AMERICAN ACADEMY of ACTUARIES

March 16, 2001

Director of Research and Technical Activities
Financial Accounting Standards Board
401 Merritt 7, P.O. Box 5116
Norwalk CT 06856-5116

Re: Revised Exposure Draft: Business Combinations and Intangible Assets—Accounting for Goodwill (File Reference 201-R)

Dear RTA Director:

We are writing on behalf of the American Academy of Actuaries' (Academy) Committee on Life Insurance Financial Reporting (COLIFR) and Committee on Property and Liability Financial Reporting (COPLFR) to comment on certain aspects of the above-referenced revised exposure draft, dated February 14, 2001. The comments, issues and questions presented in this letter are based upon the accumulated experience of our two committees with respect to the financial reporting of business combinations for the insurance industry. We do not offer comments relating to other industries, although some of our comments may apply to business combinations in any industry.

We commend the FASB for preparing a very comprehensive document that is thorough, complete and flows naturally from issue to issue. There are areas, however, where we believe additional clarification or guidance is needed. The comments, issues and questions provided below do not necessarily respond directly to the seven specific issues included in the preface of the exposure draft. We trust this will not be a problem and have attempted to provide references to specific paragraphs in the exposure draft to assist you in understanding our commentary.

1. ALLOCATION OF GOODWILL

Paragraphs 55 through 59 discuss the components of goodwill, first identified in the 1999 exposure draft. As discussed in the proposed Statement, the third and fourth components (core goodwill) should generally comprise the bulk of reported goodwill in a business combination. The third component relates to the "going concern" element of the acquired entity's existing business and the fourth component addresses the synergies to be gained by combining the acquiring and acquired entities' net assets and businesses. Both can be very difficult to quantify, as discussed further in Section 3 below.

As a result, goodwill may be difficult to reliably allocate among the various reporting units and therefore such allocation is likely to be arbitrary. However, such allocation is required in both the initial benchmark assessment for acquisitions after adoption of the Standard and the transitional benchmark assessment for goodwill existing at the adoption of this proposed Statement.

The fourth component of goodwill is the one that gives us the greatest concern. Goodwill is likely to be allocated to the respective reporting units by including the leverage to be gained in the internally generated goodwill of both the acquired and acquiring entities (discussed in paragraphs 68 through 71). As a result, companies may give considerable weight to this component, especially to the internally generated goodwill of the acquiring entity (to the extent not needed to support remaining existing goodwill), in setting the offering price for a deal. This could drive up future deal prices and result in accounting rules that encourage management decisions which are less than optimal.

Companies can expand in two ways - either through internal growth or through acquisitions. Companies that grow internally are required to expense the cost of growth either currently or through amortization over a short period of years. In contrast, acquiring entities can opt for what could be permanent deferral of these costs through goodwill accounting, especially if reporting units are combined for reasons of synergy (component four of goodwill). This places acquiring companies at an advantage, with regard to reported earnings, as they grow in this manner.

Important measures of success of an entity relate to the price-to-earnings ratio, the rate of return on equity and the market value to book value ratio. Under the proposed Statement, these measures may differ significantly for companies that grow through acquisitions in comparison to companies that grow internally.

Existing accounting rules for goodwill require amortization, forcing costs associated with growth to flow through the income statement over time, just as they do for entities that expand through internal growth. This is less likely to be true in the future under the proposed Statement.

We recognize that there is no easy solution to the "unlevel playing field" issue, short of allowing all companies to report internally generated goodwill in their financial statements. Apparently, the FASB has decided not to consider that such an option at this time. One possible solution might be to disallow the inclusion of any internally generated goodwill of the acquiring entity in the goodwill allocation process during the initial benchmark assessment at acquisition and upon reorganization.

We encourage the FASB to give more thought to this issue and select an approach that would allow greater comparability and a level playing field for all publicly owned companies.

2. INTANGIBLE ASSETS OTHER THAN GOODWILL

Paragraph 5 of the proposed Statement directs that identifiable intangible assets (IIAs) be recognized separately from goodwill. Further discussion is included in paragraphs 48 through 54. These paragraphs clearly identify the recognition criteria for IIAs.

IIAs for Life Insurance Companies

In the case of life insurance company business combinations, the most significant IIA is the value of business acquired (VOBA). This asset can be calculated in a variety of ways but the result is generally a present value of the margins or profits expected from the insurance contracts that are acquired in the business combination. The VOBA asset is easily allocated to reporting units in almost any manner that reporting units might be defined.

