Statutory Issue Paper No. 68

Business Combinations and Goodwill

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 68

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory accounting guidance and GAAP differ in accounting for business combinations. Current statutory guidance requires that an investment in a subsidiary, controlled or affiliated entity (SCA) be recorded at historical net asset value of the entity acquired (statutory book value for acquired entities). The difference between the value of the consideration given and the statutory net asset value is considered to be goodwill and under current statutory guidance may be recorded as an admitted asset, subject to certain limitations. Amortization of goodwill is limited to 10 years. However, individual state insurance laws and regulations vary with respect to requirements for the treatment of goodwill. Currently some states allow the admission of goodwill within the limits imposed by the *Purposes and Procedures Manual of the NAIC Securities Valuation Office* (SVO Purposes and Procedures), other states require goodwill to be nonadmitted.

2. Current statutory guidance does not specifically address the accounting for mergers, other than to require restatement of prior years for the effect of mergers. Current statutory practice is to account for mergers by combining or carrying forward the existing statutory amounts of assets, liabilities and related surplus accounts.

3. Under GAAP, business combinations are accounted for using either the pooling of interests method or the purchase method. GAAP has certain prerequisites which must be met for the pooling of interests method to be applied. This method accounts for a business combination as the uniting of the ownership interests of two or more companies by exchange of equity securities. No acquisition is recognized because the combination is accomplished without disbursing resources of the constituents. Therefore, the recorded assets and liabilities of the entities are carried forward at their historical amounts, and the income and expenses of the constituents for the prior periods are combined and retroactively restated.

4. Under GAAP, the purchase method of accounting is applied for business combinations which are not considered poolings of interests. Under the purchase method, the acquiring entity records the assets acquired and liabilities assumed at fair value. The difference between the cost of an acquired entity and the sum of the fair values of tangible and identifiable intangible assets (e.g., present value of future profits of a life entity) less the fair value of liabilities is recorded as goodwill. Amortization of goodwill is over the periods in which the acquiring entity benefits economically, not to exceed 40 years.

5. The purpose of this issue paper is to establish statutory accounting principles for business combinations that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts). It addresses:

- Accounting for purchases of Subsidiary, Controlled and Affiliated (SCA) investments (defined in *Issue Paper No. 46—Accounting for Investments in Subsidiary, Controlled and Affiliated Entities* (Issue Paper No. 46)),

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- Accounting for purchases of partnerships, joint ventures and limited liability companies (defined in *Issue Paper No. 48—Investments in Joint Ventures, Partnerships and Limited Liability Companies*),
- Accounting for goodwill and
- Accounting for mergers.

SUMMARY CONCLUSION

Business Combinations

6. A business combination shall be accounted for as either a statutory purchase or a statutory merger. Business combinations that create a parent, subsidiary relationship shall be accounted for as a statutory purchase. Business combinations where equity of one entity is issued in exchange for the equity of another entity, which is then canceled, and prospectively only one entity exists, shall be accounted for as a statutory merger.

Statutory Purchases of SCA Investments

7. The statutory purchase method of accounting is defined as accounting for a business combination as the acquisition of one entity by another. It shall be used for all purchases of SCA entities including partnerships, joint ventures and limited liability companies. The acquiring reporting entity shall record its investment at cost. Cost is defined as the sum of a) any cash payment, b) the fair value of other assets distributed, c) the fair value of any liabilities assumed and d) any direct costs of the acquisition. Goodwill is defined as the difference between the cost of acquiring the entity and the reporting entity's share of the book value of the acquired entity. When the cost of the acquired entity is greater than the reporting entity's share of the book value, positive goodwill exists. When the cost of the acquired entity is less than the reporting entity's share of the book value, negative goodwill exists. Goodwill resulting from assumption reinsurance shall be recorded as a separate write-in for other-than-invested assets. All other goodwill shall be reported in the carrying value of the investment. A business combination accounted for under the statutory purchase method and in which the acquired entity is valued in accordance with paragraph 7.b.iii. of Issue Paper No. 46 shall determine the amount of positive goodwill or negative goodwill created by the combination using the reporting entity's share of the GAAP net book value of the acquired entity. Business combinations accounted for under the statutory purchase method and in which the acquired entity is valued in accordance with paragraph 7.b.i. or 7.b.ii. of Issue Paper No. 46 shall determine the amount of positive or negative goodwill created by the business combination using the reporting entity's share of the statutory book value of the acquired entity.

8. Under the statutory purchase method the historical bases of the acquired entity shall continue to be used in preparing its statutory financial statements except in those instances provided for in paragraph 8b. of Issue Paper No. 46. Therefore, pushdown accounting is not permitted.

Positive Goodwill and Negative Goodwill

9. Positive goodwill recorded under the statutory purchase method of accounting shall be admitted subject to the following limitation: Positive goodwill from all sources, including life, accident and health, and deposit-type assumption reinsurance, is limited in the aggregate to 10% of the parent reporting entity's capital and surplus as required to be shown on the statutory balance sheet of the reporting entity for its most recently filed statement with the domiciliary state commissioner adjusted to exclude any net positive goodwill, EDP equipment and operating system software, and net deferred tax assets. When negative goodwill exists it shall be recorded as a contra-asset. Positive or negative goodwill resulting from the purchase of a SCA shall be amortized to unrealized capital gains and losses on investments over the period in which the acquiring entity benefits economically, not to exceed 10 years. Positive or negative goodwill resulting from life, accident and health, and deposit-type assumption reinsurance shall be amortized to operations as a component of general insurance expenses over the period in which the assuming entity benefits economically, not to exceed 10 years. Goodwill shall be evaluated separately for each transaction.

