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Session 39TS
Purchase Accounting for Life Insurance Entities

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Summary: Instructors discuss emerging best practices and controversies surrounding identification and measurement of intangible assets that include value of in-force policies, goodwill impairment testing, form and content of typical disclosures and further standard-setting developments, including the Biz Com 2 FASB project. Experts in the field of business acquisitions and corporate restructuring discuss the latest developments in accounting for business combinations, with specific reference to the issues outlined above.

MR. CHARLES CARROLL: Dave Jacoby and I hope to elucidate some of the issues involving the application of the new *FASB Statements 141 and 142* to real world situations. Dave Jacoby is vice president and controller of Nationwide Financial. Dave has played a key role in Nationwide accounting for its upcoming acquisition of Provident Mutual in a sponsored demutualization. This puts Dave in a unique position of being probably one of a very small handful of financial executives with real experience in applying *FAS 141* to an actual deal in the life insurance arena.

I'm a partner with Ernst and Young actuarial services group in New York. My consulting practice tends to focus on mergers and acquisitions of life insurance companies. I've had a fair amount of experience in my career in applying purchase accounting rules to life insurance deals.

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We are going to start with a little bit of an historical perspective on the development of purchase accounting because it helps to understand how we got here. We're going to go over the key provisions of *FAS 141* and *FAS 142* very briefly. In April 2002, the American Academy of Actuaries sponsored a full-day seminar on *FAS 141 and 142.* We're obviously not going to be able to get to that level of coverage, but we do really want to focus on some of the developing practice.

After a brief overview, Dave is going to talk about applying *FAS 141* and *142* in practice in a real field situation. I'm going to then talk a little bit about goodwill impairment testing as it has been applied by companies in the transition phase of 2002, including some knowledge gained from reading Form 10Qs from the second quarter of 2002 and companies disclosures about goodwill impairment testing results. We'll discuss current events, where things are going, and then we'll leave time for questions and discussion.

Let's begin with a historical perspective. There was controversy in the early part of the 1990s regarding P-GAAP (purchase GAAP) practices and life insurance entities. It is kind of an unusual thing for life insurance accounting to reach the level of controversy it did. There was Emerging Issues Task Force (EITF) 92-9 that was supposedly going to address or settle those issues. We'll talk a little bit about that later.

In the general merger and acquisition accounting arena, the controversy was centered around dissatisfaction at the SEC, particularly with the application of Actuarial Practices Bulletin (APB) 16 and 17, which had been growing for a number of years, probably ever since those two statements were promulgated in the early 1970s. It really reached a critical phase during the early-to-mid 1990s as the SEC perceived that there was an abuse or overuse of these so-called pooling accounting methods. Just to get us all on the same page, pooling is a simple accounting method, which is meant to apply to two companies whose shareholder group combined in a stock for stock merger. It basically just involves adding the accounts together and going forward, as opposed to purchasing accounting, which requires fair valuing all of the assets in the required entity and then reflecting the amortization of those fair values in the future.

The fantasy was noticing that it was spending an inordinate amount of time talking to registrants about whether their deal met the requirements of a pooling. I would say, as a practitioner, I would second the fact that there seemed to be a tremendous amount of energy at companies, including involvement of CEOs in this issue of people wanting to get their deal to count as a pooling? One of the objectives of accounting is to be neutral. I think there was a correct perception that the availability of pooling is an alternative. It did drive a lot of deal activity.

Because of this concern at the SEC, FASB put the business combination project on their agenda in 1996, and an exposure draft was issued in the fall of 1999. The exposure draft basically had four critical elements. One was you couldn't use pooling anymore. The second one was that you're supposed to do a better job of identifying intangible assets. The third was a presumption that most intangible assets had lives of no more than 20 years; therefore, they should be amortized. This included goodwill. The goodwill, which has previously been amortized, typically over 40 years, would have been required to be amortized over 20 years.

The exposure draft did not meet with a lot of enthusiasm, particularly on Wall Street. Investment banks made the case that the draft was too onerous, particularly the 20-year amortization. They thought it could have a negative impact on the market, and possibly on the economy. There was a lot of theoretical debate going on around that. Eventually, a compromise was arrived at to allow for no amortization of goodwill, and the final statements were adopted in June of 2001. It took almost five years for these pronouncements to be developed.

In the life insurance industry, the application of APB 16 and 17, which were the prior rules for purchase GAAP, were never really sorted out particularly well. There was a lot of diversity in practice among companies, and there was a lot of controversy and disagreements between auditors and actuaries, sometimes within the same firm. There is just a general lack of uniformity of application. As I mentioned, this EITF 92-9 tried to settle that. Normally, the largest intangible asset in the life insurance field is the value of business acquired (VOBA) or the value of the block of in-force policies. EITF 92-9 said that this was an asset in the nature of deferred acquisition costs; therefore, it should be treated and amortized the same way and tested for recoverability the same way. However, EITF 92-9 never said anything about how you should measure the value of business acquired. *FAS 141* and *142* also did not mention these measurements so the controversy and diversity in practice in life insurance probably is at least as great as it used to be if not greater.

So what were the FASB and the SEC trying to accomplish by promulgating *FAS 141* and *142*? They wanted to get rid of poolings. They very effectively did that. *FAS 141* basically starts out saying there's only one way to account for an acquisition or a business combination and that's the purchase method. There were other motivations however, particularly concern over lack of rigor in allocation of the purchase price. There is a feeling that there was a tendency among companies to dump things that really could be identified and measured as specific assets into goodwill. That is particularly true after the tax changes in 1993, which basically allowed companies to deduct all of their excess purchase price in a taxable transaction. They didn't have to justify that related to some intangible asset. There was a definite loss of some of the rigor involved in purchase price allocation at that point.

