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SESSION 31

Mergers and Acquisitions

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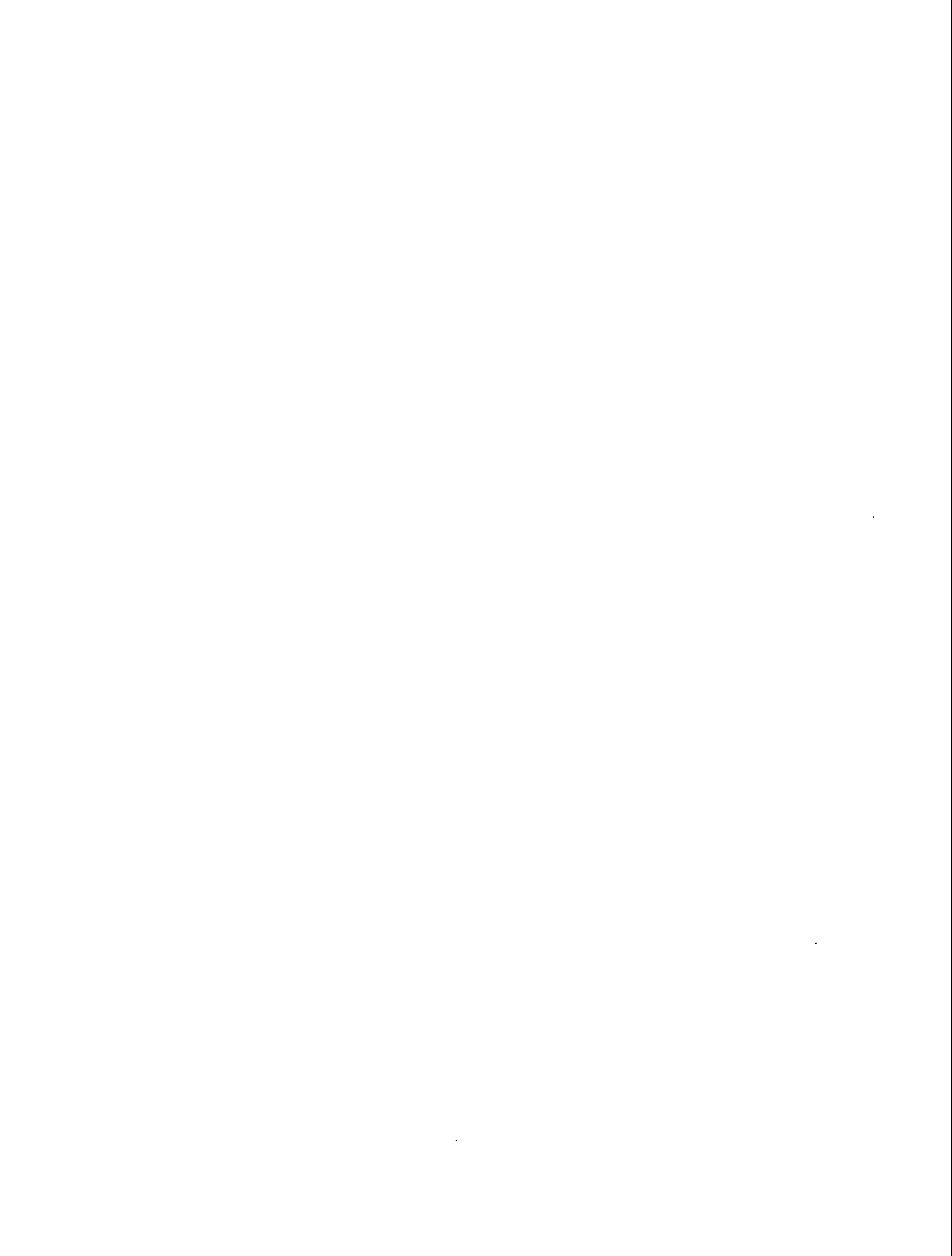

MERGERS AND ACQUISITIONS

MR. DANIEL J. KUNESH: Welcome to Mergers and Acquisitions, a teaching session. We hope to provide you with some direction and instruction on the acquisition process and the accounting for mergers and acquisitions.

Certainly there has been a flurry of activity in the marketplace in recent years, and it's been a seller's market. Prices are at record levels. They have been driven partly by the stock market and partly by demand. The ability to use stock as the acquisition currency is probably a major factor behind some of the prices that we have seen recently. This has led to value "accretion," a concept that one of our speakers, Debi Gero, will talk about a bit later.

Without further ado, I'd like to introduce our speakers and then go right into the session. Deborah Gero is from SunAmerica (Los Angeles) where she is the corporate actuary. Debi is not new to the merger and acquisition (M&A) process. She was with Tillinghast for a while, then spent several years with CONSECO, was involved in some of its major transactions, and is currently with SunAmerica, also a very active player in the M&A marketplace. Debi will share thoughts in three areas. The first concerns the drivers that have led to the flurry of M&A activity in recent years. Second, she will give an overview of the acquisition process and, third, an analysis of an acquisition; in other words, how does one get to the price of a transaction?

Then we'll shift gears and turn the podium over to Mr. Steve Mahan of KPMG Peat Marwick of Dallas. Steve is also no stranger to the M&A process. Steve heads up KPMG's life audit practice. He's also a globetrotter -- I've seen him a number of times in various countries working on projects for his firm. Steve will talk about purchase GAAP (PGAAP) accounting as it applies to a business purchase transaction. He will touch upon statutory accounting issues and auditor concerns, taking an auditor's perspective.

I will follow up with a few thoughts on three topics -- (1) what really makes up PGAAP gain or loss; (2) the relationship between present value of profits (PVP) and goodwill; and (3) what's on the horizon for PGAAP. There are some big changes to be expected from the FASB, the SEC, and the worldwide accounting community. So, without further ado, I'd like to turn to Debi.

MS. DEBORAH A. GERO: How many have been involved in acquisition/merger/divestiture-type activity? Great! Well, this is a teaching session, and experience is often a very valuable teacher.

As Dan mentioned, the three items I will look at are drivers of recent acquisitions and divestitures, the process, and, finally, what it means to get to a price in an acquisition. First, the drivers of acquisitions from the acquirer's perspective are numerous, as you'll see. We have seen many acquisitions driven off the want or the need to leverage current operating and asset management capacities. The more policies that are on the books, the less costly per policy for systems upgrades or systems issues, such as the year 2000. I believe that many companies are placing significant value on the cost savings benefit and are justifying price on this value. If you've read any of the recent press releases, the expense saving aspect of an acquisition is addressed very clearly; that is, what the benefits of consolidation are anticipated to be.