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Statutory Mergers

10. The statutory merger method of accounting is defined as accounting for a business combination in which the original investors in the investee receive equity of the reporting entity for their interest in the investee and only one entity survives. It shall be used for all business combinations accomplished by 1) issuing equity of a newly formed entity for the equity of the merging entities, 2) one entity issuing equity in exchange for the equity of another entity and immediately canceling the equity of that entity, or 3) the exchange of membership interest. Under the statutory merger method, no acquisition shall be recognized because the combination is accomplished without disbursing resources of the constituents. Ownership interest continues and the former statutory bases of accounting shall be retained. However, if one of the merged entities did not employ the statutory basis of accounting, the accounts shall be adjusted to the statutory bases with an offsetting adjustment to beginning surplus of the earliest period presented. The recorded assets, liabilities and related surplus accounts of the constituents shall be carried forward to the combined corporation at their recorded statutory amounts. The capital accounts of the entities shall be adjusted as necessary to reflect the appropriate par values of the capital stock of the new entity. Adjustments to the capital stock account shall be made to gross paid-in and contributed surplus, to the extent there is a balance in the account. Income of the combined entity shall include income of the constituents for the entire fiscal period in which the combination occurs and the balance sheet and the statement of operations for the two years presented shall be restated, as required by *Issue Paper No. 3—Accounting Changes*. Goodwill on the historical books of any merged entity that arose from a previous business combination involving the merged companies shall be charged or credited to surplus immediately.

Impairment

11. For any decline in the fair value of an entity, acquired through a purchase that is other than temporary, the investment shall be written down to fair value as the new cost basis and the amount of the write down shall be accounted for as a realized loss. The write down shall first be considered as an adjustment to any portion of the investment that is nonadmitted (e.g., nonadmitted goodwill). The new cost basis shall not be changed for subsequent recoveries in fair value. Future declines in fair value, which are determined to be other than temporary, shall be recorded as realized losses. This is consistent with *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of* Assets (Issue Paper No. 5). An impairment shall be considered to have occurred if it is probable that the reporting entity will be unable to recover the carrying amount of the investment or there is evidence indicating inability of the investee to sustain earnings which would justify the carrying amount of the investment. A fair value of an investment that is below the carrying amount based on the statutory equity method or the existence of investee operating losses may indicate a loss in value, however, they are not necessarily indicative of a loss in value that is other than temporary.

Disclosures

12. For business combinations accounted for under the statutory purchase method the financial statements shall disclose the following for as long as unamortized goodwill is reported as a component of the investment:

a. The name and brief description of the acquired entity;

b. Method of accounting, that is the statutory purchase method;

c. Cost of the acquired entity and the amount of goodwill; and

d. The amount of amortization of goodwill recorded for the period.

13. For business combinations taking the form of a statutory merger the financial statements shall disclose:

a. The names and brief description of the combined entities;

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b. Method of accounting, that is the statutory merger method;

c. Description of the shares of stock issued in the transaction;

d. Details of the results of operations of the previously separate companies for the period before the combination is consummated that are included in the current combined net income, including revenue, net income, and other changes in surplus; and

e. A description of any adjustments recorded directly to surplus for any entity that previously did not prepare statutory statements.

14. The financial statements shall disclose the following information regarding goodwill resulting from assumption reinsurance:

a. The name of the ceding entity;

b. The type of business assumed;

c. The cost of the acquired business and the amount of goodwill; and

d. The amount of amortization of goodwill recorded for the period.

15. A reporting entity that recognizes an impairment loss shall disclose the following in the financial statements that include the period of the impairment write-down:

a. A description of the impaired assets and the facts and circumstances leading to the impairment; and

b. The amount of the impairment charged to realized capital gains and losses and how fair value was determined.

DISCUSSION

16. The statutory accounting principles described above reject *Accounting Principles Board Opinion No. 16*, *Business Combinations* (APB 16) and related interpretive pronouncements, *FASB Statement No. 38, Accounting for Preacquisition Contingencies of Purchased Enterprises, an amendment of APB Opinion No. 16* (FAS 38), and *Accounting Principles Board Opinion No. 17*, *Intangible Assets*, (APB 17) and related interpretive pronouncements by limiting the admitted value of an acquired entity. *FASB Statement No. 79*, *Elimination of Certain Disclosures for Business Combinations by Nonpublic Enterprises* (FAS 79) is rejected in this issue paper as the disclosures required by paragraphs 12 and 13 of this issue paper are the same for public and non-public entities. Interpretive literature that is rejected in this issue paper is included in the Relevant GAAP Literature section. This issue paper adopts *FASB Emerging Issues Task Force Issue No. 95-19*, *Determination of the Measurement Date for the Market Price of Securities Issued in a Purchase Business Combination.*

17. Paragraph 8 of this issue paper requires that the historical bases of an acquired entity be carried forward and therefore the allocation of the purchase price is not “pushed-down.” Under GAAP, “push-down” accounting is not specifically promulgated but is suggested as appropriate by the SEC in certain circumstances as described in paragraph 30 below. Push-down accounting is often followed where the investor acquires 90% or more of the ownership interest in the investee. The statutory accounting principles described above reject push-down accounting. Current statutory guidance does not address “push-down” accounting.