The justification for the lack of amortization of goodwill revolved somewhat around this idea of ending the double deduction of the expenses. In other words, advertising costs and other things that the company spent money on to build up its goodwill would have been expensed in the past and not deferred. Then, on purchase, you'd set it up as an asset and deduct it from earnings again. This is some of the justification for no amortization of goodwill. We can see many people talking about international accounting standards and fair value. It's well known that there's a strong sentiment at the FASB that share value is a good thing. You can tell that from reading *FAS 133* and *FAS 115* and other pronouncements. *FAS 141 and 142* have a lot of information about fair value and how to measure fair value and keep things on the balance sheet that are not more than fair value.

Through *FAS 141*, FASB also wanted to harmonize U.S. GAAP rules for business combination accounting with what is the norm internationally. For the most part, international accounting standards don't allow poolings. So what does *FAS 141* say? *FAS 141* tells you what to do when you buy the company and set up the initial balance sheet. As I said before, it defines a single approach. Poolings are out. Fortunately, for those people who did poolings, you don't have to undo them. They grandfather you if you did a pooling before July 1, 2001. You keep with that.

Interestingly enough, *FAS 141* also has some clarification of what constitutes a business combination, which is an important issue. You don't have goodwill unless you have a business combination. It clarifies what constitutes an exchange of assets versus an acquisition of a real or ongoing business enterprise that could have goodwill. Most importantly, it sets rules for determining and allocating the cost on an acquired entity. That *FAS 141* approach is taking the purchase price and really allocating it for these four basic elements in the life insurance arena. In priority order, based on solidity, the first thing is net assets, which is just the excess of your hard assets, such as mostly financial instruments over liabilities. The second element is value of business acquired (VOBA), the in-force book's value. Next are other intangibles, which we're going to talk a fair amount about. Whatever is leftover goes into goodwill. *FAS 141* is telling you about that.

FAS 141 kind of focuses on these other intangibles, and the key aspect of it is the definition of what qualifies as a recognizable intangible asset that should be recorded in connection with a purchase. Basically, it has two criteria, and if the asset meets either one, it should be measured and set up on the balance sheet. There are two criteria—the legal criteria and the separability criteria. The real criterion says that if the asset is based on some contractual or legal right, it qualifies. A patent would be an example. A company has an exclusive right to a particular process or product, and that's enforceable legally.

The second criterion, separability, says if you can take the asset or the asset in combination with something else and sell it separately, that's also recognizable. An example might be the customer list, although there is some controversy over that. You could take your customer list and sell it to somebody who wanted to market to that. That would be an identifiable intangible. Then, if it doesn't meet either one of the two, it's in the goodwill bucket. With any FASB, there are transition provisions. Fortunately, for companies that have been active acquirers, there's not too much that you have to do with old acquisitions. You do have to look to see if, in previously reported goodwill, you have included intangible assets that satisfy these two criteria. If so, you have to pull them out. That almost never happens. In practice, we'll see very few examples of that. If there was something you set up as an intangible asset, that doesn't meet the criteria, you have to take it out and put it in goodwill. That has happened occasionally. There's one asset the

FASB specifically said is not an identifiable intangible, which is work force in place. If the company set that up as an asset, it no longer qualifies. They have to put it into goodwill. There is not much activity on those two transition points.

FAS 141 is about setting up the initial balance, but *FAS 142* is about what you do the day after. How do you amortize things? Of course, goodwill is not amortized. If you do or did a deal after the promulgation of *FAS 142*, you don't amortize the goodwill connected. If you have goodwill from previous acquisitions, you stop amortizing that, generally as of December 31, 2001. It requires that you take all of your goodwill and allocate it to reporting units. The definition of reporting units is fairly complex. It probably is not your reportable segments for 10K purposes. It's something below that. Once you've allocated all of the goodwill to your reporting units, you test it annually for impairment. That's sort of the compromise. Don't amortize goodwill, but if it is ever worth less than it's earning value, you have to write it off.

Let's discuss adoption requirements for *FAS 142*. If a deal is initiated after June 30, 2001, you apply the purchase price allocation methodology, and you don't amortize any existing goodwill. You continue the amortization up until the adoption point, and then you stop. Then you have to do the initial impairment test. That must be completed during 2002.

Table 1 gives you sort of an overview of intangible assets. We talked about goodwill and identifiable intangible assets that is a basic categorization. Within identifiable intangible assets, there are two types: indefinite life and finite life. Indefinite life doesn't mean it's infinite life, but if the asset has no set of time horizon over which it logically is going to go away, it's indefinite life. An example for a life insurance company might be state licenses. There's no time at which those are going to expire or be taken away from a company. The finite example of a finite useful life would be VOBA. Those in-force policies don't stay in-force forever. It has a finite life, and it should be amortized. Goodwill, of course, is that leftover thing. It's the value that we couldn't assign to anything that met the criteria as *FAS 141* that is a residual. That's not amortized. All intangibles, however, are tested for impairment. There are some differences in how they're tested. The goodwill impairment test is the most complicated, and it involves a two-step process. The indefinite useful life asset is a simple test. You look at its fair value, or it's carrying value on the balance sheet (book value), and compare it with fair value. If fair value is less, you would write it down.