The initial amount of VOBA defined in a life insurance company business combination is generally subject to the methodology and assumptions that the acquiring company selects. To the extent that this value can be reduced, goodwill in the transaction increases. Since VOBA is an amortizing asset (because it has a finite useful life), and since under the proposed statement goodwill will not be amortized, there may be strong incentive for acquiring companies to minimize the amount of VOBA and maximize the amount of goodwill.

Prior accounting standards have provided little guidance on measurement criteria for IIAs like VOBA. This has resulted in a variety of methods being used over time to calculate VOBA and inconsistency in the quality and comparability of results. The proposed Standard, as it currently stands, remains silent on measurement criteria. As a result, accounting arbitrage in life insurance company acquisitions will likely continue and may increase, because goodwill will no longer be amortized. The Academy strongly encourages the FASB to provide definitive guidance for measuring IIAs like the VOBA asset, either in this proposed Standard or in a subsequent abstract of the Emerging Issues Task Force. We would be pleased to assist in defining appropriate measurement criteria.

IIAs for Property and Liability Companies

Under existing accounting rules, a similar VOBA has generally not been recorded in prior purchase business combinations of property and liability companies because most of their insurance business is considered short-duration in nature. However, a question arises concerning the embedded value in loss reserves reported at the time of acquisition, resulting from the fact that such reserves are generally not discounted for interest. In the past, loss reserves have continued to be reported on an undiscounted basis at purchase. Any resultant margins flow into earnings as the underlying cash flows are realized.

Under the proposed Statement, measurement criteria for identifiable intangible assets (other than goodwill) are specifically defined in paragraph 5. The value inherent in the undiscounted loss reserves satisfies the paragraph 5 criteria. However, it is not clear whether the proposed Statement would call for reporting such loss reserves on a fair value basis or on an undiscounted basis, consistent with prior reporting. Clarification and guidance is needed. As with the VOBA asset for life insurance companies, if these values become amortizable IIAs in the future, guidance will be needed on measurement criteria.

An additional issue regarding IIAs exists for property/liability insurance companies. Under the criteria for identifiable intangible assets provided in paragraph 5, it is possible that the customer lists associated with acquiring a property/liability company may qualify as an IIA, further reducing the amount of non-amortizing goodwill. Transactions involving solely these customer lists have occurred in the past. Valuation of such lists (and the associated relationship) may be done using discounted future cash flows, resulting from future renewals of business in force at the date of acquisition. Uncertainty in this area may cause inconsistent accounting and may lead to a need for further guidance.

3. IMPAIRMENT TESTING ISSUES

Impairment testing of goodwill involves fair value determination of the recognized net assets of each affected reporting unit. We generally agree with the FASB's conclusion that subtracting the fair value of the reporting unit's net assets (excluding goodwill) from the fair value of the reporting unit, results in an impairment test that strikes an appropriate balance between costs and benefits. However, we do not believe that the proposed impairment test is operational for insurance companies. The difficulties we see could permit a number of accounting arbitrage opportunities that may distort financial results in certain situations.

As stated in Section 1, the initial allocation of goodwill to the various reporting units will likely be arbitrary and may be heavily influenced by the acquiring entity's ability to leverage the internally generated goodwill of its businesses by combining them with acquired reporting units. Often it is very difficult to identify and estimate the fair value of the "going concern" and synergy aspects of a business. Even in pricing a deal, broad approximations are involved.

As stated above, supporting the carrying values of goodwill involves a fair value determination. As acknowledged in paragraph 88, quoted market prices generally will not be available at the reporting unit level of an entity. Thus, in most cases, an expected present value technique (see paragraph 92) will be required. It should be applied in a manner consistent with paragraph 23 of Concepts Statement 7.

The insurance industry includes many business segments whose cash flows can be expected to be significant for an extended period of time (often well over 20 years). As a result, substantial policyholder liabilities can accrue. At the present time, the industry lacks an accepted definition of the fair values mentioned in the impairment test. Several aspects of the expected present value approach described by Concepts Statement 7 are being investigated by various professional groups, including actuaries in the U.S. and internationally, in an effort to reach agreement on an appropriate definition of the fair value of liabilities. We are confident that a satisfactory conclusion will be reached, but the industry is not at that point today.