18. The conclusions reached in this issue paper with respect to impairment are consistent with paragraph 12 of *FASB Statement No. 121*, *Accounting for the Impairment of Long-Lived Assets and for*

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Long-Lived Assets to be Disposed Of (FAS 121) to the extent that it addresses impairment of goodwill. Paragraph 12 is therefore adopted. Paragraph 13 of FAS 121 is rejected as it addresses the distinction between continuous operations and discontinued operations. The concept of discontinued operations was rejected in *Issue Paper No. 24—Discontinued Operations and Extraordinary Items*. Paragraph 14 addresses disclosure requirements for impairments. Subparagraphs 14.a. and 14.b. are adopted. Subparagraph 14.c. is rejected as specific statutory reporting requirements have been addressed in the issue paper. Subparagraph 14.d. is rejected as it refers to business segments. FAS 121 is also addressed in *Issue Paper No. 40—Real Estate Investments*.

19. The statutory accounting principles described in the conclusion above are consistent with the current statutory guidance except as follows:

a. Current statutory guidance requires goodwill in excess of 10% of a reporting entity's statutory capital and surplus to be written off immediately as a direct charge to surplus. The statutory accounting principles above require all unamortized goodwill to be recorded as an asset and any amount in excess of 10% of statutory capital and surplus to be nonadmitted.

b. Current statutory guidance does not specifically address accounting for mergers.

c. Current statutory accounting does not address disclosure of impairments.

20. This change to current statutory referred to in subparagraph 19.a. of this issue paper was made in order to recognize that although regulatory limitations are placed on the admissibility of goodwill, it does represent an asset. Placing limitations on goodwill recognizes that in order to liquidate an investment where the insurer is a significant shareholder, full value of such investment may not be realized.

21. The statutory accounting principles outlined in the conclusion above are consistent with the conservatism and recognition concepts in the Statement of Concepts. Under the statutory purchase method described above, the historical bases of the acquired entity are used to value the investment. Goodwill attributable to an acquired entity is recorded as an asset, and treated as an admitted asset to the extent that, when added to existing recorded goodwill, it does not exceed 10% of the acquiring entity's capital and surplus. Admitting a portion of the goodwill recognizes that the acquired entity may be sold for fair value (which may include goodwill) to meet and fund policyholder obligations. This is consistent with *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*. Pertinent excerpts from the Statement of Concepts follow:

> Conservatism
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> Conservative valuation procedures provide protection to policyholders against adverse fluctuations in financial condition or operating results. Statutory accounting should be reasonably conservative over the span of economic cycles and in recognition of the primary responsibility to regulate for financial solvency. Valuation procedures should, to the extent possible, prevent sharp fluctuations in surplus.
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> Recognition
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> The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which may be unavailable due to encumbrances or other third party interests should not be recognized on the balance sheet but rather should be charged against surplus when acquired or when availability otherwise becomes questionable.

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Revenue should be recognized only as the earnings process of the underlying underwriting or investment business is completed. Accounting treatments which tend to defer expense recognition do not generally represent acceptable SAP treatment.

Drafting Notes/Comments

- Accounting for investments in SCAs after acquisition is addressed in Issue Paper No. 46 - Accounting for Investments in Subsidiary, Controlled and Affiliated Entities.
- Assumption reinsurance is addressed in *Issue Paper No. 74—Life, Deposit-Type and Accident and Health Reinsurance.*

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

22. The *Purposes and Procedures Manual of the NAIC Securities Valuation Office*, Section 5. Procedures for Valuing Common Stocks and Stock Warrants provides the following guidance on valuation of acquired entities and goodwill under Section (B) Common Stocks of Subsidiary, Controlled or Affiliated Companies:

(a) Subject to the requirements of Section 5 (B) (b), shares of common stock of an insurance or non-insurance company owned by an insurer, which insurer is either the parent of, or under direct or indirect common control, or affiliated with the issuer of such stock, shall have an Association Value determined on the basis of one of the following bases, provided, however, that such basis and the resultant value are reasonable and appropriate in the circumstances, and provided further that an insurer shall not be required to value the common stock of all its subsidiary, controlled and affiliated companies on the same basis. All of the following valuation bases shall be subject to an adjustment for any reciprocal shareholdings as required by Section 5 (B) (b) (x).

(i) the value of only such of the assets of such company as would constitute lawful investments for the insurer if acquired or held directly by the insurer; or

(ii) subject to the limitations imposed herein and under Section 5 (B) (b) (ix), hereunder, the shares of a non-insurance company may be valued on the basis of the net worth of such company determined in accordance with generally accepted accounting principles, as of the end of its most recent fiscal year, provided, subject to (b) hereof, that the financial statements of the company for its most recent fiscal year have been audited by an independent certified public accountant in accordance with generally accepted auditing standards (the common stock of an insurance company may not be valued under this section); or

(If the common stock of a subsidiary, controlled or affiliated company is valued on the basis of generally accepted accounting principles in accordance with the provisions of this section, such value shall be adjusted to reflect the equity in net assets on a statutory basis with respect to the shares of any underlying insurance company subsidiaries and to reflect the market value appropriately discounted for any underlying company valued using option 5 (B) (a) (v)); or

(iii) book value, defined as in Section 5 (A) (c), provided, however, that the common stock of a non-insurance company may not be valued on the basis of this subsection (iii); or

(iv) subject to the limitations imposed under Section 5 (B) (b) (ix), hereunder, a value equal to the cost of the common stock of such company, provided such value is determined and adjusted to reflect subsequent operating results (1) in the case of insurance companies in accordance with statutory accounting requirements, and (2) for other than insurance companies from an independent certified public

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accountant audited financial statement prepared in accordance with generally accepted accounting principles; or

(If the common stock of a subsidiary, controlled, or affiliated company is valued on the basis of generally accepted accounting principles in accordance with the provisions of this section the adjustment "to reflect subsequent operating results" shall include net changes in all the capital and surplus accounts on a statutory basis with respect to the shares of any underlying insurance company subsidiaries); or

(v) the market value of the common stock of the company, if the stock is listed on a national securities exchange or entered in the NASDAQ System (other securities traded over-the-counter will not be considered under this section); The share price will be discounted for legal restrictions requiring a registration before any sale may be made and the size and depth of the trading activity in relation to the publicly traded shares outstanding; or

(vi) See Section 3 (C) (2) for valuation of preferred stocks of wholly-owned subsidiaries of insurance companies.

