what defines a business combination, but in general a typical joint venture is not deemed a purchase. Therefore, PGAAP does not apply.

Some other key provisions include recognition of more intangibles. That was one of the key focuses of the FASB. Not just goodwill and VOBA, but let's look at everything that a company has acquired. If we can identify some things as intangibles, let's put them on the balance sheet. Calculate their fair value. Some we amortize, some we don't. There are a couple of criteria to help you identify those. FASBs go into way too much detail for us actuaries, but basically there are two criteria. If you meet either one, you have to identify it as an intangible.

Of course, it wouldn't be an accounting provision if it didn't enhance the documentation requirements, and it certainly does that here, especially in the year of purchase. In transition, you also will need to look back at prior transactions. Intangibles that you had on the books from prior acquisitions ("prior" means prior to June 30, 2001), need to be separately identified, if previously it was lumped into goodwill. Conversely, if it doesn't meet the legal and separable criteria for intangible right now under the new FASBs, you lump it back into goodwill. Just take a look at those prior acquisitions and get your balance sheet set with putting either more things into goodwill or less.

This is really the only thing that you'll see that applies to historical deals. Like I said earlier, it doesn't affect prior poolings. It doesn't recharacterize those as a purchase.

Lastly, I mentioned negative goodwill earlier. You used to be able to carry negative goodwill on the balance sheet, but now as of July 1, 2001, any negative goodwill on the balance sheet gets written off to zero so that comes through as an extraordinary gain. Any change, any impact, from directly implementing the FASBs will come through during this transition period as a change in accounting principle. All that means is that it shows up and hits net income, but it doesn't hit your operating income, which is really what's focused on by analysts and others and maybe even affects your executive compensation bonuses.

Under FASB 142, there is no more goodwill amortization. It requires allocation of all purchased assets and liabilities to be allocated to the reporting units and that includes goodwill. I mentioned earlier that FASB 141 helps you decide which intangibles to identify and put on the balance sheet, and FASB 142 would help tell you which ones have to be amortized and which don't. Because we're not going to amortize goodwill any more, we need to periodically test it for impairment. The FASB has transitional steps, plus annual impairment tests, that need to be applied. The two key points that we'll see are (1) apply it at the reporting unit level, not just company-wide, and (2) on a fair value basis, however you define fair value.

Of course, there are more disclosure requirements—especially when there is an impairment that's been identified. You will see significant write-ups in the company's public financials, in their footnotes, about recognition of hits to net income because of an impairment. I'll just touch on one example briefly. This is from the April 29, 2002 *Best Week*. "Aetna had its first quarter net loss widen sharply, citing a $2.97 billion non-cash impairment of goodwill, but the operating income went up. Aetna said the loss reflected the company's adoption of FASB 142, which requires companies to value the goodwill and report any impairment." So they took this huge hit, almost $3 billion. In the very next paragraph, the CEO goes on to say, "We view the substantial financial improvement in our health care business as a critical milestone." He was basically saying, "I just swallowed $3 billion of cost that no longer is going to affect my future income. That's a good thing, you analysts out there. By the way, it didn't go through operating income; it was this one-line kind of implementation of a new FASB. You can forget about it. But going forward, we're going to be stronger than before."

Companies have been scrambling to do this sort of thing. Most of them did something in first quarter. If they have an impairment, they need to identify and record it by the end of the second quarter, by June 30, which is fast approaching. You need to identify within six months if you have an impairment. If you do, you need to book it; even if it's an estimate you have to book it. Refine it later if you have to, but by June 30, you need to do at least a high-level test to see if at the reporting unit level you have any goodwill impairment. If it's an estimate because the work is incomplete, you still have to take the hit, disclose the heck out of it and refine the calculation later if you need to.

Let's talk a little bit about intangibles. This section talks a lot more from the accounting side of the house, not necessarily actuarial. We'll touch on some of them so you know where the accountants are coming from when you hear them talking about this sort of thing. It does affect all intangibles, so it affects VOBA. We'll talk about that in a little bit, but in general this section doesn't really affect insurance companies as much as it does many other companies that have more significant research and development, like telecoms and pharmaceutical companies that have done acquisitions. There are other examples from noninsurance, such as AOL Time-Warner. I think they took a $50 billion write-off because of FASB 141 and 142.

I mentioned earlier that one of FASB's key objectives in these new FASBs was recognition of more intangibles on the balance sheets—and more intangibles on the balance sheet separate than goodwill, not just lumping everything into goodwill. The majority of these assets that are intangibles will still be amortized, like VOBA, but some other things like customer lists and so forth won't. For the ones that won't, you separately identify them, and you just determine that they have an indefinite useful life. Before, in APB16 and 17, there was a presumption that goodwill had about a 40-year useful life, so you amortized it as a straight line over 40 years. That's gone away now. Not only is there not any goodwill amortization, but even for other non-goodwill intangibles that have an indefinite life, there is no presumption that there is a magical 40-year number.

This next point is pretty important. Going forward when you're looking at deals, you need to look at pro formas and what those are going to do to your GAAP earnings. That helps you come up with your deal price and so forth, for all of you who have worked on M&A transactions before. These new FASBs make it pretty important to take a look at intangibles and how they're classified earlier on in the deal, rather than just doing it after you've done the deal, because if you just assume that there's a big chunk, it's going to be goodwill, it's not going to amortize, and you base your price that way, you may find out later that a finer definition of goodwill would mean that some other intangibles, which were separately identified, are amortized. In that case, you would have more amortization expense than you thought in your pro formas. It has become important for a lot of other reasons, but this is one that's kind of forward looking when you're looking at deals.