Second, you can cross-market to new customer bases that you may acquire in a transaction. I'll talk about this further when we get to how one values new business.

Third is growth. Now growth for growth's sake may not be a good thing, but if you can gain critical mass, both in top-line assets managed and capitalization, then there seems to be more Wall Street following. Thus, growth can have a positive benefit on the stock price of the company just because of the following it will get from investment analysts.

The fourth item relates to a concept called "morphing." A recent article that showed up on Bloomberg basically asked whether the life insurance industry is merging or morphing. That is, are we really getting fewer companies, or are we just reshuffling the pieces that we have and becoming

more highly focused, getting more single-line and niche players? I believe a lot of the recent activity has been aimed at morphing. SunAmerica is an annuity company, and we are definitely participating in the morphing process.

Another driver relates to the fact that many companies have "free" money to put to use. Capital markets have been very favorable to the life insurance industry recently, both in terms of an ability to raise equity fairly cheaply and with the interest rates being low, the ease in which a company can raise debt today. Some companies have free cash flow because they are seeing a slowing of growth in their core product lines. The business that they have on their books may be generating earnings faster than it can be invested in new business.

Another driver is the wide acceptance of purchase accounting by audiences such as the SEC and the investment community. Purchase accounting was in a bit of "flux," or there was a question about it a few years ago. There was a great divergence in its implementation in the industry. When an acquisition is added to a company's books, there can be a discontinuity in the accounting. If you use purchase accounting, you can't just add the two entities together for financial reporting purposes. Different interpretations of how to apply PGAAP has led to some confusion over the years.

In 1992, the Emerging Issues Task Force (EITF) released Issue 92-9, which provided guidance to the calculation of the intangible value due to acquisition and brought more uniformity to the process. Also, a lot of effort was exerted by acquiring entities to work with the SEC and public accountants. Financial statement disclosures are more robust in terms of discussing the whole purchase GAAP process, identifying the purchased intangible assets, and determining how they are to be amortized.

Another driver is the market appeal that a company may acquire. An acquisition may elevate the company to the position of a market leader, or it just may reemphasize, in the view of the shareholders, that the company clearly is committed to certain product lines and distribution outlets.

Finally, there's anecdotal evidence that companies just don't want to be left out. Many companies are deciding that they want to be an acquirer simply because everybody else is, or they read favorable stories in the *Wall Street Journal* about how acquiring companies have done so well.

So, with all those drivers for buyers, what are we seeing on the seller's side? Basically, the first item relates to eliminating diversionary, nonprofitable lines of business. The second is the desire to increase capitalization. This can be done in a number of ways. If you divest a company or a line of business, you can free up the capital associated with that company or business, and you also collect the purchase price for the business. Attractive market valuations are driving a number of companies. The "rising tide has lifted all boats," and there may not be a lot of discrimination among companies at this point relative to underlying intrinsic value. I think some people believe that valuations for companies just may not get any more attractive.

Finally, a driver that we're seeing more of lately is seller preference. I know that in the last three transactions we did at SunAmerica, we were not the highest bidder, but we were a proven acquirer. There seems to be a lot of comfort gained in being acquired by a highly rated, cash-on-hand, proven acquirer. They know you will close the deal. Also, the strategic buyer, one who can walk in with an existing platform and price in cost savings to the benefit of the seller, seems to be faring better as well.

Now that we've discussed what is driving acquisitions today, let me give you a brief overview of the acquisition process:

- Finding the deal
- Finding the facts
- Analyzing the deal
- Negotiating the deal
- Closing the deal
  - Regulatory approvals
  - Financing
- Communicating the deal
- Implementing the business plan

Unfortunately, no two processes are the same. In fact, three of these processes -- finding the facts, analyzing the deal, and negotiating the deal, in that order -- are very idealized. We often find that due diligence comes after we've negotiated the deal, or we're analyzing the deal at the same time we're finding the facts. So the process is somewhat idealized. The disciplines brought to an acquisition are the same as those needed in running a company; that is, actuarial, financial, legal, investment, marketing, operations, and so forth.

Securing the appropriate regulatory approvals is important in closing the deal. This can be a challenging hurdle, but how much of a hurdle depends on the companies involved and the nature of the transaction. The coinsurance of a small block of business via indemnity reinsurance may not involve much regulatory work. Larger deals, such as assumption reinsurance or a stock purchase, will likely increase the complexity of the regulatory oversight.

I want to share some thoughts on the time available for the process. I have generally found that deals fall at both ends of the spectrum. The timeframe is either unreasonably short or excruciatingly long and is very seldom anything in between. If we have only a short amount of time to do all our analyses, what we usually end up with is a value with a couple pages of caveats, a list of the things we didn't have time to look at the way we wanted to, and a list of things that we need to keep in mind when we negotiate the deal.

Deals at the other end of the spectrum are excruciatingly tedious. We have had a chance to rework our numbers dozens of times, and we start spending time guessing about the psychology of the seller and who the other players are, and thinking of things that really aren't important at all in our analysis.

On to the analysis. Three items that are the keys to a successful acquisition include getting to the right price, getting the right terms, and implementing the acquisition as planned. Whatever we consider in our analysis for postacquisition implementation needs to be something we can follow through on. The first two items, the right price and the right terms, are inextricably linked. We may

often be willing to pay more for an acquisition if the terms of the deal somehow make up for the items that we weren't comfortable with. I've seen this happen many times on the asset side of a deal. The buyer may get from the seller certain indemnities to make them whole, should some of the more questionable assets not work out exactly as planned.

We're also seeing contract terms that quite specifically address the area of market conduct, regarding activities that occurred prior to the acquirer coming into the picture.

The right terms are hard to come by if you are buying a company whose stock is publicly traded and there are many individual shareholders. Such individual sellers typically want to take their money, go home, and not hear from you again if they've sold the company.

I've listed three methods that could be used to determine price. The first is free cash flow, which investment analysts use when they are doing an equity analysis. Actuaries also call it an appraisal analysis. For a life insurance company, free cash flow or the amounts actually available to shareholders really comprise two components. One is statutory earnings, and the second is any capital that can be distributed in excess of that, which is required to keep the company's desired ratings. Any cash flows that are projected are then discounted at the target rate of return on investment for the company.

The last two measures, GAAP return on investment (ROI) and GAAP earnings-per-share accretion, are year-by-year measures that fall out of GAAP accounting once we have determined the price and set up the accounts. At the end of the day, whether we look at return on a GAAP basis or on some other basis, aggregate earnings will still be the same. It's just that senior managers tend to think more in terms of GAAP. Earnings-per-share accretion is a concept that is almost always quoted in press releases on acquisitions. They talk about whether a deal will be accretive, how accretive it will be, and the timeframe that it will be accretive (usually 12 to 18 months).