(vii) In applying the provisions of this section to insurers organized in foreign countries, the provisions of Subsection (i) of this section will be applied (based on financial statements for the most recent fiscal year as prepared by an independent certified public accountant), except where special considerations indicate other treatment would be appropriate; or

(viii) any other value that the insurer can substantiate to the satisfaction of the SVO staff as being a reasonable value.

(b) (i) The provisions of Section 5 (B) shall in all cases be subject to the procedures prescribed by state insurance department practices or laws concerning the use of acquisition cost or any other basis for the valuation of common stocks of subsidiary, controlled or affiliated companies.

(ii) Not later than April 1 of each year, every insurer shall file with the SVO staff, on the appropriate form prescribed by the Valuation of Securities Task Force, (Task Force), relevant information identifying, supporting and justifying the value of, and the basis of valuation used in accordance with the provisions of Section 5(B)(a) for each of its subsidiary, controlled or affiliated companies reported upon in the Annual Statement for the preceding year.

(iii) Within thirty (30) days after the acquisition or formation of a subsidiary, controlled or affiliated company, every insurer shall file with the SVO staff, on the appropriated form prescribed by the Task Force, relevant information identifying, supporting and justifying the value of, and the basis of valuation used in accordance with the provisions of Section 5(B)(a) for such company.

(iv) A valuation basis used for a subsidiary, controlled or affiliated company shall thereafter be consistently applied unless a change is substantiated as reasonable and on that basis is approved in writing by the SVO staff.

(v) If a subsidiary, controlled or affiliated company is valued on the basis of Section 5 (B) (a) (ii) and its books are not audited at the time the valuation is included in the insurer's annual statement, the insurer shall thereafter report to the SVO staff and explain the difference, if any, between the value of such company as reported in the annual statement and the value as determined by audit. Such report and explanation shall be made as soon as possible following such audit.

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(vi) If the common stock of any subsidiary, controlled or affiliated company is valued other than on the basis of market value as defined in Section 5 (B) (a) (v), there shall be deducted from the otherwise determined value a sum equal to the value claimed for any of its assets that would not constitute admitted assets for the insurer if held directly by the insurer, if such assets

(1) are held by the company but used, under a lease arrangement or otherwise, significantly in the conduct of the insurer's business; or

(2) were acquired from or purchased for the benefit or use of the insurer by the company under circumstances that, in the opinion of the SVO staff, support a finding that the primary purpose of such acquisition was the evasion or avoidance of state laws or regulations pertaining to non-admitted assets.

(vii) The SVO staff may require filings to be by the use of such forms as it prescribes and may requests such supplemental information as it deems desirable. The SVO staff shall utilize the information in such filings and supplemental information to make its determination as to the reasonableness and appropriateness of the valuation basis and the resultant value and shall notify the insurer and its state of domicile of such determination.

(viii) In making its determination as to the reasonableness and appropriateness of the valuation basis and the resultant value for each subsidiary, controlled or affiliated company, the SVO staff shall, among other relevant factors, take into account the following:

(1) the effect of subsidiary valuation on the solvency of the insurer (it being the intent hereof that doubt as to reasonableness shall be resolved by selection of a conservative valuation standard in those circumstances where the higher valuation would make an otherwise insolvent insurer appear solvent);

(2) if the valuation involves acquisition cost, the degree of affiliation between the insurer and the party from whom such company was acquired, the form of the consideration (cash, property, or the exchange of stock), evidence of ability to recover cost, and whether the acquisition price represented the result of arms-length dealing between economic equals; and,

(3) whether revaluation of assets is involved, and the reasonableness thereof.

(ix) With respect to values determined under Sections 5 (B) (a) (ii) and 5 (B) (a) (iv), amounts attributable to goodwill, as defined in (a) hereunder, and other intangibles shall not, except as provided in (b), hereunder, in the aggregate (of all direct and indirect subsidiaries), exceed, (either initially upon the acquisition of a subsidiary, or thereafter), 10% of the capital and surplus of an insurer, as reported in its next preceding Annual Statement. Such amounts shall, except as provided in (c) and (d), hereunder, be written off over a period not in excess of 10 years, commencing in all cases with the accounting period ending December 31, 1972. (For instructions as to the manner of write-off in certain cases, see (e) and (f), hereunder.)

(a) For the purposes of this section, "goodwill" shall be defined as the amount arising at a given point in time, resulting from an arms-length transaction involving the transfer of a business, representing the difference between the value of the consideration given and the net

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asset value of the properties acquired on the books of the predecessor company. With respect to insurance company subsidiaries "net asset value" shall mean statutory or annual statement book value. In addition any asset account representing the present value of future contractual or estimated revenue streams will also be deemed goodwill and subject to the limitations of this section.

(b) The limitation with respect to the permissible amount of goodwill shall not apply in the cases of subsidiaries acquired or under contract to be acquired on or prior to June 14, 1972.

(c) The write-off period for goodwill in the cases of subsidiaries described in (b), above, may, upon application to and approval by the Securities Valuation Office, be extended to not in excess of 20 years.