There are some criteria for helping you determine what's an intangible. The two key things to remember are contractual/legal rights and also if it's separable. One example is customer subscriber lists—mailing lists—that you might purchase. They may not be contractual, but they are separable. It's something that could be sold if you wanted to. Because of that, if you meet either of these two criteria, you recognize it as an intangible. On the other hand, if you have companies that have what we might consider walk-in business, where people just call up and buy your policy, even if you could value it, that is not an intangible because it's not only not contractual, but it's not separable. There are no legal rights to it. These people are just walking in off the street. And if it's a "no,"—recognized column says no—that means put it into goodwill. Work force or assembled work force is another example. These are your employees. If you can assign any value to them at all, it's just classified as goodwill.

You can see that the FASB is trying to come up with a lot of specific examples where you need to somehow come up with the value for some of these intangibles where you wouldn't have before. You just flush them all into goodwill.

Some other examples that mean more to the insurance industry are VOBA and the value of the licenses that you have. Another example is the value of the distribution system or the agency force. And a question comes up very quickly: I understand VOBA, we've been doing that for a while, but how would I come up with a fair value for the opening balance sheet of a distribution system, for example? That's something we haven't done a lot before. One of the things you need to do is look at some general principles. One says hold it at fair value, but how do I get there? Look at a quoted market price, but you're not going to find a quoted market price for a lot of things we deal with. It says if you can't find that, look at a comparable market price or some present value techniques. The valuation people who specialize in this have three methods for coming up with the value of a piece of real estate or a trademark or what have you.

The first method is the cost approach. What's the replacement cost? The second is market approach, using comparables in the industry. Obviously, there are problems with these two when you try to apply them to actuarial items. How do you handle the cost approach if you have a proprietary asset? On the market comparable approach, quite often there's such a range and there's not a consensus on what defines a market comparable. And how do you compare your company against another? There are similarities, but there are always differences. Quite often you really can't use these first two methods.

Most often for insurance companies, you end up with what they refer to as the income approach, which is what we would just say is discounted cash flows—present value of future benefits. What you also find is maybe you use the present value of future benefits method, but then you take a look at some of these other methods and come at it a couple of different ways and see if you can triangulate on a value. Quite often there's more than one method, but we actuaries are going to mostly use what's referred to as the income approach.

The distribution system is one of the areas other than VOBA where your accounting folks might come to you, the actuaries, and say, "Help me out on this thing. I'm buying a company. They have an agency force under contract. I know that's pretty clear that that's an intangible on FASB 141. I need to somehow come up with a fair value and put it on the opening balance sheet. How do I do it?"

First of all, if it's career employees, and not some independent agents that you've got a contract with, that's considered part of your work force, which is just goodwill. But if you have got a contractual relationship with some producers, that's separable. It meets some of the criteria, so you have to separately identify it. What do you do? Obviously you would think that the income method might be the appropriate one. Look at the present value of the profits that these agents produce, and discount them back and take a look at the likelihood that they're going to renew their contract. It's a pretty good classic actuarial exercise. Once you've come up with that initial value, because it's the value of business that effectively is acquired, you know it has a finite life. It's going to run off over time, so it should be amortizing, and that present value of profit stream can help you with the amortization of that intangible. Of course, there are key assumptions that we're used to seeing, like the probability of new business coming through, a discount rate and lapse assumptions, but there are other things that we normally don't deal with, like agent attrition.

FROM THE FLOOR: Do you just look at your existing agents under contract or do you assume that there will be some new people coming through?

MR. MORTON: This would look at just the agents who are currently under contract, taking into consideration the likelihood that they might renew their contract. The rest would be considered goodwill because there's no contractual obligation for people who you don't have under contract to get under contract.

On the subject of amortization of intangibles other than VOBA, if you determine that a life is indefinite, you don't amortize it, but you will take a look at this life over time. If the asset has a life that becomes finite, for whatever reason, you'll have to start your amortization at that point. Otherwise if it's not deemed to be an indefinite life, you do amortize over whatever you've determined is a useful economic life. Quite often accountants might just use straight line, and sometimes that's okay. FASB even says if there is no identified economic useful life pattern of earnings and how the earnings emerge, straight line is okay. But if there's something that's more accurate, you should reflect a more accurate emerging of profits.

FROM THE FLOOR: If you have a distribution system where you need to come up with initial fair value, how do you go about it?

MR. MORTON: You would use the best tools you have. Again, fair value is not really defined. There are some general principles around how to get at it. Basically you use as accurate a model as you can, the best assumptions that apply today, not when the agents came on or what you expect them to be, but today from the buyer's perspective, which could be different from the seller's perspective. Just try to come up with the best estimates that you can. There's not a lot of guidance here.

One of the big implications of the new rule is subjectivity. There's a lot of judgment, and there are two problems with it: (a) it hasn't been defined clearly in these FASBs, but (b) it's been required to be used and the SEC is going to look at it. Hopefully, this Biz Com II is going to help with the more practical aspects. It won't be an FASB; it will be more of a standard of practice (SOP). I don't think it will get to the point where it's a Q&A, like Practice Bulletin 8 was for FAS 97 DAC, but this practice is going to emerge over time. Whether it's coming up with these initial fair values or doing your goodwill testing that we'll talk about in a minute, it's important to do as good a job as you can right now because that will set the precedent for what you do in the future. Consistency is one of the cornerstones of GAAP and that will have to continually be applied. We all know that practice is going to evolve as people learn more from doing and best practices emerge and maybe subsequent guidance comes out, maybe it's in this Biz Com II. But there's not a lot of guidance.