Accretion is an interesting measure to show in a press release because it depends not only on price but also on how the acquisition was financed. If you are currently sitting on bonds that are yielding 4% after tax, any acquisition you do with that money will be accretive as long as you earn at least 4%. So, accretion not only deals with price. It also addresses how you will finance the transaction and the bottom-line impact, which investment analysts are interested in.

I will spend the rest of my time talking about actuarial appraisals and their presentation. There are three components that one will typically find in a presentation of an actuarial appraisal -- adjusted net worth, the value of the in-force business, and the value of new business. The calculation of each component gets more subjective as we go down the list. An appraisal requires the involvement of many disciplines in the company, especially to get a value of the in-force business and the value of projected new business.

Adjusted net worth is typically defined as statutory capital and surplus plus the asset valuation reserve (AVR). When buying a holding company, the acquirer needs to look at what is sitting in the parent company, be it debt or other excess assets. Some value may also be ascribed to certain nonadmitted assets. Finally, to the extent that the company has entered into surplus relief reinsurance agreements, their impact on value might be shown here, or it might be shown in the value of in-force. Adjusted net worth is really only applicable if we're looking at an entire company. When buying a block of business, we just need to concern ourselves with the next two items.

The value of in-force business includes two components. One is the present value of future earnings from the statutory reserves, using a process similar to that employed in asset adequacy analysis. The second component relates to the cost of capital, which is the present value of capital transfers available from the company. We assume that at the beginning of the projection we need to put capital into the company, as required by rating agencies or regulators, to support the business. These two components are typically calculated separately and shown separately. One reason for this is that each individual buyer will have its own unique capital considerations. Calculating each separately allows the buyer to "cut and paste" the pieces together as appropriate.

An appraisal typically uses base case assumptions, which in effect puts you in the mind of the seller. Additionally, there will typically also be some sensitivity tests on those assumptions. We have to remember, though, that we're the buyer, and our plan for running the company and our actions may have a different impact on policyholders than the way the seller ran the company. So, when selecting the base case assumptions, we need to be aware of what is appropriate for us. How will the policyholders behave under our product management, our operating plans, our marketing plans, and our crediting rate strategies? The sensitivity analyses that are included in the seller's appraisal should help us as the buyer in making these decisions.

Next is the issue of whether the appraisal includes a level scenario or stochastic scenarios. The base cases in different appraisals can be prepared differently. In some cases, a level scenario is used, with sensitivity analyses given to show the effect of alternative interest rate environments. Other appraisals will develop a single value that is based on stochastic scenarios.

Other elements considered in the value of the in-force include the discounted value of the interest maintenance reserve (IMR) balance, investment income thereon, and any value associated with the historic deferred acquisition cost (DAC) tax. From a GAAP accounting perspective, the buyer will use projections such as these to establish the purchase GAAP equivalent of a deferral acquisition cost asset. Our other speakers will address adjustments required to this process for GAAP accounting purposes.

Finally, we get to the most subjective portion of an actuarial appraisal, the value of new business expected to be generated by the distribution channels of the acquired entity. The first of three items of value is the present value of projected profits at the target's ROI. This in turn may comprise three different components. (1) What is the value of business that the target is currently writing through its own distribution channels? (2) Does the new company we're buying have products we can sell through our current distribution? If so, we may want to ascribe some value to that. (3) We have products, and they have distribution. Can we profitably sell some of our products through their distribution channels?

From another perspective, increased new business may raise or profile and reduce our cost of raising debt in equity. Also, by buying a new distribution channel or increasing an existing channel, we may be able to convince rating agencies that we are less risky now because we have business plans that demonstrate we will grow faster and continue to do what we do best. When we combine the acquired entity with our current company, we may be perceived to be less risky overall.

I will conclude with some practical considerations in getting to the price. Similar to the role he/she plays in financial planning, an actuary involved in the acquisition process is really a synthesizer. We're really taking all -- or significant amounts -- of our cues and directions from managers of different areas of the company, be it investments, administration, or marketing, when selecting our assumptions and key drivers of value. In other areas, however, we do what we do best, selecting mortality and lapse assumptions in the context of what the plans are for the company under our direction.

A second consideration relates to taxes. The exact tax implications of a deal can be very important in determining value. They are complex, tedious, and require the involvement of your tax counsel or tax accountant, a person who should be your friend in this process and a very close one, for that matter.

Third, comparisons should be made to other deals. Sometimes, after we do our analysis, it's good to step back and say, okay, we've calculated some numbers. How do these compare with other recent transactions? This analysis can help put into perspective whether we are "in the ballpark" of what's happened recently. Certainly the seller might be expecting an offer consistent with recent activity. The problem with this is it requires expertise in every deal. This is difficult because every company has different lines of business and requires different considerations.

Finally is the issue of "assumptions to develop price versus assumptions to justify the price." What I just walked you through was very idealized. We collect information, we chew it all up, and we spit out the price we want to pay. Often it works in reverse. A company may be publicly traded and

expect to receive premium added to its current market price, or it may wish to achieve a certain GAAP earnings objective by selling a division. So we may start the process with a certain price and then select assumptions that justify that price or, given the assumptions we love and hold onto so dearly, solve for an ROI.

Next, Steve, tell us how to account for a transaction.

MR. STEVEN H. MAHAN: It is intimidating to talk to a room full of GAAP experts, all of whom have acquired or have been acquired probably in the last 12 months, on a subject as controversial as purchase GAAP. This isn't necessarily a good forum for talking about purchase GAAP. A better forum would be to pull up a chair and have an informal session on the variety of experiences that we've had. Dan and I have done that many times on a couple projects we worked on. In many cases, we were in agreement on many issues, and we were not on other issues. On most issues, however, we probably were in agreement and didn't even know it. That often can happen.

Purchase GAAP has been the subject of a variety of sessions, entire sessions, not only at Society of Actuaries meetings but also at Valuation Actuary Symposiums. So, my remarks are not meant to be comprehensive. Instead, I'd like to present a brief summary of the principles and some of the key issues that I've faced. Let me say that my comments will reflect my own experiences because this is what I've seen. I know that other people have seen other treatments that I may not have seen, and so there is room for differences in opinion.