(d) Where warranted in exceptional cases, the Securities Valuation Office may require a more rapid write-off of goodwill than is otherwise provided in this section.

(e) In the cases of subsidiaries acquired or under contract to be acquired on or prior to June 14, 1972, an insurer may charge the write-off of goodwill to the common stock component of the Asset Valuation Reserve, where such a reserve exists.

(f) In the cases of subsidiaries acquired after June 14, 1972, amounts of goodwill in excess of 10% of an insurer's capital and surplus shall be written off immediately by a direct charge to surplus.

23. NAIC Annual Statement Instructions provide the following guidance on the restatement of prior year financial information presented after a merger occurs:

> Except in situations where a merger has occurred, amounts reported for assets, liabilities, surplus, revenues, and expenses for prior years in the current year's annual statement shall be identical to the amounts that were reported in the annual statement of the prior year. However, amounts reported in prior years may need to be adjusted in the current year as a result of the following:
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> Changes in accounting principles or practices or changes in the methods of applying accounting principles or practices.
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> Changes in accounting estimates as a result of new events or new information.
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> Corrections of errors in previously filed information.
>
> A merger.
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> If changes are required for amounts reported in prior years, such changes should be included in the amounts reported for the current year and the effects of such changes should be reported as follows, unless these instructions or the NAIC Accounting Practices and Procedures manual for Life and Health specifically provide for a different treatment:
>
> (1) The cumulative effect of a change in accounting principles or practices or a change in the method of applying accounting principles or practices should be reported with an appropriate identifying title as a write-in item for gains and losses in surplus (Page 4, Line 46). The cumulative effect of changing to a new accounting principle is the difference between the amount of capital and surplus at the beginning of the year and the amount of capital and surplus that would have been reported at that date if the new accounting principle had been applied retroactively for all prior periods. An example of a

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change in accounting principles would be a change in the method of accounting for pensions or other post-employment benefits.

(2) The effects of changes in accounting estimates are included in income and expenses in the Summary of Operations for the current year. For example, a change in estimate for reserves for accident and health claims related to prior years should be included in the Summary of Operations in disability benefits and benefits under accident and health policies (Page 4, Line 11) for the current year.

(3) The effects of changes resulting from corrections of errors in previously filed information (for example, mathematical mistakes, misapplication of accounting principles, or oversight or misuse of facts) should be reported as an adjustment to surplus in the current year. Such adjustments to surplus should be reported with an appropriate identifying title as a write-in item for gains and losses in surplus (Page 4, Line 46).

(4) In the case of a merger, prior year's amounts reported for assets, liabilities, surplus, revenues and expenses, as well as those amounts reflected in supporting Annual Statement schedules, should be reported on a merged basis consistent with the current year's post-merger reporting basis. A footnote should be inserted on each page of the Annual Statement which contains such merged amounts clearly detailing the circumstances.

24. Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force Issue No. 94-1 and 94-2 provide the following guidance:

The working has been asked to consider whether it is acceptable statutory accounting practice for an insurer to continue to carry an asset for the unamortized goodwill arising from the acquisition of another insurer after the acquired insurer has been merged into the acquiring insurer (former parent)

After considerable discussion, the working group reached a preliminary consensus that continuing to carry unamortized goodwill under such circumstances was not appropriate for statutory purpose and that the unamortized goodwill should have been charged to surplus at the time the acquired insurer was merged with the parent.

After further discussion, the working group agreed to reaffirm the preliminary decision reached in March. In addition, they concluded that the issue of goodwill in general should be referred to the Codification of Statutory Accounting Principles Working Groups for the review of the appropriateness of goodwill for statutory purposes.

25. Individual state insurance laws and regulations vary with respect to requirements for the treatment of goodwill. Many states require goodwill to be nonadmitted. Certain states do allow the admission of goodwill but impose stringent limitations on the amount of goodwill that is considered an admitted asset.

Generally Accepted Accounting Principles

26. GAAP for business combinations is contained in APB 16 which was rejected in its entirety in this issue paper. Rather than repeat APB 16 in the Relevant GAAP Literature Section of this paper a summary of GAAP for Business Combinations from The Current Text - Section B50 - Business Combinations is provided.

BUSINESS COMBINATIONS SECTION B50

Sources: ARB 43, Chapter 1A; ARB 51; APB Opinion 16;
AICPA Interpretations of APB Opinion 16; FASB Statement 10;
FASB Statement 38; FASB Statement 72; FASB Statement 79;
FASB Statement 87; FASB Statement 106; FASB Statement 109;

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FASB Statement 111; FASB Statement 121; FASB Interpretation 4;
FASB Interpretation 9; FASB Technical Bulletin 85-5

B50 Summary

A business combination occurs when a corporation and one or more incorporated or unincorporated businesses are brought together into one accounting entity. The single entity carries on the activities of the previously separate, independent enterprises. The purchase method and the pooling-of-interests method are both acceptable in accounting for business combinations, although not as alternatives in accounting for the same business combination. This section provides that a business combination shall be accounted for as a pooling of interests if it meets certain specified criteria. Business combinations that do not meet all of the specified criteria shall be accounted for as purchases.

The criteria for the pooling method relate to the attributes of the combining enterprises before the combination, the manner of combining the enterprises, and the absence of certain planned transactions after the combination. The pooling-of-interests method accounts for a business combination as the uniting of the ownership interests of two or more companies by exchange of equity securities. No acquisition is recognized because the combination is accomplished without disbursing resources of the constituents. Ownership interests continue and the former bases of accounting shall be retained. The recorded assets and liabilities of the constituents shall be carried forward to the combined corporation at their recorded amounts. Income of the combined corporation shall include income of the constituents for the entire fiscal period in which the combination occurs. The reported income of the constituents for prior periods shall be combined and restated as income of the combined corporation.