TABLE 1
Summary of Accounting for Intangible Assets

	Goodwill	**Indefinite Useful Life**	**Finite Useful Life**
Characteristics	Residual value after allocation of purchase price to other items	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

Then the finite useful life assets use the same basic test. *FAS 121* is applied to most noninsurance finite useful life assets. VOBA has its own impairment testing requirement, which is in this EITF 92-9 that is still in force. That's really the applicable rule there. The test should be done annually for both goodwill and indefinite useful life assets, and only when there's an indication of a problem with finite useful life assets.

That's a real quick tour. Dave is now going to take us through some practical experience.

MR. DAVID JACOBY: Charles indicated that my experience with *FAS 141* and *FAS 142* really revolves around the transaction that we currently have underway with Providence Mutual Life Insurance Company. We hope to close sometime in early October. I'd like to just to give you a feel for the efforts and the activities at our end. We really got started with this activity in terms of our purchase price allocation and purchase accounting back in the first quarter. We've been delayed a little bit because of the timing of the close. That would give you a flavor for some of the activity in the period in which we have been involved with this.

I think we realized early on in the process, given the newness of *FAS 141* and *FAS 142* that we needed some assistance to value of some of the intangible assets. We engaged Ernst and Young (E&Y), and that's why we've been working with Charles and a number of his colleagues in that effort. We have been working very closely with our auditors at KPMG on the process to obtain their insight and interpretations.

My goal is to focus on some of the implementation considerations and things that we've learned from our experience in this process. There are five topics I wanted to talk about. Number one, is it's just going through the process of identifying intangible assets. Once you know what the criteria are, what kinds of things should you be considering, and what kind of things should you be doing to identify intangible assets? Once you've identified intangible assets, you need to put a fair value on those assets. The second topic is just determining fair value. What is the process, what's required under *FAS 141,* and what are some practical implementation issues that we've encountered? Once you've identified the assets and put a fair value on, you have to amortize the assets. What is an appropriate life for amortizing these assets? What kind of methods would you employ to amortize that balance?

Charles touched on the concept of reporting units. That is a new concept that's introduced in *FAS 142,* and the purpose of that is to give companies a framework in which to test goodwill for an impairment, now that it's no longer being amortized. Finally, what are the requirements, and what are some of the considerations as you set procedures to do impairment testing?

In terms of identifying intangible assets, this is a step that is taking on much more significance. Prior to the new rules that have come out, intangible assets as well as goodwill were being amortized. So did it make much difference if you didn't go through a process of identifying intangible assets? I think that is probably the attitude that a number of companies took. They both ultimately found their way into the income statements. Maybe there were different useful lives in terms of an intangible versus goodwill. The bottom line is they all made their way into the income statement. Obviously, with *FAS 141* and *FAS 142,* goodwill is no longer being amortized, and this will take on new meaning for companies. I think you can guarantee that this will be a topic that will be a focus for your auditors. If you're a public company, your investors, the analysts, and certainly the SEC are all going to be very interested in this exercise and what you've done. The SEC has essentially gone on record saying it expects companies to go through a very complete and thorough assessment in identifying tangible assets. When companies meet those criteria, they must recognize that those assets are separate from goodwill.

Charles mentioned two considerations related to the criteria for recognizing an intangible asset. One deals with contractual or legal rights. If those criteria are met, then you need to identify the assets separately. The other criterion concerns whether it's capable of being separated and sold from the entity. Suppose you have things in the past that you feel were assets that were deserving of separate recognition. If they don't meet these criteria, you're essentially precluded from breaking those out and reporting them separately. I think we acknowledge that there might be some inconsistencies from that standpoint, but there could be some assets that people would want to break out. From a consistency standpoint, they thought it was important to have very specific criteria followed and to enhance comparability between companies.

There are a couple of points that I would like to address in terms of the process that you might want to consider as you look to identify intangible assets. The first is within *FAS 141* itself. The statement provides an Appendix A with examples of the types of assets that would generally meet the criteria for separate recognition. Appendix A gets into items that would deal with contractual type rights or agreements. It provides examples of customer relationships, related assets, and technology type investments as well. It provides a whole host of things to consider. I think the FASB has said this is not meant to be an all-inclusive list. You need to go out and look for other things as well. It really is a good starting point. I think both the FASB and the SEC are pretty much on record of saying they would expect companies to essentially walk through that and treat it as a checklist. Even if you have something, unless you can show that it would be immaterial, you ought to be breaking those assets out and recognizing those separately.

In terms of other considerations in identifying tangible assets, you should certainly have discussions with key personnel at the acquired company. You should be talking to people that would be involved from the legal side and that are familiar with key contracts and relationships on the distribution side. What are the various selling relationships and channel relationships that

that company has? What are the terms of those agreements and do they meet the criteria for separate recognition? You'd probably want to talk to people in the information technology (IT) area. There are certain proprietary systems that would meet the criteria for separate recognition that need to be pulled out.

You also want to talk to people that have been involved from the acquirer side as well. There are people that were on the transaction team. They would be familiar with the company in terms of going in and doing due diligence. They are familiar with significant legal agreements, and contractual relationships that would be out there. There are the people that were involved with assessing the value in support of the ultimate bid and the purchase price. What kind of things were assigned value and identified separately in that process? There is a good exercise you should go through to help with allocating your purchase price and identifying intangible assets.