If you identify a separate intangible, and it has an indefinite life, like brand name, for example, how do you amortize that? You don't. However, as I mentioned, if for some reason the life of that intangible becomes finite, at that point you would jump in and start amortizing it. Then you would test for impairment.

FROM THE FLOOR: I have a question about this agency force and how to value it. Do we look at redoing this initial fair value every year in the future?

MR. MORTON: No, it's the fair value upon acquisition. That's the balance that gets put on the balance sheet one time only. Then it would be deemed to be amortizing because it does have a finite useful life, because the life is the life of the business that was sold. That's where the profits are. That's where the value is based because the business is going to run off over time. You know that for sure, not like a brand name like Coke might have. That's always going to have value, you think. Since the basis at which you've performed the fair value for the initial opening balance sheet is based on something that goes away over time, you do have to amortize it. And that's the pattern over which you would amortize it. Three or four years from now, or every year after acquisition, you would do another calculation to amortize it and then the change in the value goes through income as an expense. You can look at it that way or you can look at it as fair valuing it every year and taking the change in the fair value through income, but normally we think of just capitalizing it and amortizing it over time like DAC or VOBA. It's the same concept.

I want to hit on some actuarial VOBA and reserve issues, since we're talking about identifying intangibles and putting them on a balance sheet. One of the keys is looking at fair value. VOBA is one of them. It's one that we actuaries deal with.

The steps are certainly to first of all come up with reserves on a PGAAP basis. You have to do reserves first whenever you're forming an initial opening balance sheet. Reserves come first, then you do the VOBA. The VOBA does not include new business. It's the value of the business that's on the books when you acquire the company. Normally you have to calculate the VOBA, and you solve for the goodwill. However, for companies that buy blocks of business, quite often you just solve for the VOBA as the residual. You should calculate it as well to make sure that it's a reasonable number, but the way the economics work out is you're just buying a block of business. There are no producers. There are no brand names. There's no plant. There's nothing that goes with it. It's just a block of business, so all the intangibles are one and it's VOBA. Therefore, you've paid a price, you have the assets and liabilities that come over, you can solve for the VOBA, and it makes it pretty simple. That's a specific case. Generally you calculate the VOBA and solve for the goodwill.

We don't have any authoritative guidance for how to calculate this initial VOBA yet. Hopefully, Biz Com II is going to get there, but right now even after EITF 92-9, and FASB 141 and 142, we still don't have it.

There are common methods in practice, which you've heard about and dealt with before. There are lots of them, but I want to summarize three. For FAS 60 it's a defined initial reserve method or the defined valuation premium method; those two are variations on a theme. For FAS 60, present value of future benefits minus present value of valuation net premiums is your reserve. Use best estimate assumptions to come up with these present values and either state what the initial reserve is and solve for what the valuation premium comes out to be or state what the valuation net premium is and solve for the initial reserve going forward.

ROI method is one of a lot of variations, but basically it's present value of earnings on a pretax basis without DAC amortization or VOBA amortization in there. You can think of it for FAS 97 business, for example, as like the estimated gross profits (EGP) stream.

Then there is the actual appraisal value method. We'll dwell on that one a little bit because it's becoming more and more used as the industry standard. It's easier to use in some respects, because quite often the calculation is done as an adjunct to the deal pricing that management did. You go in and you're working on coming up with a purchase price to bid and, if you're successful, you can take the model and all that work that you did to come up with a purchase price and use that same model to come up with your VOBA, which has a lot of appeal. Not just because it's a little bit more simplistic to apply and calculate, but it hangs together with the price of the deal, which makes a lot of sense.

Let's go to the appraisal value method. What is it? You take a look at the appraisal that was done when you were looking at the company. Most companies, when they're doing a deal, they just don't use the seller's appraisal, they'll recreate that and then put in their own assumptions. From that model, you can use that for the VOBA, but, of course, any kind of a purchase price from an appraisal is going to be on an after-tax stat basis. Because this is GAAP, it needs to be on a GAAP basis, and it's like DAC, so it needs to be pre-tax. Also, there are mark-to-market differences that sometimes don't get in the appraisal. Effectively, all you're doing is you're taking the value of the in-force from the model or the pricing sheet, as we say in the deal, making an adjustment for the GAAP reserves being different than stat, making an adjustment for fair value versus book value, and then grossing the whole thing up to make it pretax. Or, skip right through it and forget about the grossing-up thing and calculate things just using pre-tax numbers. But it seems pretty simple. I think the key difference between this and the ROI method is you always tend to include cost to capital whenever you're looking at a deal. Some of the other VOBA methods used in the past didn't do that always, and that's a big difference. The reason I'm really going through all this isn't to rehash VOBA and PGAAP, but to talk about the implications of applying this.

Here's a simple example, but it gives some pretty good information. Goodwill in this case is valued at $600. How did we get there? The purchase price was $1,778. Liabilities at fair value were $10,000. There were some deferred tax liabilities of $96. There were some assets of $11,000, plus there's a VOBA, which is an asset of $274. Goodwill is calculated as the purchase price of $1,778 minus the net asset acquired on a fair value basis, so it's the value of the assets minus fair value of the liabilities. If you do that calculation, you get the $600.