The authoritative literature is lacking on the subject of purchase GAAP for life insurance companies. Accounting Principles Board (APB) 16, issued in 1970, set forth many of the basic principles for all industries relative to purchasing business combinations, and all subsequent practices have been an attempt to conform to those basic principles. APB 16 provides for two fundamental models when accounting for business combinations -- the pooling of interests method and the purchase method. Under the pooling method, a rigorous set of criteria apply. Most acquisitions are generally unable to satisfy these criteria. I won't get into them here. At least until the last few years, it had been rare

to see accounting for life insurance acquisition on a pooling basis. Recently, the number of poolings has increased dramatically, largely due to "stock for stock" transactions. Fundamentally, under a pooling arrangement, historic GAAP accounting continues after the business combination. My remarks will focus on purchasing accounting (or PGAAP) under APB 16.

Actuarial Standards of Practice Interpretation 1 (d) -- for you older folks, the American Academy of Actuaries Interpretation 1 (d) -- attempted to provide some guidance with respect to actuarial calculations relative to purchase GAAP. More recently, the EITF of the Financial Accounting Standards Board had issued Statement 92-9 (1992). This provided clarification in amortizing the PVP asset. Statement 92-9 disallowed the use of a risk rate of return in the amortization of the PVP. It clarified that unlocking should continue for *Statement of Financial Accounting Standards (SFAS) 97* products, and it clarified that the PVP should be subject to recoverability and loss recognition tests as provided in *SFAS 60.*

It's important to remember that, except for certain concepts unique to a purchase situation, the remaining applicable financial accounting standards still apply. In particular, that includes *SFAS 60* (for traditional products of insurance companies), *SFAS 97* (for universal-life-type and investment contracts and limited-pay policies), *SFAS 109* (regarding the treatment of federal income taxes), and *SFAS 115* (regarding certain asset valuation issues).

I will outline a few basic purchase GAAP principles. Upon purchase, a new accounting basis is established. It is a current cost model, based on restating the assets and liabilities as of the acquisition date. The GAAP accounting basis prior to an acquisition is often called historical GAAP (HGAAP), and it is based on the original historic costs of assets and liabilities. Under purchase GAAP, the existing deferrals are eliminated. For example, the DAC asset is eliminated from the balance sheet and is replaced by a "value of business acquired" or PVP asset. Those two terms will be used interchangeably throughout my talk. Actually, terms such as "the value of business acquired," or "the cost of insurance purchased" are older terms. More recently, PVP is the term that has been used to describe the intangible asset representing the value of the in-force.

Deferred taxes are restated at purchase based on differences between the tax and PGAAP values appearing on the balance sheet. Shareholder equity is set equal to the purchase price paid and is unrelated to any accumulation of retained earnings as we might have had under historic GAAP.

Table 1 shows a classic initial purchase GAAP balance sheet. On it, investments are shown on a mark-to-market or fair value basis for both income statement and balance sheet purposes. Actuarial reserves, along with the value of business acquired, are restated using purchase GAAP assumptions. The deferred tax liability reflects the applicable tax rate times temporary timing differences between the PGAAP and tax bases of investments, the PVP asset, reserves, and other items. Goodwill is the balancing item because total assets must equal total liabilities plus equity.

TABLE 1

P-GAAP Balance Sheet as of Purchase Date

Assets:		**Liabilities:**	
1. Investments	A1	1. Policy Reserves	L1
2. VOBA or PVP	A2	2. Claim Reserves	L2
3. Goodwill	A3	3. Deferred Taxes	L3
4. Other Assets	A4	4. Other Liabilities	L4
		Total Liabilities	L-Sum
		Equity	PP
Total Assets	A-Sum	Total Liabilities and Equity	L&E-Sum

Goodwill, by the way, is often amortized on a straight-line basis. It used to be common to use a 40-year amortization period for goodwill. In recent years, more scrutiny has been raised by the SEC in the accounting industry, and it is more common to see a goodwill amortization period 25 years or less. The value of business acquired has always in some way represented the present value of profits as related by the indicated policy reserve. In my view, however, it wasn't until EITF 92-9 that the term PVP became more commonplace.

Now I will talk about the actuarial effort required to implement PGAAP. The PGAAP methods defined by actuarial literature focus on the development of a benefit reserve and the PVP asset either on a distinct basis or on an integrated net liability basis; that is, the benefit reserve less the PVP. The first method I will mention is the oldest method and is defined in Interpretation 1(d). It is called the net valuation premium method or defined valuation premium (DVP) method. The method was defined for FAS 60 products because that was primarily what existed when 1(d) was written.

The DVP method as stated in Interpretation 1(d) is the one that I most commonly ran into until a few years ago. Of the first 100 purchase GAAP situations I saw, I think that 98 of them fundamentally used this method, as defined by Interpretation 1(d). The DVP method describes the development of a net liability as the present value of future benefits and expenses less the present value of a defined net valuation premium. The defined net valuation premium is a percentage of the gross such that the remaining portion of the premium represents profit loading. This is also referred to as an unloaded gross premium valuation method, whereby the gross premium is unloaded by a profit provision similar to that amount that would be expected on new business. This resulting unloaded gross premium valuation represents the GAAP net liability; that is, the benefit reserve reduced by the PVP asset. This GAAP net liability is then typically split between a benefit reserve and a PVP asset by first determining a typical net premium benefit reserve using current assumptions as of the purchase date and then backing into the PVP asset. In other words, the net benefit premium is the same as that net premium you would get on newly issued business. There are other splits allowed by Interpretation 1(d), but this is the one I've seen the most.

I'd like to reiterate one thing here about Interpretation 1(d). It starts off talking about the development of the "reserve." It doesn't say benefit reserve. After it talks about the net valuation premium approach, near the end it says that the resulting number needs to be split between a liability benefit reserve and an asset. Interpretation 1(d) doesn't call it a PVP, a value of business acquired, or anything else. It's an asset, and any reference made to it is in the context of a DAC asset because it is the cost of acquiring the business.

It is interesting to note that *SFAS 97* account value products do not fit well into this mold of the defined net valuation premium method.

The more commonly used method today is the risk rate-of-return approach. Under this approach a benefit reserve is first established. For *SFAS 60* products, as I mentioned before, the reserve is a typical net valuation premium reserve, with the selection of a net premium similar to that which would be used for new business as of the purchase date. For *SFAS 97* products the benefit reserve is the account value.

Having determined the benefit reserve, you then use this reserve in the projection of the expected emerging profits, using current GAAP assumptions. These profits are discounted at a risk rate of return to arrive at the present value of profits or PVP.