Finally, just read a number of contracts. We found ourselves, on some of the distribution relationships, going through the contracts and wondering whether the agreement should meet the criteria for separate recognition. Are there contractual or legal rights that should be separately recognized? Those are just some ideas of things to consider as you look at identifying the intangible assets.

In terms of fair value, the FASB has defined fair value by the amount that an asset could be bought or sold in a current transaction between willing parties. That sounds great, and it makes a lot of sense. Once you start to apply it in practice, it becomes a little bit more difficult. They've gone on to say clearly that quoted market prices are the best indication of fair value when those are available. That's not the case for a number of assets.

In terms of valuation approaches, there are really three broad categories or three basic techniques that I think all valuation experts use. The first is the cost approach. The basic premise there is that you wouldn't put a fair value on an asset that would be more than the cost it would take to go out and duplicate that asset, or build it, or replace it.

The other approach is a market approach. Look at transactions and determine what buyers and sellers are doing out there. Some assets are useful for others where it might not apply. Finally, an income approach is just simply looking at a stream of cash flows and discounting at an appropriate rates. This is one that you'll use quite often for a number of intangible assets. In terms of approaches, valuation experts might look at one or all three of these for a particular asset and then decide what might be most relevant. They're usually looking at more than one technique.

In terms of fair value, the FASB has introduced a concept that has a bearing on the work that's done. When setting fair values use assumptions that marketplace participants would use. That's the case even if those assumptions might be different than the company has experienced. The FASB does go on to say that in the event that marketplace assumptions are not available or they can't be obtained without undo cost and effort, the companies' experience and assumptions can be used in that place. From a practical aspect, this does create some issues. Are they obligated to go out and then try to search for the marketplace assumption? When we've used expense numbers in a VOBA calculation, I think we use what the company's experience was. I think we had the judgment of a number of individuals that were involved to say essentially these numbers are in alignment with what the marketplace participants would be using. Does it mean you have to go out and search for things? I think you have to use reasonable judgment.

In terms of setting fair value, there are a number of considerations and issues that came up as we went through this process. I'd like to touch on some of those key items. The first deals with overhead expense. As companies valued intangible assets, I don't think overhead was always used. It might not have been the practice in a lot of situations. As we thought through the definition of fair value and how we would test for impairment down the road, we came to the conclusion that it was appropriate to include some level of overhead as we looked at valuing tangible assets.

Another consideration is transaction synergy. The reason most of these transactions are done is because value is created. It can be on the topside, but generally it's on the expense side. Would those be reflected in some way in a fair value? I think you have to go back to the definition of fair value in this concept of what assumptions market participants would use. If those synergies get you into those levels of where you are with market participants, then I think you have to consider using those. If you're using your own assumptions, then I think you have to assess your comfort level with those synergies and how achievable they are.

There is another topic with respect to income taxes. There could be a transaction where an intangible asset might be bought and sold between two parties that might produce tax benefits. If that would be perceived to be included in a fair-value type of calculation between participants, then you have to think hard about including that in the value of your intangible assets, even if the transaction doesn't produce the same kind of value because of the way it's structured for your company. This is something you need to consider and talk about with your valuation experts.

There is another topic in terms of cost of capital. As companies looked at VOBA calculations and other intangible asset calculations, cost of capital might not have been explicitly provided for, or it might have been considered when selecting a discount rate. As we thought about the definition of intangible assets and fair value for intangible assets, and as we considered what impairment testing we would be held to down the road, we explicitly thought it was appropriate to put in an explicit cost-of-capital charge.

With regard to discount rates, I think you need to look at your company's capital structure and cost of capital relative to what the industry might have and what other market participants might have. To the extent you have a discount rate, cost of capital, or capital structure that is much different than other companies, then I think you need to look at, from a market participant standpoint, what cost of capital and discount rate they would be using as well.

As we went through the process of looking at fair value, these are the things to be considered. I'm sure others will crop up as other transactions unwind.

In terms of intangible assets in potential fair-value approaches there is the income approach or the fair-value approach that might be used. There is clearly a distribution force out there. If they meet the criteria, which they often would for separate recognition, you need to put a value. The income approach would probably be the most common fair-value approach that would be used in simply looking at the value that that distribution force would produce in terms of new business. You’re looking at the distribution and the relationships that there are today, not taking into account new agents and new relationships that might be coming in the future.

Another approach that could be used is simply a cost approach. What would be the cost to recruit and train a comparable distribution relationship as well? VOBA is going to meet the criteria for separate recognition, and an income approach is always what has been used. I suspect it will continue to be used.

Brokerage accounts or mutual funds. If you have a company that has a broker deal or a mutual fund operation, those need to be identified and they would likely meet the criteria for separate recognition and they would need to be valued. I think an income approach would be the most common methodology deployed.

Licenses would be another asset that would typically meet the criteria. What’s the cost to go out and obtain those licenses? A cost approach is very common. There are situations where certain licenses might be bought or sold in a market place as well, and to the extent that market information is available, it would certainly be used.

Software type relationships. You have proprietary software or systems out there that have value and would meet the criteria. If so, those would need to be separately valued. A cost approach is probably going to be most appropriate. What kind of cost would it take to go out and replicate that software? Or what cost did it take to build that?