Also, let's address a couple of summary points on methods that come up with the initial VOBA. One of the reasons, I think, that the appraisal value method is being used more than other methods, like the ROI method, is not only because it's easy to use and it comes off the deal and all those good reasons, but because whenever you do a deal you're always looking at including the cost of capital. It's going to end up giving you a smaller VOBA. A smaller VOBA tends to give you a larger goodwill. A larger goodwill doesn't amortize any more, but VOBA does, so you'd rather get the one that amortizes smaller and the one that doesn't amortize larger. But there is reality, in fact, in doing this. It's not just an accounting game. It better matches the economics of the situation to reflect the cost of capital, and it's a good result.

FROM THE FLOOR: It's not only a convenient or a nice result to end up with a higher goodwill and a lower VOBA from applying something like the appraisal value method, which incorporates cost of capital, but you should do it because it's a better reflection of the fair value.

MR. MORTON: That's all this thing is after is to get the best fair value-based number on the books. That's very true because when you're buying a block of business or when you're buying a company, you do have to reflect the cost of capital. That's reality. Reality is fair value. If you don't reflect it, you're not doing a good job marking your balance sheet to market.

FROM THE FLOOR: The question for you is whether you even have to reflect fair value. Do you think you can avoid reflecting fair value?

MR. MORTON: No, you cannot. You have to mark-to-market. You have to call it fair value. There's no firm definition, but this is a better definition. Therefore, you should use it. As I said, I've looked at not as many deals recently because things have slowed down in the M&A market, but over the last, say, four or five years, this is really the only method that's used. There are variations on it, but it's effectively what is being used in the industry today.

We've talked about methods that give you a different VOBA. Other things that will, of course, are assumptions. The more conservative the assumptions, the lower the VOBA and the higher the goodwill. The higher the discount rate—again, anything that lowers the VOBA tends to increase the goodwill. The sum of all the intangibles is a known once the deal price is set, so the only question is the allocation of one intangible to the other.

When it comes to amortizing VOBA, we actually do have some information here from the FASB. It's this EITF 92-9. It's very brief. It says to amortize the VOBA the same way you'd amortize a DAC. If it's FAS 60, amortize it over premiums using the earned rate and so forth. If it's FAS 97, use the creditor rate, and amortize over EGPs. You don't lock things in for FAS 97. You lock them in at FAS 60. It's exactly the same methodology.

Of course, any intangible needs to be tested for recoverability: VOBA, DAC, goodwill, anything. VOBA recoverability needs to be performed just as you would do recoverability studies for your DAC.

Table 1 is a good summary of accounting for the intangibles. Do you amortize them or not? It contains information about the testing that you use and the timing.

Table 1

Summary of Accounting for Intangible Assets

	Goodwill	Indefinite Useful Life	Finite Useful Life
Characteristic	*Intangible not meeting legal, separability criteria*	*No factor (legal, contractual, economic, other) limits useful life*	*Expected useful life is limited*
Amortization	*None*	*None*	*Over useful life*
Impairment Test Methodology	*Two-step test (fair value based)*	*One-step test (FV vs. BV)*	*One-step test (SFAS 121)*
Timing of Test	*Annually, or more frequently as circumstances indicate*	*Annually, or more frequently as circumstances indicate*	*When there is an indication that the asset may be impaired*

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Now we're going to go into the goodwill impairment testing. The basic steps here are pretty simple: identify reporting units, then perform goodwill impairment testing at the reporting unit level by first allocating the assets, liabilities, and goodwill to that level. Once you do the first test to see where you stand, do an annual update impairment test in the future.

Within six months of adoption—by June 30 of this year—if companies have an impairment, they have to take it even if they have to estimate it. But the other way to look at it is that it's a one-time window; it's an opportunity. If I do some assumptions a certain way, a little bit more optimistically, yes, I don't have to write anything off. But you're going to have to keep doing this goodwill impairment test, and if in the future you have to take a write-up, that goes right through regular operating income as an extra expense, whereas if you do it now, it's a one-liner; it's separated out. It's changing accounting principles and, like I said, it's not totally ignored by analysts, but much more so than when your operating income takes a dip. Some people look at this as not a bad thing, but a window to clean up their balance sheet. But that window is, of course, closing very quickly.

Identify reporting units, allocate the assets and liabilities and goodwill, and do the test. There's a lot of information in FASB 142 about how to define these reporting units. Basically, your company already has defined operating segments due to the implementation of FASB 131. That's the segment level reporting that's done in the 10-K, the level at which you cut the results down by. There are certain situations where you have to define a reporting unit on a finer basis than this operating statement, and FASB 142 goes into a lot of detail about it. There are certain criteria that you need to apply. Chances are your accounting people have looked at this already and have a pretty good idea. It really should be how you run the business, not legal entity. A lot of companies out there with consolidation over the years have really combined a lot of their acquisitions and actively manage all the life business in one center of excellence, annuities in another, health in another. Maybe you have three reporting units even though you might have 14 or 15 legal entities. Of course, the SEC is really going to scrutinize this—not only upon implementation, but in the future.

On the subject of identification of reporting units, you really do want the fewest number of reporting units possible. That gives you fewer calculations to do, but it also gives you the greatest chance of not having a goodwill impairment. You want the fewest number of reporting units as possible, if there's a gray area.

After you identify the reporting units, you assign the goodwill to those reporting units. Not only do all the acquired assets and liabilities have to be allocated down, but also corporate items. There are two criteria for helping with the reporting unit definition: (1) segment management reviews and assesses performance of the operating segment at a level below the operating segment and (2) a business that has discrete financial information available and has economic characteristics different from other components of the operating segment. If both conditions are not met, the reporting unit would be the same as the operating segment.