This method is now more commonly used for both *SFAS 60* and *SFAS 97* products. It establishes the benefit reserve and the PVP separately, whereas a strict reading of Interpretation 1(d) would have you go straight to a net liability and then split it. The resulting PVP here is amortized following guidance from EITF 92-9 which says that, regardless of the discount rate used to establish the PVP, you amortize it by using a credited rate or a GAAP-earned rate.

Now, when you think about it, given that amortization must be at a GAAP-earned rate for *SFAS 60* products, the profits that you projected, at least in theory, will have emerged as a percentage of premium. Once determined, this PVP will be amortized by using a GAAP-earned rate over those profits. This will result in profits as a percentage of premium as well. In the end, even though this method, as I just described it, involves the discounting of future profits at a risk rate, it can really be thought of as the same as the defined net valuation premium method for a *SFAS 60* product. That's because it results in a portion of the premium being used for the benefit reserve, a portion of the premium to amortize the PVP, and what remains is a percentage-of-premium profit margin.

Finally, Interpretation 1(d) also describes the initial reserve method, which I won't get into here. It's not commonly used, and of all the transactions I've seen, I have yet to see that method used.

Regardless, all the above methods require the use of actuarial assumptions. For *SFAS 97* products, assumptions are needed for the projection of profits. Obviously, they're not needed to get the reserve, which is the account value, but they are needed for the projection of profits. For *SFAS 60* products, assumptions are used both for the benefit reserve and for the projection of the profits. The difference and PGAAP assumptions and HGAAP assumptions is the HGAAP uses assumptions appropriate at the time of issue, and PGAAP uses assumptions that are to be current as of the acquisition date. The rules for selecting provisions for adverse deviation (PADs) are the same for HGAAP; that is, PADs are used for *SFAS 60* products but not for *SFAS 97* products. After the purchase date, the lock-in principle also continues to apply to *SFAS 60* products, just as it does under HGAAP.

I'd now like to comment on a few miscellaneous issues that have arisen and that I've run into. The first one I have has to do with federal income taxes. *SFAS 109* continues to apply here, just as it does under HGAAP. *SFAS 109* provides that differences between the GAAP carrying value of assets and liabilities and their respective tax bases are referred to as temporary differences. These temporary differences result in future taxable income or future taxable deductions when they are recovered or settled.

Under *SFAS 109*, a deferred tax liability is established for temporary differences that result in future income, and, similarly, a deferred tax asset is established for future deductible temporary differences. In the case of assets, these differences are often reduced by a valuation allowance if it is more likely than not that some portion of this tax deduction or the asset won't be realized. The deferred tax asset or liability, thus, results from applying the appropriate tax rate to the temporary differences.

It is important to note that all these *SFAS 109* rules basically apply equally to purchase GAAP and to HGAAP. So your purchase GAAP balance sheet will normally start out with a deferred tax

account, whether it be a liability (most typical), or an asset. Finally, any resulting goodwill is not a temporary difference if the goodwill is not amortizable for tax purposes.

Other issues are recoverability and loss recognition. EITF 92-9 clarified that the PVP asset is subject to recoverability and loss recognition, just as DAC is. An issue arises as to whether the purchase block should be considered as a separate line of business for this purpose or if its adequacy should be measured in combination with similar business issued after the purchase. I've seen it both ways, with the decision focused on exactly how the company manages its business. If it manages the business as a single unit, then typically both pre- and postpurchase would be combined for loss recognition purposes. But if in some manner the company views it as a different unit and manages it differently, then loss recognition analyses may apply uniquely to the acquired block.

I mentioned earlier that under PGAAP assets are marked to market at the purchase date, but this is a bit more confusing now with *SFAS 115* than it was in the past. Many I talk to say that they classify their assets as "available for sale," and are already marked to market under HGAAP. However, that is for balance sheet purposes only and not the income statement. For income purposes, available-for-sale investments reflect book values under *SFAS 115*. However, under PGAAP the book value is reset to the market value as of the purchase date. Thus, at acquisition there is no difference between book and market, and this becomes the new cost basis going forward. At reporting dates after the purchase date, the market value will change, but your PGAAP accounting will be on a new book value basis, based on market values at the acquisition date. This could create the need for a shadow DAC adjustment to offset unrealized gains and losses that are included with equity for balance sheet purposes.

PADs are an issue that can be confusing under purchase GAAP. As mentioned earlier, these are required for *SFAS 60* products. It is important to note that when calculating benefit reserves, PADs are used not only in the calculation of the benefit reserves but also in the projection of the profits for purposes of determining PVP. Some have wanted to release those PADs into the profit stream used

for determining the PVP, but this isn't appropriate. PADs supports the sum total of the PGAAP calculations on both sides of the balance sheet, and they should be used in both places.

Of course, with *SFAS 97* products, PADs are not used. Sometimes this creates a bit of a problem and makes people feel uncomfortable with *SFAS 97* EGPs. For a variety of reasons, they feel as if the result is more marginal with PGAAP than under HGAAP, and it exposes them more to recoverability problems after the purchase date because there are no PADs. The only reason that the resulting amortization rate is not 100% is because of the difference between the discount of the profits at a risk rate of return versus a credited rate. Therefore, most actuaries try to be somewhat prudent in setting assumptions, reflecting the fact that there is some uncertainty in the future earnings stream.

It's common to see simplified methods used for purchase GAAP. Especially for *SFAS 60* business, there's often a desire to simplify the process and perhaps use appraisal calculations or set the benefit reserve equal to the statutory reserve, and, therefore, let the PVP be the present value of statutory profits. In cases where the acquired company is immaterial to the parent, and there are no stand-alone financial statements, this may be okay for an acquired block or company, but care should be taken.

The use of redundant statutory reserves can cause a disproportionate amount of profit emergence to be represented by the release of this redundancy rather than as a percentage of premium, as called for under *SFAS 60*. The timing of this release of the redundancy in statutory reserves might be drastically different and may distort the emergence of earnings. If you use statutory reserves, there is a tendency for earnings to be reported materially earlier than they would have been had you really restated the benefit reserve for PGAAP. Also, if you use appraisal values, sometimes this information is contaminated by federal income taxes and target surplus, and this can, in some cases, make them inappropriate if proper adjustments aren't made. Finally, the use of HGAAP benefit reserves can be tempting, but if the assumptions are out of date, the results can create a distortion.

There is also an issue regarding the acquisition of blocks of business. Do you use purchase GAAP or HGAAP? There is definitely a PGAAP-like acquisition cost. With block acquisitions, goodwill is almost always zero, and the balancing item is the PVP. PVP must, of course, be supported by an actuarial demonstration that shows it is recoverable. If the actuarial calculation of the PVP produces a result that is greater than the balancing item we back into, the difference really represents negative goodwill. However, negative goodwill must be netted against PVP. This results in a net PVP equal to the amount of the balancing item. It is possible (but rare) that this net PVP can actually become negative. This results in a deferred profit liability.