Trademarks and trade names. These generally meet the criteria for separate recognition. You might find market situations where those are bought or sold. There is an income approach and that’s sort of a relief from a royalty fee. If I was in essence paying somebody a fee to use a trade name, or trademark, if I own it I don’t have to do that. That is typically the approach taken, and I think there is a database in terms of information out there on how those kinds of royalty payments would work. These are just some examples, from my experience of things, that we've identified separately and would likely come up in a number of life insurance transactions.

Once the assets are identified in value, the question then becomes how do we amortize these things? The useful life is the period over which the asset is expected to contribute to the cash flow of the company. Charles had mentioned earlier that if an asset is deemed to have an indefinite life, that doesn't mean it goes on forever. You just don't have a period to pin that to. Those types of assets are not amortized. In terms of a useful life period, there are some things to consider. You'd have to look at the effects of obsolescence on a particular asset. There are other legal or regulatory considerations that might limit your use in the future.

Another thing to consider is the renewability. If you have a specific term to an asset or an agreement, and you expect to renew those and can renew those arrangements without substantial cost or effort, you would generally include that renewal period when looking at the useful life. What amortization methods should be deployed? The FASB states you should reflect a pattern of economic benefit. VOBA is still covered by 92-9, which was not superceded by the new rules on purchase accounting. In our opinion, you continue to amortize VOBA with interest over the expected gross profits (EGPs) or premiums depending on the nature of the product. For other types of intangible assets, you probably look at the underlying cash flows because that's really where the economic value is derived.

If amortization patterns cannot be determined, then you fall back to sort of a straight-line method, which is just the opposite of where we were. Companies were forced to use a straight-line method for intangibles in VOBA, unless they can prove another method was superior. The terms of once useful lives and amortization periods, methods are set and those need to be reviewed on a regular basis to determine if any kind of revisions are warranted. The VOBA that was covered in the ETIF essentially requires that those be subject to the premium deficiency testing that exists today. In my opinion, we continue to apply and you continue to subject VOBA to that kind of process. For other assets, you'd simply do that prospectively if you had a change on a useful life or method that would be handled on a prospective basis.

The concept of reporting units is new to the goodwill statement that is out there. Once the FASB made a decision to no longer require the amortization of goodwill, they said, "We need to have a good rigorous process in place for companies to test for impairment of goodwill." Generally, once you've assigned reporting units, then all the assets and liabilities associated with the acquisition would be assigned to reporting units. The reporting unit is a new concept. You might be familiar with segment reporting. Public companies have typically disclosed that in their footnotes of the financial statement. They might disclose it to analysts as well. We're talking about a different concept. The reporting segments that the company does externally starts with a concept of an operating segment in that it might aggregate those to get to what is reported outside. Generally, for this reporting unit, you start at that same operating segment level, and then you decide if you should drill down and assign goodwill at one level below that. You're actually going below levels that you might be familiar with for reporting segments. Generally, a component of an operating segment is a reporting unit if it is a business with discreet financial information that segment management regularly reviews. There are some circumstances where you might aggregate those if they have similar economic characteristics.

The bottom line for this is more detailed than what you might be accustomed to dealing with, if you are familiar with reporting relationships. For the public companies out there, you're going to have a leg up because you've already worked with reporting segments. For the nonpublic companies, this applies as well. Getting in there and understanding these concepts of operating segments would be sort of new territory.

Once you've set up the reporting units, all goodwill needs to be assigned to the reporting unit in order to do the impairment testing. In terms of the methodology for allocating, there is some discretion involved. Basically, the FASB statement says that the method has to be reasonable, supportable, and applied on a consistent basis. The point I would make with respect to leaving on reporting units, is I would encourage you to take a look at this and think of this process early on in the effort. If you start reporting units that are going to allocate assets, including goodwill, to these reporting units, that's really going to define and dictate the level of what you'll need to gather information, perform calculations, and so forth. You'd be well served by looking at these reporting units early on in the process. For the nonpublic companies, looking at operating segments will be sort of new uncharted territory. I think the other thing that's clear is, the level at which you assign goodwill sometimes depends on how management reviews the results of these different segments. You almost need to have an understanding of how the organization will be managed, run, and reported going forward in order to go through this exercise.

In terms of impairment testing, my recommendation would be to think about the types of exercises you'll go through to do impairment testing at the front end as you start the purchase price allocation process. For us, that clearly made us think of some things that we wanted to take into account when setting the fair value. For example, there are things such as overhead as I mentioned earlier. Intangible assets, if they have indefinite lives, are tested for impairment on an annual basis and on an interim basis, if there are indications that the asset might be impaired. The test is solely based on a fair-value approach, so it was recorded initially at fair value, and essentially any change or decrease in the fair value of that asset is going to prompt an impairment charge. For example, if you use an income approach with a discounted cash-flow method, even an increase in interest rates and an increase in a discount rate, absent changes in any other assumptions, could require that or could cause that asset to go down in fair value and essentially have an impairment charge.

To the extent you have intangible assets with finite lives, you would review those for impairment if certain indicators are present. The concept there is really more of the recoverability approach. If the notional amount of those undiscounted cash flows were to be less than the remaining caring value, then you would have an impairment charge. There is an issue with respect to the life insurance world. From a VOBA standpoint, EITF 92-9 deals with VOBA and was not superceded. It does talk about subjecting VOBA to impairment testing premium deficiencies that existed all along. If you are still following that, and because that's a present value type of concept, you're going to have an issue there before you would have one with undiscounted cash flows under *FAS 142*.