The purchase method accounts for a business combination as the acquisition of one enterprise by another. The acquiring corporation shall record at its cost the acquired assets less liabilities assumed. A difference between the cost of an acquired enterprise and the sum of the fair values of tangible and identifiable intangible assets less liabilities assumed shall be recorded as goodwill. The reported income of an acquiring corporation shall include the operations of the acquired enterprise after acquisition, based on the cost to the acquiring corporation.

27. *Accounting Principles Board Opinion No. 17*, *Intangible Assets* (APB 17), addresses goodwill and amortization of intangible assets. APB 17 specifies that the amortization period should not exceed 40 years and the straight line method is appropriate unless a company demonstrates that another method is more appropriate. APB 17 also requires companies to perform a subsequent review of amortization to determine if changes should be made in the amortization period:

SUMMARY

1. An enterprise may acquire intangible assets from others or may develop them itself. Many kinds of intangible assets may be identified and given reasonably descriptive names, for example, patents, franchises, trademarks, and the like. Other types of intangible assets lack specific identifiability. Both identifiable and unidentifiable assets may be developed internally. Identifiable intangible assets may be acquired singly, as a part of a group of assets, or as part of an entire enterprise, but unidentifiable assets cannot be acquired singly. The excess of the cost of an acquired company over the sum of identifiable net assets, usually called goodwill, is the most common unidentifiable intangible asset.

2. Accounting for an intangible asset involves the same kinds of problems as accounting for other long-lived assets, namely, determining an initial carrying amount, accounting for that amount after acquisition under normal business conditions (amortization), and accounting for that amount if the value declines substantially and permanently. Solving the problems is complicated by the characteristics of an intangible asset: its lack of physical qualities makes evidence of its existence elusive, its value is often difficult to estimate, and its useful life may be indeterminable.

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Conclusions

9. The Board concludes that a company should record as assets the costs of intangible assets acquired from others, including goodwill acquired in a business combination. A company should record as expenses the costs to develop intangible assets which are not specifically identifiable. The Board also concludes that the cost of each type of intangible asset should be amortized by systematic charges to income over the period estimated to be benefited. The period of amortization should not, however, exceed forty years.

28. *FASB Statement No. 38, Accounting for Preacquisition Contingencies of Purchased Enterprise an amendment of APB Opinion No. 16* (FAS 38), deals with preacquisition contingencies. Amounts that can be reasonably estimated that are considered probable are recorded as a part of the allocation of the purchase price. Subsequent adjustments are included in net income when the adjustments are determined except in limited circumstances.

Summary

This Statement specifies how an acquiring enterprise should account for contingencies of an acquired enterprise that were in existence at the purchase date and for subsequent adjustments that result from those contingencies. Amounts that can be reasonably estimated for contingencies that are considered probable are recorded as a part of the allocation of the purchase price. Subsequent adjustments are included in net income when the adjustments are determined except in limited circumstances described in this Statement.

29. *FASB Statement No. 79*, *Elimination of Certain Disclosures for Business Combinations by Nonpublic Enterprises* (FAS 79), amends APB 16 to eliminate the requirement for nonpublic enterprises to disclose pro forma results of operations for business combinations accounted for by the purchase method:

INTRODUCTION

1. The FASB has undertaken research on financial reporting by private and small public companies to obtain information about the practices and views of managers, financial statement users, and public accountants involved with those companies.[1] A number of participants in those research efforts stated that the requirement to disclose pro forma results of operations for business combinations accounted for by the purchase method was unnecessary and too costly for private companies.

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[1] Refer to (a) FASB Invitation to Comment, Financial Reporting by Private and Small Public Companies, 1981; (b) FASB Special Report, Financial Reporting by Privately Owned Companies: Summary of Responses to FASB Invitation to Comment, 1983; and (c) FASB Research Report, Financial Reporting by Private Companies: Analysis and Diagnosis, prepared by A. Rashad Abdel-Khalik, 1983.

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2. Paragraph 96 of *APB Opinion No. 16, Business Combinations*, requires an acquiring enterprise to disclose the following information in financial statements of the period in which a business combination accounted for by the purchase method occurs:

   a. Results of operations for the current period as though the enterprises had combined at the beginning of the period, unless the acquisition was at or near the beginning of the period.

   b. Results of operations for the immediately preceding period as though the enterprises had combined at the beginning of that period if comparative financial statements are presented.

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3. The Board has concluded that the disclosures prescribed by paragraph 96 of Opinion 16 should not be required in the financial statements of nonpublic enterprises. The basis for the Board's conclusions is presented in the appendix to this Statement.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

4. Disclosures of pro forma results of operations prescribed in paragraph 96 of Opinion 16 for business combinations accounted for by the purchase method are not required for nonpublic enterprises.

5. For purposes of this Statement, a nonpublic enterprise is an enterprise other than one (a) whose debt or equity securities are traded in a public market, including those traded on a stock exchange or in the over-the-counter market (including securities quoted only locally or regionally), or (b) whose financial statements are filed with a regulatory agency in preparation for the sale of any class of securities.

Amendment to APB Opinion No. 16

6. The following footnote is added to the end of paragraph 96 of Opinion 16:

* The disclosures prescribed by paragraph 96 are not required in the financial statements of nonpublic enterprises as defined by *FASB Statement No. 79, Elimination of Certain Disclosures for Business Combinations by Nonpublic Enterprises*.