Questions arise as to the assumptions to be used for the benefit reserves in a block acquisition. Are they based on the date of issue or on the acquisition date? I've seen differences of opinion out there. Because this is a coinsurance transaction, there have been a variety of opinions. Some feel that a new company's frame of reference has nothing to do with the ceding company and the ceding company's original assumptions. Further, they usually receive cash as consideration. Therefore, current assumptions are often felt to be needed. But others say, "Wait, this is a co-insurance transaction, and, therefore, we ought to be using HGAAP reserves." So far, I haven't seen a definitive answer to this issue. Although I have seen it treated both ways, usually current assumptions are used.

Because it is a coinsurance transaction, there are certain statutory ramifications. Chapter 24 of the *NAIC Accounting Practices and Procedures Manual* for life companies addresses reinsurance and should be consulted, although state-by-state laws and administrative code may overrule this. Differences may arise if a transaction is assumption reinsurance versus indemnity or just straight coinsurance. Per Chapter 24, under assumption reinsurance, the excess of liabilities assumed over assets acquired on a statutory basis may be established as goodwill that must be amortized over the life of the policy. Individual state laws, as I said, do impact this. In some states, goodwill is not allowed at all. In others, the goodwill is to be established, but it is a nonadmitted asset. Where allowed, goodwill on a statutory basis is typically amortized over a period not to exceed 10 years.

The codification project on statutory accounting principles attempts to clarify the confusion over goodwill on a statutory basis with its paper 68 on business combinations and goodwill. It provides for the admission of goodwill with a limitation of 10% of the parent company's capital and surplus. I believe that the final codification result adopted this approach, but I haven't confirmed that.

As an actuary with an accounting firm, I often see purchase transactions from an auditor's perspective. I would like to run by a few issues that we have to deal with. The first relates to data. In many cases there is the problem of data availability, especially with the acquisition of blocks of business. This puts pressure on the company to defend the results, and it puts pressure on the auditor to be happy with the results. Also, the development of GAAP models is typically a major part of the PGAAP development. Sometimes these are comprehensive and complete, but often a tremendous time pressure leads to shortcuts being taken. Often, models used build on models established for appraisal or for HGAAP or for other projection activity, and special care is needed in those situations to make sure that no distortion arises. This can often happen by using models built for other purposes.

Assumption setting can be sticky under purchase GAAP. One issue is the availability of data to support the assumptions. With an acquired company, information may be lost and what is available may be less than desirable. Another concern is the establishment of the PAD on *SFAS 60* business. What is conservative? With PGAAP, the results can be counterintuitive. A company is motivated to hold as high a net liability as possible on the purchase date to set up future earnings emergence. All our normal instincts for skepticism are reversed, and yet at valuation dates after the purchase, the motives are flipped back. I could find myself arguing with a client about having a lower liability for the purchase balance sheet only to turn around and require rigorous demonstrations of recoverability just a short time later after the purchase accounting is closed.

There's also an issue of institutional knowledge. The acquisition of a company or a block of business often leaves resources strained. Expertise of the acquired company often dwindles, and the

acquired company doesn't have the knowledge to support the work to the extent that we would like, and that's a problem.

There is the belief that for certain aspects of PGAAP implementation, there is a one-year window to complete the work, and sometimes this creates a misconception. I'll visit with clients during a PGAAP project and they'll say, "Well, we have one year to straighten this all out." I'm not sure how tightly enforced this is, but the one-year window to finalize purchase GAAP is restricted as to the kind of items that can be left open. It's not supposed to be any and all things that you want to change. It's supposed to be for things you didn't know about and things that perhaps you couldn't estimate. The one-year window after purchase is designed to clarify that, but it's not a free-for-all. There are various degrees of rigor in which the window is enforced.

Acquired companies often want to use the one-year window, and sometimes I, more than they, know that the parent doesn't want a one-year window. This may result from poor communication but can lead to problems for both the acquired company and the auditors.

Finally, let's discuss the discount rate used in the PVP determination. There are many theoretical underpinnings of cost of capital, risk-free rates of return, variability and volatility, and so forth in determining a risk rate of return. They are all good, but my personal experience has been it's been more of a trial-and-error process within a range of reasonable results looking at the resulting goodwill. I believe I saw 20 straight purchase situations at one time that used a discount risk rate of return of 15%. I doubt if they had all the same cost-of-capital parameters. Now that interest rates are lower, we're seeing a lower risk discount rate, perhaps in the 11-12% range.

MR. DANIEL J. KUNESH: Let's first explore the question of what makes the PGAAP result. I believe that there are six elements from an actuarial perspective. The first is a level percentage of the PGAAP revenue that, in effect, you allow to flow out as a profit. It is that portion of total GAAP revenue beyond that needed to amortize your PVP asset and build reserves. So it would be expressed as a level percentage of premium under *SFAS 60* products and a level percentage of the

margins under *SFAS 97* products; that is, the margins from investment returns, mortality, expenses, and surrenders.

A second element represents the release of the provision for adverse deviation on *SFAS 60* products and *SFAS 97* limited-pay products. The third and fourth elements are variations in actual experience from the assumptions, a very critical element, and investment income on retained capital and surplus; that is the invested assets supporting retained capital and surplus. Finally, there are two negative elements, the level amortization of goodwill and, of course, federal income taxes. Note that the release of the PADs can be a major element of total PGAAP profit, and, of course, a very dampening effect is the amortization of goodwill, particularly if it's allocated to a specific line of business.

Let me say, a bit tongue-in-cheek, that there are opportunities to manage PGAAP result. I don't mean deliberate attempts to control the balance sheet and income statement, but opportunities within the GAAP rules keeping in mind our standards of professionalism.

PGAAP is not a very well-defined animal, as Steve indicated. The guidance has been limited and, accordingly, many practices have resulted. One area, of course, is the amortization period selected for goodwill. Steve has indicated that recently it has been 20-25 years. I still think many transactions are using 40 years. Because amortization over a longer period is favorable to earnings, the selection of an appropriate amortization period can have a fairly significant impact, particularly for high-priced deals.

Excess purchase price (the excess of price paid over restated assets less restated liabilities) is allocated between the PVP and goodwill. It is the relative speed at which each of the two elements amortizes that provides the opportunity for earnings management. In effect, you really don't need PVP except to the extent that PVP amortizes in relationship to the business. Goodwill, on the other hand, amortizes on a straight-line basis, and so it's the balance between these two items that could have a fairly dramatic impact on both the timing and level of earnings, particularly in the early years.