You are required to formally test for goodwill impairment once a year, and on an interim basis as well if there are certain indicators that might make you believe that goodwill could be impaired. These indicators could be changes in the marketplace, increased competition, or poor financial results. There could be a number of factors that might pop up. To actually go through the goodwill impairment testing is essentially a two-step process. First, go back to these concepts of reporting units. You would determine the fair value of the reporting unit. If the fair value of that reporting unit is more than the caring value, you don't have an impairment, and you can stop at that point. You can have business in a reporting unit that's in addition to the acquired business. You might be wondering how you isolate that piece that just came with the transaction and with the acquisition. You don't. You can essentially have situations where an existing business is shielding or providing cushion for an impairment testing of goodwill that results from an acquisition. I think the FASB recognizes that. However it does not make sense to require companies to maintain detailed specific records that would isolate only that required business. You're comparing results with the way that management has looked at them.

In the event of the two-step process, if you do fail the first test at the reporting unit level, then you essentially have to go through and calculate and imply fair value of goodwill. You would essentially go through and assign new fair values to all of the assets and liabilities in that reporting unit. You're not re-measuring them. This is just for impairment testing. You're subtracting those fair values of the assets and liabilities from the fair value of the reporting unit. What is left over is the implied fair value of the goodwill. To the extent that is less than the caring value, you would have an impairment that you would have to recognize.

There are some considerations for impairment testing. You have an annual review that's required. We have elected to do this at the start of the fourth quarter. There are two benefits in that. First, by doing it at the start of the quarter as opposed to the end of the quarter, you have the entire quarter to perform the analysis. You even have some additional time until you actually have to release your financial statement. That provides a little bit more time. I think the other benefit of doing it in the fourth quarter is that auditors should have more comfort knowing that you've gone through that process very close to year-end. I think the other thing to keep in mind is you do need to have processes in place that would alert you if there's an indication of an impairment. Who is monitoring that process and who's reporting it? The last thing you want to do is wait a couple of quarters down the road and find out you have an impairment issue that should have been recognized a quarter or two earlier.

Practice will clearly continue to evolve. With *FAS 141* and *FAS 142* and for life insurance companies, it's all very new to everybody. The other point I would clearly like to make is the effort is much more substantial than what you might be accustomed to in the past. It requires the involvement from probably a much broader and diverse group throughout the organization to complete this exercise. Your auditors, your public company and the SEC are going to be expecting much more as well. Once they're alerted, or once they're clearly focused, management is going to be very focused on that as well. Start early, get a good work plan together, and get the right resources together.

MR. CARROLL: I'm going to talk a little bit about the goodwill impairment testing as it has come to fruition in the actual reports of public companies. If you had goodwill from prior acquisitions, prior to the onset of these statements, you had to complete step one of the impairment test that they've described by the second quarter of 2002. By the end of the year, you would have had to complete step two. Generally, there were predictions in the financial press. We could see some pretty substantial write-offs occurring in goodwill. Lehman Brothers was expecting big write-offs. In some cases, they were right. This is a great occurrence. There was a $54 billion write off of goodwill occasioned by *FAS 142*. It's understandable in this case. Many tech companies made acquisitions during the bubble. Some people at least call it a bubble when the valuations were kind of crazy. So if you bought anything during that post-bubble period, it is almost inevitable that you would have a step one problem. If you have a step one problem, you more than likely have a step two problem and then a write-off.

Interestingly enough, the market really has not reacted very much to the impact of a lot of these things. Essentially, the information was always already included in the market's valuation of the prices of these high-tech companies and communication companies.

In the life insurance industry, there really wasn't much in the way of write-offs. Write-offs were fairly rare. I basically read the second quarter 10Qs for 26 publicly traded U.S. life companies. They tried to restrict the group to be just companies that were primarily life insurance and not property/casualty companies. It was not general financial services entities. Of the 26 that I included in my survey or my reading, seven had some transitional goodwill write-off. The ones that had write offs had completed step two as well as step one. Of course, the most significant one was Conseco. Most people are aware of the financial difficulties that Conseco is in. It took a write off of $2.9 billion of their goodwill, which totaled $3.6 billion at the beginning of this year.

Then there were a couple of moderate amounts of goodwill write-offs. Although Principal is primarily a life insurance company, it is also in the asset/management business. This write off had to do with an asset management company that they had bought. Phoenix had a small amount of write off. Others were minimal or in the single-digit millions. So, it is really insignificant.

I would say the only significant write off was Conseco. Why is that? Why was there so little written off in the life insurance industry, given the predictions? There might be several reasons. One is that the market in the life insurance area didn't get as crazy as some of the other industries. There are also two other phenomenon. One is that many acquisitions were made by foreign companies. I don't have information on those companies because they're not reporting in the same mode that the U.S. companies are. The other is that a lot of the largest acquisitions and the ones probably with the most goodwill were done as poolings before July 1, 2001. Therefore, they didn't have goodwill that was subject to this test.

How did they determine fair value? I was very interested in what companies might disclose about how they were doing the impairment test. The determination of fair value of the reporting unit, much less the more detailed measurement you have to do in a step two test is not quite an obvious exercise. Of the 26 companies, 19 basically gave no information about their methodology. I read a statement that the reporting unit was valued under the procedures outlined in the statement. Seven of the companies did give a little bit more information or color commentaries on how they did this measurement of the fair value of the reporting units. Two indicated that they used multiples based on comparable companies. We'll take our reporting unit. We'll measure its GAAP caring value, its GAAP earnings, and we'll compare that to other publicly traded companies that look like our reporting unit. We'll do a comparison. This type of business should be valued as earnings multiples. We'll take ten times our GAAP earnings and use that as the measurement of fair value.