Effective Date

7. This Statement shall be effective for financial statements for fiscal years beginning after December 15, 1983. Earlier application is permitted in financial statements that have not previously been issued.

30. GAAP literature is silent on push-down basis of accounting, although it was raised by the FASB in a 1976 Discussion Memorandum on business combinations. The FASB has included the issue of push down in the New Basis Accounting part of its Consolidations and Related Matters project. The SEC staff's views regarding the application of pushdown accounting are discussed Staff Accounting Bulletin Topic 5J. The staff believes that purchase transactions that result in an entity becoming substantially wholly owned, should establish a new basis of accounting for the purchased assets and liabilities which should be reflected in the acquired entity's separate financial statements. In circumstances where outside interest in the form of minority stockholders, or holders of public debt or preferred stock remain, the staff would encourage but generally not insist on the application of pushdown accounting.

31. *FASB Statement No 121*, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of,* provides the following guidance with respect to the impairment of goodwill.

Goodwill

12. If an asset being tested for recoverability was acquired in a business combination accounted for using the purchase method, the goodwill that arose in that transaction shall be included as part of the asset grouping (paragraph 8) in determining recoverability. If some but not all of the assets acquired in that transaction are being tested, goodwill shall be allocated to the assets being tested for recoverability on a pro rata basis using the relative fair values of the long-lived assets and identifiable intangibles acquired at the acquisition date unless there is evidence to suggest that some other method of associating the goodwill with those assets is more appropriate. In instances where goodwill is identified with assets that are subject to an impairment loss, the carrying amount of the identified goodwill shall be eliminated before making any reduction of the carrying amounts of impaired long-lived assets and identifiable intangibles.

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Reporting and Disclosure

13. An impairment loss for assets to be held and used shall be reported as a component of income from continuing operations before income taxes for entities presenting an income statement and in the statement of activities of a not-for-profit organization. Although there is no requirement to report a subtotal such as “income from operations,” entities that present such a subtotal must include the impairment loss in that subtotal.

14. An entity that recognizes an impairment loss shall disclose all of the following in financial statements that include the period of the impairment write-down:

a. A description of the impaired assets and the facts and circumstances leading to the impairment

b. The amount of the impairment loss and how fair value was determined

c. The caption in the income statement or the statement of activities in which the impairment loss is aggregated if that loss has not been presented as a separate caption or reported parenthetically on the face of the statement

d. If applicable, the business segment(s) affected.

32. *FASB Emerging Issues Task Force Issue No. 95-19*, *Determination of the Measurement Date for the Market Price of Securities Issued in a Purchase Business Combination* provides the following guidance.

ISSUE

Opinion 16 appears to include contradictory guidance about the date that should be used to value equity securities issued to effect a business combination accounted for using the purchase method. Paragraph 74 of Opinion 16 states that “the market price for a reasonable period before and after the date the terms of the acquisition are agreed to and announced should be considered in determining the fair value of securities issued.” On the other hand, paragraph 94 of Opinion 16 refers to determining the cost of an acquired company as of the date of acquisition, which is defined in paragraph 93 as, “ordinarily . . . the date assets are received and other assets are given or securities are issued.” This Issue addresses that apparent contradiction.

The interval between initiating and completing a business combination may involve an extended period of time. Although management of the companies involved may agree to and announce the terms of a business combination at the initiation date, internal or external contingencies, such as the need to obtain shareholder or regulatory approvals, may exist and prevent concurrent consummation of the combination. Because of the length of time that may be required to resolve those contingencies, the market price of the securities that are expected to be issued to effect a purchase business combination may fluctuate. As a result, the total cost of the acquired company assigned by the acquirer may vary significantly depending on the date that is used to value the securities that are issued.

The issue is what date should be used to value marketable equity securities issued to effect a business combination accounted for using the purchase method.

EITF DISCUSSION

The Task Force reached a consensus that the value of marketable equity securities issued to effect a purchase business combination should be determined, pursuant to the guidance in paragraph 74 of Opinion 16, based on the market price of the securities over a reasonable period of time before and after the two companies have reached agreement on the purchase price and the proposed transaction is announced. In other words, the date of measurement of the value of the marketable equity securities should not be influenced by the need to obtain shareholder or

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> regulatory approvals. Task Force members observed that the reasonable period of time referred to in paragraph 74 of Opinion 16 is intended to be very short, such as a few days before and after the acquisition is agreed to and announced. Task Force members also observed that in transactions involving a hostile tender offer, the measurement date for the value of the marketable equity securities occurs when the proposed transaction is announced and sufficient shares have been tendered to make the offer binding or when the proposed acquisition becomes nonhostile, as evidenced by the target company's agreement to the purchase price.
>
> The Task Force also reached a consensus that if the purchase price (the number of shares or other consideration) is subsequently changed, a new measurement date for valuing the marketable equity securities that will be issued to effect the combination is established as of the date of the change. Task Force members observed that a change to the purchase price may result from further negotiations or from changes in the market price of the equity securities causing, perhaps pursuant to the initial agreement, a change in the security's exchange ratio or in a cash component of the purchase price.
>
> The Task Force reached a consensus that the consensuses described in this Issue should only be applied prospectively to purchase business combinations consummated after November 16, 1995.