Other areas of opportunity are the level and pattern of future assumptions. You're supposed to go with so-called best-guess assumptions. However, best-guess assumptions are in the mind of the beholder. Everybody views the world differently. Varying future assumptions can have a dramatic impact on PGAAP result. Similarly, the level of PADs can impact PGAAP result, as Steve had indicated. Large PADs can result in a different pattern of earnings in the future.

There are two other areas of opportunity. One involves postacquisition investment management. For example, a company may sell assets in periods of declining interest rates to realize capital gains. Two cautions should be noted, however. (1) It could lead to loss recognition concerns in later years because you have effectively lowered future expected returns. This is because reinvestment has to be in lower yielding assets. (2) It will lower future profits.

A final idea for managing PGAAP result is to sell less profitable business segments acquired in a transaction. Just two things here. I've seen some companies do this. They're not quite certain what they can sell the unprofitable segment for, so they will take a conservative posture regarding future expectations partly to realize a profit on sale. More importantly, the denominator (equity) reduces and this improves ultimate ROE performance. So, the divestiture of unprofitable or less profitable business segments can actually improve earnings as you go along in terms of ROE.

One question has often come up, and I will let you form your own opinion about an answer because it has been a politically hot issue in some cases. The question is, can appraisal value be used as the initial PVP? Steve talked about this a bit. I will do so by way of comparison; that is, what comprises an appraisal value and what comprises PVP in GAAP determination? My focus will be on four elements, and the first is asset valuation. In an appraisal, statutory book values are generally used for the assets in support of liabilities and target surplus. Fair values are used for assets supporting surplus. As Steve indicated, fair values must be used under PGAAP, at least initially at the time of acquisition.

The second is project assumptions. Both appraisals and PGAAP use best-guess assumptions. Appraisal value does not use PADs. PVP must use PADs for *SFAS 60* and *SFAS 97* limited-pay products. It is important to note that if you're going to revalue all investments at market value, you'd probably better adjust your interest rate accordingly for PGAAP purposes. Use of a market interest rate rather than a book value interest rate can have an impact on reserve levels and PVP amortization.

Third is expense recognition. Appraisals generally recognize all ongoing expenses including overruns and expected one-off expenses. Under PGAAP, I've seen it go both ways. Sometimes overhead is in and sometimes it's not. Accounting firms have different opinions about this. I, for one, believe it should be in. One-off expenses are generally excluded for PGAAP.

Fourth is discount rates. Under PGAAP, the rate is generally intended to represent shareholders' expectations and/or the expected rate of return from the investment in new business. Under appraisal value, while the overall objective is perhaps the same, the discount rate generally ends up being a negotiated item and it turns out to be more discretionary.

Let me share a couple thoughts on goodwill. Goodwill and PVP are elements of what are known by accountants as identifiable intangible assets. Goodwill is made up of things such as patents, franchises, state licenses, the value of the field force, customer lists, favorable leases, things such as that. The total amount of excess purchase price (defined as the price paid minus the fair value of the net assets acquired, with net asset acquired being defined as restated investments less restated liabilities) comprises <u>total</u> goodwill. For insurance companies, this must be split into two components -- PVP and residual goodwill.

In accounting literature, goodwill must have economic value or lead to economic benefit if it is to be capitalized. Then if it is capitalized, it should be amortized over its useful lifetime. This, however, is difficult to define because oftentimes you will associate residual goodwill with things such as planned new lines of business, reputation of the organization, and other very abstract

concepts that are difficult, if not impossible, to translate into value and define a useful lifetime. Insurance companies have an opportunity, as Steve indicated, to allocate a part of total goodwill to PVP. The impact on an insurance company's financial statements results from the difference in the way these amounts amortize over time. APB 17 does specify up to a 40-year period to amortize goodwill on a straight-line basis, but goodwill has generally been amortized over a much shorter period, although some recent transactions, I understand, have still used 40 years.

An interesting phenomenon has occurred in recent years involving many large acquisitions involving stock swaps. There has been greater use of the "pooling-of-interests" method of accounting in business combinations. As Steve indicated, there are two methods under APB 16, the pooling-of-interests method and the purchase accounting method. Purchase accounting is by far much more difficult to accomplish. A pooling of interests is a stock-for-stock-type situation in which HGAAP can be continued, and there is no goodwill. So there has been a preponderance of activity mainly outside the insurance industry that favors the pooling approach. In the international marketplace, however, goodwill is generally amortized over a much shorter period, ranging from five years to 20 years in some countries. Until recently, companies could write off goodwill immediately in the U.K.

One final thought on goodwill is how much is too much? There are a couple considerations here. First, goodwill amortizes against operating profits and tends to dampen future returns. Yet, by its nature, it probably shouldn't be directly associated with or charged against the results of the business acquired. Second, shareholders concerned about value dilution may ask company management to justify excess purchase price. This is something to consider. Third, investment analysts and rating agencies may also ask the question about the relationship of goodwill to total purchase price. The solution, however, can vary by industry and by the strength and reputation of the acquiring and acquired entities. For example, in Disney's purchase of ABC, it was reported that goodwill represented 84% of the purchase price. So, you can get some fairly high relationships.

What is the current situation for PGAAP? PGAAP accounting is really based on two major accounting pronouncements (APBs 16 and 17) plus a myriad of amendatory pronouncements of the

FASB, the SEC, the EITF, and the AICPA. This has led to a quilt work of guidance from the accounting profession. APB 16 relates to business combinations and APB 17 relates to goodwill. Since 1970, when these two pronouncements came out, there have been 41 AICPA Interpretations, four FASB Interpretations and technical bulletins, more than 50 Emerging Issue Task Force issues papers, 13 SEC staff accounting bulletins, and four SEC accounting series releases. I understand that a very large proportion of FASB time and SEC time is being spent on matters involving business combinations, responding to questions that have come up over time. Combine this with the recent high prices paid in major transactions and the rush toward the use of the "pooling-of-interests" accounting method and you have a problem.

To really qualify for the pooling-of-interests method, there are 10 or 12 very strict requirements within APB 16. Yet it seems that some of the companies using the pooling approach are ignoring these criteria and are still getting SEC approval. As I indicated earlier, this appears to be happening mostly outside of the insurance industry, but I believe at least two or three have used the pooling method in recent major acquisitions in the insurance industry.

The SEC is becoming concerned about this, and, accordingly, it has asked the FASB to take on a project to revisit APBs 16 and 17 in the next year or two with the objective of coming up with new accounting guidance. I'll talk about that more in a bit.