On the allocation issue, you have to allocate all of the goodwill. You can't have any corporate goodwill any more. All of the goodwill has to be allocated down to reporting unit. As many assets and liabilities as possible, even from the corporate segment, have to be allocated down. Even some that you don't think can be allocated down, really can be—like corporate debt. You can look at where that debt came from or why it was raised and allocate it that way, or you could just allocate it over invested assets by reporting units. But, if at all possible, you push it down. Pension items is another one. That's stays in the corporate line, but certainly you could allocate that over each of the reporting unit's payroll expense, for example. The idea is to push all the liabilities and assets that are completely possible down to each reporting unit. You have to push all the goodwill down to the reporting units. There still in the end might be a couple of corporate assets or liabilities when you're all done, like maybe some tobacco liability you might be on the hook for that just doesn't tie to any one reporting unit. Some things like that can stay there, but all the goodwill must be allocated.

The goodwill impairment test is a two-step approach. For most companies in most situations, they'll get through step 1 and stop. Step 1, which is at the reporting unit level, compares fair value to the amount of the equity on the historical GAAP income statement, or what's known as the carrying value. If the fair value is greater than the carrying value, you're okay. If it's not, then you have to go on to step 2. Step 2 says compare the implied fair value of that goodwill within that reporting unit to its carrying value on the books. If the fair value is less, you take the write-off and go forward from there. It's a two-step approach. Once you've written down something for impairment, even if you do a subsequent fair value calculation that looks rosier, it stays written down. It's a permanent write-off. So it's very important to get it right the first time (Tables 2, 3 and 4).

Table 2

GW Impairment Testing - A Two-Step Procedure

Step 1

- *Compare FV of reporting unit with carrying amount (including goodwill)*
  - If the fair value is less, proceed to step 2
  - If greater, GW is not impaired and no further testing is required

Step 2

- *Compare implied FV of GW to its carrying amount*
  - Record any excess of carrying value over implied FV as an impairment loss, and set carrying amount of GW to implied FV
- Once written down for impairment, GW cannot be reinstated

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Table 3

GW Impairment Testing

Step 2 (continued)

- "Implied FV" is calculated as if the RU had just been acquired, with the FV of the RU considered the "purchase price." Any excess of this purchase price over the FV of amounts assigned to assets and liabilities of the RU is the implied FV of GW for the RU.
  - Taken as a hypothetical acquisition at the valuation date, same process of allocating tangible assets, intangible assets other than GW and liabilities as discussed earlier
  - Assets and liabilities are stated at fair value
  - Implied FV of GW is equal to FV of RU less net assets "acquired"
  - This process allows unrecognized intangibles to be considered

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Table 4

GW Impairment Testing

Step 2 (continued)

- If the second step of the goodwill impairment test is not complete before the financial statements are issued and a goodwill impairment loss is probable and can be reasonably estimated, the best estimate of that loss shall be recognized in those financial statements and disclosed as an estimate.
- Once written down for impairment, no future recovery of goodwill value may be recognized

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Basically, step 2 is a purchase price allocation step that we walked through a little bit earlier. Step 2 is really getting at this implied fair value. You're going to compare the implied fair value of the reporting unit to the amount of goodwill on the books for that reporting unit. Basically you look at the reporting unit and say, "What if I acquired this today? What would its appraisal value be, for example? What would its acquisition value be?" That will help you determine a fair value. Once you do that, and you know the fair value of all the assets and liabilities, the residual from this fair value that you give it versus the net assets acquired is the implied fair value of the goodwill. It's very similar to what we talked about earlier. You come up with a purchase price somehow, which in this case is for just a reporting unit. You mark everything to market, including the liabilities. Whatever is left over is your implied fair value of goodwill. That's really the key to this thing. If the first step says you have an impairment, and you go to the second step but you're not quite done, you have to do your best job at estimating the thing, and clean it up later. You have to get something on the books if you fail step 1.

In the example in Table 5, we pass at Step 1, so we stop. How do we do that? The left side of the balance sheet shows the historical U.S. normal carrying value balance sheet. For the assets, there's a $70 VOBA, and there's goodwill on the books of $30. This is for one particular reporting unit. Let's say it's your life business. You have surplus of $140. You'd use some sort of appraisal value technique, which we'll talk about a little bit later, but you somehow come up with a fair value for this life business of $155. Step 1 is simply comparing $155 to the $140, the carrying value on an HGAAP basis that's on the books of this reporting unit. Carrying value is the surplus, so the fair value of $155 versus the $140 says, "I'm okay, I don't have a problem."

Table 5

Goodwill Impairment Tests (Example 1)

US GAAP Balance Sheet for RU (Carrying Values)

Tangible assets	600	Liabilities	570
VOBA	70	Surplus	140
Other intangibles	10		
GW	30		
Total Assets	**710**	**Total Liabilities & Surplus**	**710**

Determine FV of RU to be 155, using appraisal value techniques

Unrecognized and FV-adjusted intangibles

Value of business written since acquisition	16
Adjusted GW representing FV of ability to write future new business	34
Total	**50**

Components of Fair Value Balance Sheet

FV of tangible assets	610	FV of liabilities	585
VOBA	70		
Other intangibles	10		
Value of business written since acquisition	16		
Total Assets at FV	**706**	**Total Liabilities at FV**	**585**
Net Assets	**121**		

Step 1

Fair value at RU	155*
Carrying value of RU	140
Excess of FV over carrying value	15
Potential Impairment?	**No**

* (=121 Net Assets + 34 AGW for future business)