OTHER SOURCES OF INFORMATION

33. The draft discussion material from previous Life codification project provides the following guidance on mergers in the Introduction section under Accounting for Assets Transferred Between Affiliates:

> A merger or consolidation of insurance companies under common control is to be recorded at book value. The combined surplus should not be enhanced or reduced as a result of the restructuring. A bulk reinsurance agreement of all the business where substantially all of the assets and substantially all of the liabilities are transferred in order to create a shell is to be considered a merger or consolidation for purposes of this section.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 6, *Investments in Subsidiaries, Controlled or Affiliated Companies*
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 6, *Investments in Subsidiaries, Controlled or Affiliated Companies*
- *Purposes and Procedures Manual of the NAIC Securities Valuation Office*
- Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force Issue No. 94-1 and 94-2
- *Issue Paper No. 3—Accounting Changes*
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairment of Assets*
- *Issue Paper No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties*
- *Issue Paper No. 46—Accounting for Investments in Subsidiary, Controlled and Affiliated Entities*
- *Issue Paper No. 48—Investments in Joint Ventures, Partnerships and Limited Liability Companies*

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Generally Accepted Accounting Principles

- *FASB Statement No 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*
- *FASB Emerging Issues Task Force Issue No. 95-19, Determination of the Measurement Date for the Market Price of Securities Issued in a Purchase Business Combination*

Rejected Herein

- *Accounting Principles Board Opinion No. 16, Business Combinations*
- *Accounting Principles Board Opinion No. 17, Intangible Assets*
- *FASB Statement No. 38, Accounting for Preacquisition Contingencies of Purchased Enterprises*
- *FASB Statement No. 79, Elimination of Certain Disclosures for Business Combinations by Nonpublic Enterprises*

Related and Interpretive Literature Also Rejected Herein

- *AICPA Accounting Interpretations, Business Combinations: Accounting Interpretations of Accounting Principles Board Opinion No. 16*
- *FASB Statement No. 10, Extension of "Grandfather" Provisions for Business Combinations*
- *AICPA Accounting Interpretations, Intangible Assets: Unofficial Accounting Interpretations of Accounting Principles Board Opinion No. 17*
- *FASB Emerging Issues Task Force No. 85-14, Securities That Can Be Acquired for Cash in a Pooling of Interests*
- *FASB Emerging Issues Task Force No. 86-9, IRC Section 338 and Push-Down Accounting*
- *FASB Emerging Issues Task Force No. 86-10, Pooling with 10 Percent Cash Payout Determined by Lottery*
- *FASB Emerging Issues Task Force No. 87-11, Allocation of Purchase Price to Assets to Be Sold*
- *FASB Emerging Issues Task Force No. 87-15, Effect of a Standstill Agreement on Pooling-of-Interests Accounting*
- *FASB Emerging Issues Task Force No. 87-16, Whether the 90 Percent Test for a Pooling of Interests Is Applied Separately to Each Company or on a Combined Basis*
- *FASB Emerging Issues Task Force Issue No. 87-27, Poolings of Companies that Do Not Have a Controlling Class of Common Stock*
- *FASB Emerging Issues Task Force Issue No. 88-26, Controlling Preferred Stock in a Pooling of Interests*
- *FASB Emerging Issues Task Force Issue No. 88-27, Effect of Unallocated Shares in an Employee Stock Ownership Plan on Accounting for Business Combinations*
- *FASB Emerging Issues Task Force Issue No. 89-7, Exchange of Assets or Interest in a Subsidiary for a Noncontrolling Equity Interest in a New Entity*
- *FASB Emerging Issues Task Force Issue No. 90-5, Exchanges of Ownership Interest between Entities under Common Control*
- *FASB Emerging Issues Task Force No. 90-6, Accounting for Certain Events Not Addressed in Issue No. 87-11 Relating to an Acquired Operating Unit to Be Sold*
- *FASB Emerging Issues Task Force No. 90-12, Allocating Basis to Individual Assets and Liabilities for Transactions within the Scope of Issue No. 88-16*
- *FASB Emerging Issues Task Force No. 90-13, Accounting for Simultaneous Common Control Mergers*
- *FASB Emerging Issues Task Force No. 91-5, Nonmonetary Exchange of Cost-Method Investments*
- *FASB Emerging Issues Task Force Issue No. 92-9, Accounting for the Present Value of Future Profits Resulting from the Acquisition of a Life Insurance Company*
- *FASB Emerging Issues Task Force No. 93-7, Uncertainties Related to Income Taxes in a Purchase Business Combination*
- *FASB Emerging Issues Task Force No. 95-3, Recognition of Liabilities in Connection with a Purchase Business Combination*

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- *FASB Emerging Issues Task Force No. 95-8, Accounting for Contingent Consideration Paid to the Shareholders of an Acquired Enterprise in a Purchase Business Combination*
- *FASB Emerging Issues Task Force No. 95-12, Pooling of Interests with a Common Interest in a Joint Venture*
- *FASB Emerging Issues Task Force No. 95-14, Recognition of Liabilities in Anticipation of a Business Combination*
- *FASB Emerging Issues Task Force No. 96-8, Accounting for a Business Combination When the Issuing Company Has Targeted Stock*
- *FASB Technical Bulletin 85-5, Issues Related to Accounting for Business Combinations*
- *FASB Interpretations No. 4, Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method an interpretation of FASB Statement No. 2*

State Regulations

- Indiana Insurance Statutes Title 27, Article 1, Chapter 12, *Life Insurance Company Powers and Policy Requirements*
- Indiana Insurance Statutes Title 27, Article 1, Chapter 13*, Casualty, Fire and Marine Insurance Company Powers and Policy Requirements*
- Pennsylvania Advance Laws to the Insurance Code, *Act 8--SB701*

Other Sources of Information

- Draft discussion material from previous Life Codification projects.

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