We ask that the proposed Statement acknowledge the current uncertainty that exists regarding fair value measurement techniques and provide for an alternative transitional methodology until such time that a consensus on the fair measurement of liabilities can be reached.

Since the measurement methods are not yet fully defined, we question whether goodwill impairment testing will be refined enough to cause timely (and perhaps frequent) reductions in goodwill, reflecting the events or circumstances outlined in paragraph 18. The result could be that the recognition of impairment is taken only when the need is overwhelmingly obvious. In this situation, the write-down of goodwill may be sudden and large.

Finally, paragraph 93 indicates that the FASB recognizes there will be exceptions to the use of fair value measurement for certain assets and liabilities acquired in a business combination. Explicit reference is made to deferred taxes and to APB 16 requirements. Historically, decisions about the fair value of policyholder liabilities and the VOBA asset in life insurance company acquisitions have been heavily influenced by Statements 60 and 97, accounting standards that are specific to the life insurance industry. Many of these decisions also comprise exceptions to the fair value measurement approach anticipated by the proposed Statement. We believe that additional clarification is needed to determine if the guidance of Statements 60 and 97 will continue to apply or if the guidance of the proposed Statement will apply, when testing goodwill for impairment.

4. REQUIREMENTS FOR BENCHMARK ASSESSMENTS

Insurance companies may define “reporting units” within a segment by production channel (e.g., direct versus agent), market segment (e.g., personal versus commercial, large risk versus middle market) and/or line of business (e.g., aviation versus marine, traditional life versus variable products). Under the provisions of the proposed Statement, this is the level that goodwill impairment testing will have to be performed. However, we have reservations about the ability of insurance companies to confidently and objectively measure goodwill at this level, particularly property and liability insurance companies.

Many companies do not (and probably cannot without substantial burden) maintain complete financial information at a reporting unit level. As a result, it may be difficult for many companies to allocate goodwill (and other items needed for determining the fair value of net assets) at the reporting unit level. Also, reporting units often share resources (e.g., claims adjusting), where allocation to a given reporting unit may not be meaningful or practical. Compliance with the proposed Statement will require the accumulation of a complete set of financial information at the reporting unit level, as well as an allocation of various shared resources. Such financial information and resource allocations will require significant subjectivity and judgment, likely limiting the reliability of the resulting assessment.

5. TRANSITIONAL BENCHMARK ASSESSMENTS

It is not clear from the guidance in paragraph 131 how a company is to perform a transitional benchmark assessment, with an allocation of remaining existing goodwill. Must management reassemble original facts about the acquisition or can they use current information? Undoubtedly many companies will no longer have the information necessary regarding how the deal was priced and what the goodwill was intended to support. However, if companies are able to use current facts, they may be able to avoid an impairment situation by the way they define reporting units and allocate the remaining goodwill. We encourage additional guidance on this topic.

6. NEGATIVE GOODWILL

It is possible to acquire an entity with one or more reporting units that have negative goodwill (before a reallocation thereof), because the acquiring entity is willing to pay more than they are worth just to be able to acquire other reporting units offering significant advantages (e.g., synergies, etc.). In such cases, can the acquiring entity assign negative goodwill to some units and positive goodwill to others? If not, is the implication that the less successful units would be assigned zero goodwill?

7. REORGANIZATION

Paragraph 14 indicates that a benchmark assessment is also required in the case of reorganization. Will companies be able to reallocate goodwill from prior acquisitions, if the reporting units contributing to such goodwill are involved in the reorganization? If so, would such reallocation be based solely on current facts or will aspects of the prior organizational structure carry over? Use of current facts may only encourage companies to reorganize in an effort to avoid an impending goodwill write-off or to cause an intentional write-off. The Academy believes some additional clarification and guidance is needed.

8. DISCLOSURE

The proposed Statement does not require the acquiring company to disclose in summary format the methods, models and non-proprietary assumptions underlying an impairment test in the financial statements. We believe that this information would be valuable to investors and investment analysts. Required disclosures should probably also include justification for the selection of a given method, whether it has been used consistently and, if not, why a change was justified.

We appreciate this opportunity to comment on this exposure draft. Please contact Steve English at the American Academy of Actuaries (202-785-7880 or english@actuary.org) if you would like us to clarify any of the points made in this letter.

Sincerely,

/S/ Daniel J. Kunesh

Daniel J. Kunesh
Chairperson, COLIFR

/S/ Patricia A. Teufel

Patricia A. Teufel
Chairperson, COPFLR