Three indicated that they used discounted cash flows of some sort. There was not much information about how that was exactly done. That would be again, projecting forward the earnings of the company and discounting back. It could be as complex and extensive as an actuarial appraisal. Two indicated that they used three methods, a comparable approach (that I described earlier), a discounted cash-flow approach, and an allocated market value of equity approach. In other words, you look at the companies that are publicly traded. You can take that market cap and allocate it in some way to the reporting units and use that as your estimate of fair value of the reporting units. Some valuation experts would say that that process is not appropriate. Some of our valuation experts have said that. It seems to me that it's some sort of indication and it could give you some valid information about market value. The one thing you can say about it is it does reconcile back to the companies market capitalization.

I don't think we should draw any particular conclusions from these seven companies because only one of the seven didn't have an impairment issue. In other words, companies that have an impairment issue are going to naturally describe, more completely, what their method was. If you didn't have a problem, the means in which you determine that is not quite as important. That one company that had no problem with disclosing used the comparable approach. Based on our work with clients and discussions within the industry, my general impression is that the vast majority of companies are simply using a comparable approach. They're taking the multiple of earnings approach and generally looking at comparable companies, even if there is not a problem. In general, the margin that they're getting would kind of tell you that it's probably a good conclusion.

Some are adding this allocated market-value approach, which is also a very simple approach, and it gives you at least one more benchmark to go on to support your goodwill. There are very few using a discounted cash-flow approach, and even fewer are using a full-blown actuarial appraisal. I believe that in the case of Conseco that there were actuarial appraisals underlying some of the goodwill write-off measurements. But other than that, I have trouble identifying any company that might have used an actuarial appraisal, despite the fact that most actuaries would think that that would be a pretty good technique.

Companies are not using outside advisors for step one. That's probably understandable in the current circumstance. Most companies don't have a problem. The comparable approach is a pretty simple approach to use. It doesn't require a lot of expertise. However, I think a word of caution is probably worthwhile here. The current situation with the market for life insurance stocks might not hold forever. The markets are acting irrationally. If you pegged all of your goodwill impairment testing purely to a comparable approach, you could be in a difficult situation if the stock market hit a period like that.

There are three different approaches. It's probably a more rational, and in the long-term, more prudent approach to take to this goodwill impairment-testing task, despite the fact that it involves more work and more documentation than companies are generally applying. These multiple approaches would include multiple of earnings, allocated market cap, and discounted cash flow (DCF) or actuarial appraisal methodologies.

It's very important to document that you're using this approach. The last thing you want to happen is to run into a stock market problem in the fourth quarter when you're doing your test, and find that you haven't looked at any other benchmark or approach for your goodwill impairment testing. That's not the time you want to tell your auditor, "We think this kind of cash flow is going to make a lot of sense." So you should look at it and develop an approach that's consistent with this hierarchy of measurement criteria in *FAS 142*. It should be consistent with concept statement seven, which talks about determining fair value. It is going to become an increasingly more important statement as we go along. It should be consistent across time. In other words, we're always looking for some degree of these three consistencies. It should also be consistent cross reporting units. I don't mean using one method for reporting unit A, and another for reporting unit B.

I'd just underline the fact that the discounted cash-flow appraisal methods involve a bit more expense. However, there are ways of alleviating that expense by using information that might be available from other exercises, such as embedded value reports or cash-flow testing models. There is a technique that deserves a lot of attention. When you a buy a company, you will have had an actual appraisal done, which might have served as your basis for negotiating and determining value. If you simply make sure that you don't just lose that appraisal tool, but sort of keep it up to date, it can serve as a good model for impairment testing.

There are a couple of other interesting sidelights to this study of the 26 company 10Qs. There was one company that actually wrote off the value of an indefinite life intangible. They had done this impairment test that Dave described during his presentation. They found a problem and wrote it off. One company eliminated a small amount of negative goodwill. We haven't covered *FAS 141's* approach to negative goodwill because it hardly ever happens. It is kind of interesting theoretically. You get negative goodwill if you take your purchase price and, after you start allocating it, find that you have more assets than you have purchase price. If that happens, start to proportionately write down your identifiable intangibles until they are zero. If they are zero, and you still have a purchase price leftover that's recorded as an extraordinary gain. This one company actually had a piece of negative goodwill like that related to a prior acquisition. They reported that in their transition report as an extraordinary gain. This was a very lucky company.

In some cases, you have to look at the way you allocated purchase price on your prior deals. If you put something in as an asset that doesn't meet the criteria, it has to go into goodwill. Assembled work force is one of those. One company had that situation. But otherwise, there is very little in the transition that is of any great impact.

I'd like to talk a little bit about my impressions of how things have worked out. Again, this is based on very little actual experience because there are very few deals that have occurred. One of the FASB's and SEC's concerns was that goodwill amounts were very high. I think goodwill amounts are still high. My own view is that's probably an accurate reflection of the economics of deals. The purchase price includes a substantial amount related to values in the company that cannot be assigned any relevant asset that needs the FASB's criteria. The other observation I would make is that the valuation process for intangibles is very subjective. I've gotten a lot of education from talking to the valuation people in our firm. They are very accomplished professionals and have literature and a set of procedures that are pretty extensive. It appears to me as if there's a lot of room to maneuver within that, and that the standardization of this measurement process is very difficult.