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The example in Table 6 is a little different. It's the same balance sheet as before on the left, but for some reason we do our fair value calculation using an appraisal technique, using your cash flow testing model. You come up with $135 this time. We know $135 is less than $140, and you don't really care what the difference is. It's negative, that's all that matters, you failed, so that pushes you over to step 2. Step 2 says, " Let's fair value the whole balance sheet. Let's look at those tangible or hard assets." They really have a fair value of $610 instead of $600. The liabilities on a PGAAP basis are more like $585 instead of $570. You carry over the other intangibles, like VOBA, but you don't carry over the goodwill. So it's everything carried over from HGAAP intangibles except for the goodwill, because that's what you're testing. Then you see the fair value of the hard assets, plus the historical VOBA and other intangibles, is $706 and the fair value of the liabilities is $585. So the net assets acquired is $121. Goodwill equals purchase price minus net assets acquired. The purchase price is $135 and the net assets acquired is $121, so the fair value of the goodwill for this reporting unit is $14. You compare that to the carrying value that was on the books. We knew that was $30, so we see that the fair value was less than what you have on the books. You take the $16 hit as a write-off in the current period. Now the only question is how you get that fair value, which we'll talk about in a minute.

Table 6

Goodwill Impairment Tests (Example 2)

US GAAP Balance Sheet for RU (Carrying Values)

Tangible assets	600	Liabilities	570
VOBA	70	Surplus	140
Other intangibles	10		
GW	30		
Total Assets	**710**	**Total Liabilities & Surplus**	**710**

Step 1

Fair value at RU	135*
Carrying value of RU	140
Excess of FV over carrying value	(5)
Potential Impairment?	**Yes**

* (=121 Net Assets + 14 AGW for future business)

Components of Fair Value Balance Sheet

FV of tangible assets	610	FV of liabilities	585
VOBA	70		
Other intangibles	10		
Value of business written since acquisition	16		
Total Assets at FV	**706**	**Total Liabilities at FV**	**585**
Net Assets	**121**		

Adjusted GW representing FV of ability to write future new business 14

Step 2

Implied FV of GW	14**
Carrying value of GW	30
Impairment Loss	**16**

** (=135 RU - 121 Net Assets)

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Let's talk about transitional tests. We've talked about this already. Once you've done this transitional test, you'll also need to do annual tests. The annual tests should be done at the same time every year, but if you have more than one reporting unit, you could do those tests at different times throughout the year. If you have two reporting units—one's annuities, one's life—you always have to do life at the same time every year, you always have to do the annuities at the same time every year, but you don't have to do both of them at the same time every year. Whatever you do sets precedent—and not just the timing, but also the procedures. It's always important to take care even if you pass things. You don't have any kind of write-off. The methods that you use, the definition of reporting units—are all very important to get right the first time, even if you don't have a write-off.

You can do annual impairment tests at any time, but it should be the same time every year. If, the first time you do this at transition or initial adoption, the fair value of reporting unit is significantly greater than its carrying value—even if you do some sensitivity testing—the FASB says, "You don't have to kill yourself by doing a very detailed, rigorous calculation for step 1 for that reporting unit every year." Instead, just as long as things haven't changed significantly, you still have to do something and document it, but you don't have to agree to apply the same degree of rigor that you would the first time you do this or in situations where you have a write-off, unless there are some sort of adverse events that come through. If there have been some substantive changes even though you really passed with flying colors in the past, you do need to go through and do a more rigorous test.

Let's talk about these interim impairment tests. Let's say something has changed during the year. Maybe I passed—my fair value was greater than carrying value in the past, but right now I know that I sold a block of business that was all within that reporting unit or something has changed in the economy that goes adverse to the fair value of the block of business for that reporting unit. I'd better step in and do some testing. The idea is not to wait until the annual time period, but to take a look at it on an interim basis and make sure that fair value is still okay. There are various things that you need to go into to look at, and the FASB does list several items in particular. But if it looked like there's something that's happened that's significant or you sold a block of a business, you might have to do this test outside of the annual test. If you identify an impairment, you take that hit at that point and you don't wait.

FROM THE FLOOR: If your annual impairment test date is June 30 and in September you sold a block of business that was pretty profitable or you took a look at the fair value and you saw that that caused you fail Step 1 and so forth, would September 30 become your test date?

MR. MORTON: I'm not sure that FASB would tell me, but you might just go back to the annual date. We could check.

I mentioned that FAS 141 and 142 are another step–to try to prod us along to the concept of fair value without really defining fair value yet, which is a bit of a problem. But if you think about everything you need to do going through all the steps and applying these things, the idea of purchase price allocations are always done on what's discussed to be a fair value basis. Both step 1 and step 2 of the impairment test for goodwill are fair value-based. A lot of the aspects of PGAAP are on fair value basis and those are carried through even more on FAS 141 and 142. The concept is here; it's yet to be fully defined. There is some general guidance that the FASB does provide, though, to help you identify how you would define a fair value. Certainly there's a real generic definition—the amount of the asset that can be bought or sold in a transaction between willing parties—but really how do you calculate that from a mechanical standpoint? They don't go into that kind of detail.