Another significant observation is that the SEC and the FASB have both expressed a strong desire to cooperate with an international effort to achieve comparability in cross-border security filings. There are many acquisitions in the U.S. today by non-U.S. corporations. In most situations, non-U.S. corporations wishing to receive capital in the U.S. market to buy a U.S. company will present their financial statements on a U.S. GAAP basis. For one thing, it is easier for the U.S. investor to understand.

There are a number of initiatives going on here. One is that the International Organization of Security Commissions does not like the "forced" use of U.S. GAAP in such filings. It is currently

going along with it, but it doesn't like it. It really wants to see a consistent set of international standards applied worldwide, U.S. included, and those standards, it believes, should be based on something other than U.S. GAAP. So, it has charged the International Accounting Standards Commission (IASC) with the responsibility of coming up with a complete set of new standards. The IASC is currently heavily involved in the process of developing these standards, including one for insurance, by the year 2000. This is a very aggressive agenda, and it will be interesting to see what happens.

It is interesting to note that the trends in the U.S. have been running counter to existing international standards. I want to mention three areas. First, in the treatment of purchased research and development (R&D), FASB Interpretation 4 interprets an old FASB Statement 2 on R&D costs. R&D costs, mainly in the computer industry, are allowed to be written off immediately on the premise that they have no useful lifetime. This has been used more and more because in today's environment, shareholders don't seem to show much concern about large hits to earnings at the time of an acquisition. They look for progress in bottom-line earnings, in earnings per share, and so forth. The immediate write-off of goodwill allows you to improve future results, and it reduces the denominator (equity) of the acquired entity, thus improving ROE.

There are many concerns in this area. It creates an unlevel playing field for countries such as Canada that cannot do this at all. Also, other industries, such as the insurance industry, do not have the same opportunity to point toward research and development as an immediate deductible item.

A second area relates to the increased use of the pooling-of-interests accounting method. This practice is not found outside the U.S. borders. In Europe, the pooling-of-interests method is almost never used.

The third area relates to the period of goodwill amortization used in the U.S. As indicated earlier, it is up to 40 years in the U.S. This compares with a maximum of 20 years in most other countries around the world. There has to be some parity, it is believed, if we're going to have consistency.

Finally, I want to make a few comments on the FASB project. As indicated earlier, the SEC has asked FASB to take on a project on business combinations. The request came down a little more than a year ago, and it will result in a new standard to replace APBs 16 and 17. Focus will be on what constitutes a business combination, when the pooling-of-interests versus the purchase method should apply, income statement recognition issues, the timing of PGAAP adjustments, and the accounting of goodwill and other identifiable intangible assets.

In June 1997 a special report was released by the FASB entitled "Issues Associated with the FASB Project on Business Combinations." Those of you interested might wish to get a copy from the FASB. It's an interesting document and is very revealing. Here are some preliminary decisions in that document. The first is that the FASB will reconsider the immediate write-off of goodwill related to R&D costs or any other reason, for that matter, as currently provided for under Interpretation 4. It will likely go in one of two ways: either FASB will allow it for everybody or it will disallow it entirely. If FASB allows it for everybody, this might have a significant impact on insurance company acquisitions, meaning that a lot of goodwill resulting from a transaction probably might be justified as an immediate write-off, if the company can show that it is not recoverable from future profits. An interesting question is, will companies then attempt to reduce or eliminate PVP as well?

A second item relates to the FASB's decision to defer the analysis of soft assets until later. Soft assets include things such as research and development, franchise, brand development, and similar items. Why is this important? Well, soft assets in the context used here are defined not only in purchase situations but in all situations. An example of a soft asset to an insurance actuary is the embedded value of the business in force. Reading between the lines and from some of the conversations I have had with knowledgeable accountants, there is a possibility, if soft assets are to be considered later, that all companies may be able to consider the value of business in force, an embedded-value-type calculation as part of their GAAP balance sheets. So, the industry will be following this development closely.

Finally, the FASB hopes to narrow the difference between the pooling of interests and the purchase methods, and it will reconsider the need for having two methods at all. So FASB's progress will be very interesting to follow during the next couple years.

MR. CHARLES D. FRIEDSTAT: Before I make my comment, based on my experience, I want to compliment all the panelists on their excellent presentations. There are many nuggets of really valuable information that can be gained, and a lot of very valuable information was presented in a very short period of time.

The one comment I want to offer was touched upon in Debi's presentation, and that relates to the due diligence process. It's been my observation, I think of others, too, that in a merger and acquisition situation, you really need to look at some of the products and see if they meet certain tax definitions. More than one acquisition has been scuttled or has had difficulties in negotiations because certain universal life products, for example, did not meet the definition of Section 7702(a). That might also be extended, to a lesser extent, to annuity products in meeting the IRS 72(s) definitions. So, I just want to add that the due diligence process should specifically look for tax-related matters such as these as being important considerations in a merger and acquisition situation.

MS. GERO: That's true, and this could be extended even to matters involving market conduct. Perhaps even before you ask for product brochures and whatnot, it may be important to review illustration histories, documents in the agents' hands that aren't supposed to go to the policyholders, things such as that, even nonforfeiture options in some cases. Some states are very strict about using both the retrospective and prospective methods for annuities in the policy approval process. You may run into some nonforfeiture issues if you're looking to bring a block of business to a state that may have been a little more diligent in interpreting nonforfeiture provisions than the state of domicile of the seller.

MR. R. THOMAS HERGET: I have a question on recoverability testing. I wonder if you could compare and contrast how the PVP recoverability testing work compares with recoverability testing for goodwill, say, two or three years down the road.

MR. MAHAN: I'll make an initial comment and let Dan come in on it. It's very tempting for people to try to demonstrate recoverability of goodwill out of the existing in-force at the purchase date or shortly thereafter. But goodwill is not for that. It's supported by future things, such as future new business. So especially at the purchase date or shortly thereafter, goodwill is not subject to traditional recoverability testing.

MR. KUNESH: I agree, except that I believe that what is behind Tom's question is what about goodwill itself, is it subject to recoverability? I, for one, have never seen anybody test for recoverability on goodwill, at least in the insurance industry. I think it should be done. I don't believe I've ever seen an accountant ask for justification as to what supports goodwill and what earnings stream will support a 40-year amortization period. It's a very nebulous question, and it has to be addressed by the FASB in its current project. I suspect that we're going to see some vast changes coming forth on this topic.

MR. MAHAN: Sometimes recoverability of goodwill can manifest itself as a going-concern issue, and I've seen that happen.