There are still these issues with regard to measurement of VOBA. Dave mentioned them during his remarks. They are still there, and I think there are approaches to them, but different companies are taking different approaches. There's little standardization.

I'll discuss a little bit about the future. FASB has this Biz Com 2 project, which is working at trying to better define how to measure these identifiable intangibles. Giving more guidance might actually ameliorate some of the problems I was mentioning before about subjectivity. Issues are beginning to bubble up through the EITF process that deals with *FAS 141* and *FAS 142*. I think I might talk about one here. There is this AICPA task force that's working on something that gives some guidance in the insurance world. In the farthest background, we have the potential onset of fair-value accounting sometime in the future. If that ever came into play, we would have to completely rethink business combination accounting. That might become irrelevant in fact.

The one EITF issue I wanted to mention involves customer-related intangible assets. This issue and its resolution by the EITF are indicative of some of the slipperiness of these concepts. The question was as follows. Suppose you have a customer-related intangible asset, part of which meets the criteria of *FAS 141* for recognition on the purchase GAAP balance sheet. Suppose, in addition, that this same customer relationship has other aspects of value that do not meet the criteria. Should you recognize these other aspects as an intangible asset? Say you write group insurance and you have a contract with XYZ Company. You can demonstrate that the company has renewed this coverage over many years. That is a measurable and valuable asset that's based on the legal right.

Let's say, in addition to that, you have the opportunity and demonstrated that you can sell a lot of other things to XYZ and make a decent profit on it. Should you recognize that part of your customer relationship? To my surprise, the EITF tentatively concluded that you should recognize it, even if those aspects are noncontractual. If you think about it, this really expands the concept of what satisfies these two criteria. The EITF went on to say that in this situation you should measure the value of the asset as the additional profit you can make on sales to this customer over and above what a company without the pre-existing relationship could make, and not as the total gross margin on such sales. Think about how difficult it is to measure the gross margin on future sales. That's difficult enough to calculate. We want only the margin that you get in addition to what somebody else would get. It seems like it would be a tough thing. In my mind, you'd probably say, "We don't have any advantage over other customers so we will value this at zero."

I do want to cover the AICPA task force, which I believe is going to give some guidance. The AICPA task force is working on preparing an SOP on application of *FAS 141* and *FAS 142*. The issues it is addressing is what constitutes acquisition of insurance business? Some transactions are in the form of reinsurance or business combinations. The issue that it's mainly looking at is discounting of claim liabilities for short duration contracts. This is something that is primarily applicable to property and casualty companies. It will also tackle the present value of future profits (PVFP) and some other insurance specific assets. It probably won't come out with anything before Biz Com 2, which I think is scheduled to come out later in 2003. This effort might improve the situation in terms of the guidance that is out there for companies.

FROM THE FLOOR: I have a question related to identifying intangible assets. One of the comments made earlier was that the distribution force should be taken into account as one of the items of intangible assets. But I also understand from my limited knowledge that the value of a work force, or the value of the people is not to be valued. So I'm having a little trouble reconciling those two because your distribution force, in many cases, could be part of your work force.

MR. JACOBY: That's a very interesting concept there. I guess from our experience, we were dealing with third party distributors where they were not employees. To the extent you have employees, I would think the overriding criteria would be that the work force would not meet the criteria for separate recognition.

FROM THE FLOOR: A specific example would be if you have group business. You have group representatives who market through brokers, and obviously the group representatives are employees of the company. They do develop relationships with brokers. How do you know if you have to place the value on that or not?

MR. JACOBY: I think then you have to ask about the relationship with your brokers and whether those relationships meet the criteria for separate recognition as an intangible asset?

FROM THE FLOOR: Do you mean the value of the relationship with the brokers?

MR. JACOBY: Yes. In that situation I would look at those brokers as your distribution. You have people off servicing them, but I think you'd have to ask whether that relationship meets the criteria for separate recognition?

MR. ROBERT L. BUCKNER: This is a question for Charles. It actually precedes all of the discussion we've had on *FAS 141* and *FAS 142*. P-GAAPs should be applied in the stock acquisition. I was wondering at what point do you apply P-GAAP in a reinsurance transaction? Where do you draw the line on reinsuring an existing book of business between a business combination and just co-insurance?

MR. CARROLL: As I mentioned that is an issue that this AICPA task force is addressing. Generally, I think you have to look at what you acquired. There is a FASB statement that defines what a business is. It sort of includes distribution. You know a bunch of elements that make up a definition of what a business is. A business combination where this applies is when you acquire a business. As part of the co-insurance transaction, the distribution system that produced the business and is continuing to produce business comes over. The employees that administer the business leave the company that you're buying the business from and come to your company. Those are elements that would indicate that you have a business combination and not just a straight asset or a straight coinsurance deal. I think there are significant examples of deals like this. There were two that Lincoln National did a few years ago with Aetna and CIGNA life business where you can see those elements as part of the deal. I think you'd look at distribution systems and employees—things that you connect with an ongoing business.

MR. JACOBY: You can appreciate that there's a continuum there.

MR. CARROLL: That's very definitely so. I think if you look at this piece of literature from the FASB that sort of defines the business. There's clearly a continuum and exactly where on that continuum or whether you call something a business combination is the question. It is a difficult judgment in some cases.