Of course, with a lot of things that you and I deal with, we don't get the quoted market price or multiples of revenue. But let's say you have two reporting units. You come up with fair values for those that include the whole thing to fair value of those two entities. Maybe you needed to use actuarial discount cash flow methods to get those fair values, but maybe, as I mentioned earlier, that's one method. Compare them against two or three other methods to make sure that it's all reasonable. Maybe you could translate the fair values that you calculated into a market price, and see if that adds up to your quoted market price today times your number of shares, for example. Or, if you know deals are going for 1.2 times GAAP equity, what do you get when you do your kind of bottom-up actuarial approach? Do you get 1.1 to 1.3, or do you get four times equity? There are some benchmarks to help you along. Of course, in the end if you're asked to support the assumptions and methods, you'll need to do that, so documentation is always pretty important. They're going to look for something reasonable and supportable, just like assumptions for any best estimate number like DAC.

Consistency is key. Also, as far as reasonable and supportable assumptions and methods, the FASB has this Concept Statement No. 7 that tries to get some information, but when you start reading that it looks at using probabilities and multiple outcomes, you think a normal actuarial appraisal approach is just a single deterministic situation. This concept of fair value isn't, so what does that mean? How do I apply this concept statement?

FASB is saying, "You should look at possible outcomes and probabilities." Then the FASB later on clarifies it. They really want a single-point estimate; they don't want a range, so how do you do that? One of the things we're saying, this concept statement says, "Maybe you could look at probability weightings of different outcomes." As actuaries we think, "Does that mean stochastic methods?" That would be the natural thing we would think of. Their response is, "Whoa, we weren't thinking anything so grand as stochastic, but that's the idea." It's round and round, but basically it's not just a single deterministic. Let's look at some sensitivities. Whatever you need to do to define your assumptions and methods is reasonable and supportable. To do that you're going to need to do sensitivities. Maybe you'd even do some stochastic work, but FASB here isn't saying you have to use stochastic methods to value your balance sheet per se.

FROM THE FLOOR: What's the guidance for determining a discount rate for this?

MR. MORTON: There isn't. All you have to do is just look between Canada and the United States. In Canada, it looks like some of their valuation methods have a stochastic process. You discount the cash flows, you order the results, and you take either the weighted average or the quintile or the conditional tail expectation. There are various ways to do it, but all the discounting is at a set percent, say, 6 percent. Whereas most people would think that for fair value you should discount at each of the various paths that you project it down. Even that simple difference isn't identified yet as what's going to come through as fair value, definitions for risk discount rate. In the international accounting standards, I think it's very similar. There might be a risk-free rate, plus a risk premium. Would that vary by each of your stochastic paths? Maybe, maybe not. Even that simple first step isn't defined, so how can you really get down further into the mechanics?

FROM THE FLOOR: What do you do when you do an actuarial appraisal is a good way to look at it?

MR. MORTON: Normally, it's a risk discount rate. It's not just the rate of your assets today, but we know that we're not going to get all those profits, so there are two fundamental ways you could do it. You could use risk-free rates and load up your assumptions and your projections with some provisions for adverse deviation. Or you could use best estimate assumptions, which is what we normally do and then load up the discount rate with some kind of a market risk premium. But nowhere will you find it saying, "Yes, GAAP is okay, if you think it's reasonable." You're going to have to make that determination and support it, but you should use the same principles that you use when you might be acquiring a company, which is normally to take a look at interest rates in the marketplace and then take a look at what extra premium you should add because you might not get those profits.

MR. MORTON: This would be if you did the acquisition today. That would drive the derivation of the assumption. Yes, because you're only going to test for goodwill where you've got goodwill and that would be existing prior purchases, but even when you do that test, you have to use today's assumptions; that's the idea of fair value.

For this goodwill impairment test, effectively you bought this reporting unit today. What are the steps you'd go through? What are the methods? How would you derive the assumptions? Think about it that way for doing this test. Then when you come up with this fair value, whatever you want to call it, treat that as the purchase price of what you could sell this block for and then that goes into the step 1 and step 2 calculations. Again, goodwill is the residual that falls out.

If you think about some practical implementation ideas, we've talked a lot about fair value, but how would you really do it? How are companies doing it today? Certainly, you're going to use your existing models. If you do embedded value, maybe that's an even better stop, but certainly even cash flow testing models are a good start. There's a recent *Financial Reporter* article written by Vincent Tsang and somebody he works with that talks about FASB 141 and 142, and he hits a little bit on some of the practical implementation of this. He says, "Maybe you have a pretty good cash flow testing model, but you just can't rely on that. It's going to be statutory-based and it might have some conservatism built in because it's a one-sided test; if you pass, you're done. Maybe put some better assumptions in there as of today: best estimates, GAAP assumptions, that sort of thing. Make sure it's on a GAAP basis and not statutory." It's similar to this appraisal value method that we talked about for calculating VOBA. Make sure it includes the cost of capital, those sorts of things.

But why wouldn't you use a corporate model that you have today as a starting point? It makes all the sense in the world. But maybe the way your models are built, they don't line up exactly with your reporting unit definition. Maybe you have old acquisitions and some newer organically grown business, and your models are built that way versus at the reporting unit level. So there's some work that you might need to do to get there in addition to changing assumptions including cost of capital and so forth. But that would certainly be what most companies are doing today and will do going forward with this.

I think the other thing is, get help if you need it. I can't stress it enough: even if you don't have a write-off today, this is going to set precedent, so find out what other companies are doing. What we've seen in the little bit that we've seen of companies being proactive enough to be doing this right now is starting with an internal model, making the adjustments necessary, and expanding it to cover all your business. A lot of times you don't cover all your business in cash flow testing, so the model needs a lot of refinement quite often, in addition to the assumptions that feed it.

Let's discuss the impact of the new standards. The impact of the goodwill impairment rules depends on a lot of things. The number of reporting units identified is one. Try to get the smallest number possible. Chances are this work has been done by your accounting staff already, but you should find out. The amount of the goodwill that's allocated to each unit is another one. If there's no goodwill allocated to their unit because it's all organically grown, you could go through the process of doing the step 1 calculation so that you could add up the fair values of all your reporting units and get the grand total value to give you some comfort, but the test doesn't have to be applied because there's no goodwill to test. If you wanted to take a shortcut for quick implementation here, start first where you have existing goodwill.

If you have a little goodwill on the books, but most of your growth has come from organically grown business, chances are there's not going to be an impairment versus if you're grown primarily from acquisition. Also, certain industries like I've mentioned—telecoms and others—have really paid ridiculous amounts for their acquisitions, I think. Insurance companies have been a bit more sane, maybe not totally. on what they've paid, so hopefully that translates into recoverable goodwill. I didn't bring a list, but I have a list of about 20 disclosures in the first-quarter 10-Qs of insurance companies that have taken goodwill write-offs.

There will be more judgment that comes in. More is being asked of us. There are more things like fair value, and that takes subjectivity and judgment, but not a lot of help on how to get that judgment. At the same time, the SEC and FASB are going to really, if they want to, drill down on challenging how you define the reporting units, how you've done the tests, and how you've chosen your assumptions to determine the fair value. The judgment is really across the board.

What is the reaction to the standard? It depends on who you talk to. Obviously, if you talk to actuaries who are in financial reporting and are going to have to do the testing in addition to everything else that they do, they're not going to like it. But if you talk to leaders of the M&A groups in your practices, your CEOs and so forth, they certainly think this is a positive thing. Getting rid of the amortization of goodwill, ending the double dilution of earnings idea, and having that window to clean up their balance sheet one time. because you can't do pooling even if it's a merger of mutuals. With an acquisition there is more flexibility in setting the deal. Because of that, your M&A folks and your CFOs like this a little bit more because the deal consideration can be a combination of cash and stock where you couldn't do that before if you wanted a pooling. There are a lot of very strict rules. You could put in equity incentives and stock buy-back programs that maybe you couldn't do under pooling, so maybe there's more flexibility.

I mentioned earlier that one of the reasons why these FASBs were coming about, or at least one of the published reasons, was that FASB wanted more agreement with the application of PGAAP in the United States to what's going on outside the United States. They really didn't get there. There's still, as we say, an unlevel playing field, especially with Europe, so that's not a good result. It will continue to evolve, and I think the only way we're going to get there isn't just from what one FASB is going to do, but it's going to be the international accounting standards, and who knows when that will hit the United States.

FROM THE FLOOR: In our discussion, we talked a lot about coming up with the value of initial opening balance sheet intangibles, one of them being VOBA. There are different methods out there. If you do include the cost of capital you get a lower VOBA. Can you do that now under this FASB and fit it into the six-month window and wipe it off your balance sheet?

MR. MORTON: No, you can't; it's only the goodwill. It's a goodwill impairment test only.

I think two items are pretty important here. One is the more comprehensive valuation models. Whether you look at it because this FASB is telling you to do this work or if you just think a little more broadly about the evolution toward fair value, it really tells you that you need a complete model of your entire balance sheet, not just little bits and pieces to do certain things like cash flow testing or maybe you can use margin analysis here and other non-cash flow testing modeling methods there. The idea is that it's going to make companies want to expand their corporate models to cover their entire balance sheet, clean them up, control them, challenge the way they've built them, incorporate riders, get the best assumptions they can in there, and turn it more into a controlled environment. We're seeing that already because some companies just realize that needs to be done. Part of it is just these ongoing requirements of FAS 133 and now they're saying, "I just need a better model." So that's hopefully one of the results that comes out of this, because I think it makes a lot of sense.

The other important item is the increased focus on integration. If you buy a company now, even though you don't amortize the goodwill, you have to do a pretty good job of maximizing the value of that deal and you have to do it quicker than before because you don't want to take an operating income hit in the future when you're least expecting it. I think integration has always been important, and companies have talked about synergies and so forth, but the statistic varies. It's that two-thirds or 80 percent of acquisitions fail from their anticipated intentions, mostly due to integration. But I think with this FASB, it's going to make the deal prices a little bit more sane and make integration more important. Companies are going to get to it quicker.

As for other expected outcomes, I think this whole issue of methods and judgment is going to evolve. Additional disclosure is required. You're going to deal more with your accounting people because they're the ones who have to craft the footnotes, and they're going to need your help to do it, but disclosure is going to be important. Even if you pass everything here, there is a disclosure requirement that you did pass and why you passed and to support it. Also, I think eventually we'll get more guidance here. Certainly, FASB has tried to get a better answer. They want more transparency to the investing public, and they want to make sure that they get rid of earnings management tools as much as they can. If things crop up here, I think we're going to see some additional guidance come out of it, maybe through the standard of practice, maybe through other ways. But whether it's formal or informal, as this evolves, we're going to see more standards come through from the SEC.

FROM THE FLOOR: Is this standard going to lead more toward the acceptance of embedded value in the United States?

MR. MORTON: I think so. I think more companies are moving toward it. If you think about embedded value, if the way you choose the assumptions is on a today's best estimate basis. From what the outside public would be, you're basically taking a step back and looking at what the acquisition price would be of your company, which is embedded value. It's what this fair value test is all about for the goodwill. I don't know if it will drive it, but certainly in applying this FASB, if the company wants to take the step and do economic value added analysis or something like that, it would be an easier step. To do that, of course, you need the comprehensive model and have it rigorously applied and expanded to the entire balance sheet.