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Proposed Amendments to FASB Statement No. 141 and International Financial Reporting Standard No. 3, *Business Combinations* (FAS 141 and IFRS 3)

Dear Technical Director and Mr. Teixeira:

After some very valuable discussions with both the FASB and IASB concerning proposed amendments to FAS 141 and IFRS 3 concerning the accounting for business combinations (hereinafter “BusCom ED’s”), we present the following list of comments and recommendations concerning the proposed guidance. We appreciate the extension of time given for comments due to the proximity of the comment deadline and the roundtables. For future standards, where the Boards believe a roundtable is appropriate, we suggest that there be at least thirty days from the roundtables to submit comments.

Question One – Objective, Definition, and Scope

Valuation of Purchase Consideration

We generally disagree with the proposal to measure the value of stock consideration paid as of the transaction closing date and instead support the continued application of EITF Issue No. 99-12, *Determination of the Measurement Date for the Market Price of Acquirer Securities Issued in a Purchase Business Combination*, as we believe events arising subsequent to the announcement date (e.g. shareholder and regulator approval) should not impact the measurement of the fair value of consideration inherent in the transaction. More specifically, we believe the acquirer’s valuation of a target is completed on the announcement date, making that date the most appropriate to value stock consideration to be transferred to complete the combination given that neither party can generally exit the transaction after the announcement date without incurring significant costs.

Application of the Purchase Method to a Merger of Mutual Insurers

We disagree with the proposal to apply the purchase method to a merger of mutual insurers where there is no clear acquiring company and an absence of reliable fair value indicators such as publicly traded stock or an exchange of consideration and therefore no basis upon which to reliably estimate the fair value of the combination.

We believe that where there are no reliable fair value indicators (e.g. no publicly traded stock and no exchange of financial consideration), no clear acquirer or acquiree, no shareholders that own a residual interest in the combined entity, and no reliable models that can be used to estimate the fair value the combined entity, it would be most useful to apply Pooling of Interests accounting to the merger. This would eliminate the estimation error that would otherwise emerge through an attempt to fair value the combined entity. Moreover, given the absence of shareholders (note that participating policyholders have no direct residual ownership interest in the entity and therefore have no vehicle through which they can directly monetize any value created by the merger) there does not appear to be any clear need or use for financial statements of the combined entity prepared using the purchase method of accounting. Accordingly, we question whether any requirement to apply the Purchase Method to mergers of mutual insurance companies would meet any basic cost-benefit constraint.

Question Two – Definition of a Business

We do not believe the proposed guidance adequately distinguishes an asset purchase from the purchase of a business and could lead to confusion in practice. More specifically, the implementation guidance (paragraph A2) defines a business and discusses inputs and processes necessary to be considered a business. The following paragraph (A3) then states that a business need not include all of the inputs or processes a seller previously utilized. Accordingly, it appears that if an entity were to purchase business assets and not acquire the associated assembled workforce and systems that may not qualify as a business combination, but it would be helpful to clarify that it would not, perhaps by eliminating the paragraph (A3) wording that introduces the ambiguity.

Question Three – Recording Full Fair Value of an Acquiree when Less Than 100% is Acquired

The BusCom ED's would require that when an acquirer takes control of an acquiree it should fair value 100% of the acquiree even if less than 100% of the acquiree is acquired. In addition, the ED requires that goodwill be recognized related to the non-controlling interest and be reported as a separate component of shareholders equity. We generally believe that recognizing goodwill related to the non-controlling interest is inappropriate as it requires the acquirer to in some way extrapolate the control premium it paid to acquire its controlling interest to the value of the non-controlling interest, which may or may not be valid depending on a variety of factors. Moreover, we believe attributing goodwill to the non-controlling interest and classifying it as a component of "total entity" goodwill will result in the overstatement of both assets and shareholders equity, distort key financial performance measures, and may ultimately lead to the recognition of impairment charges on assets not owned by the reporting entity. As a result of the preceding, we believe that if the FASB and IASB retains the proposed "economic unit" as opposed to "parent" view of reporting business combinations, reporting entities will likely resort to pro-forma presentations and exclude the effects of consolidating assets they do not own.

We believe the existing mixed-attribute model that exists in FAS 141 and IFRS 3 should be retained as it appropriately reflects the economics of the underlying transactions inasmuch as it only re-measures to fair value interests that are acquired and calculates goodwill related to the acquired interest as the excess of the cost over the fair value of net assets acquired. While we

believe that recording 100% of the fair value of the identifiable assets acquired and liabilities assumed where control has been obtained is an interesting idea, we do not believe the costs and operational difficulties associated with recording the fair value of the acquiree as a whole (including goodwill attributable to the non-controlling interest) are outweighed by the benefits of providing that information. More specifically, as previously discussed, because of the lack of consistent, reliable, and understandable methods to compute the fair value of certain assets and liabilities as well as the value of a non-controlling interest, the proposal may not only be difficult to implement but may also not provide information that is useful to financial statement users and may expose financial statement preparers to liability if their fair value estimates later prove to be inaccurate.

Question Six - Accounting for contingent consideration.

The BusCom ED's would require reporting entities to fair value contingent consideration. We note that contingent consideration is most often involved in business combinations expressly because the acquirer and acquiree cannot agree upon the fair value of the acquiree. Accordingly, requiring the acquirer to estimate and recognize the fair value of the contingent consideration appears to be both counter-intuitive and inconsistent with the fundamental reason for its presence in the transaction. Moreover, it is our further belief that where an amount is not probable or reliably measurable, any resulting estimate recognized in the financial statements is generally not useful nor is the process of estimating the value likely to meet the cost-benefit constraint present in all FASB and IASB statements.

We believe the FASB and IASB should retain the existing accounting model for contingent consideration in FAS 141 and IFRS 3. More specifically, contingent consideration should be recognized at the acquisition date only if the value of such consideration is both probable and reliably measurable. In the event no adjustment is recorded on the acquisition date (presumably because the amount was not probable and reliably measurable) but subsequently reaches the probable threshold and becomes reliably measurable, the incremental consideration should be accounted for as an increase in the cost of the business combination except in situations where the adjustment clearly relates to the issuance of additional debt or equity instruments in a guarantee of the market price of either debt or equity instruments issued (paragraph 35 of IFRS 3).

Question Seven - Accounting for direct acquisition-related costs

The BusCom ED's would generally require that costs incurred in connection with a business combination be accounted for as period costs as opposed to an element of the total cost of the acquired business which we believe most appropriately reflects the economics of a transaction that is anticipated to benefit future periods.

We believe that until the FASB and IASB embark on a broader project to readdress the overall accounting for acquisition costs, they should continue to be handled consistently; whether paid as a result of separately acquiring assets, selling products or issuing debt, or through acquiring assets by way of a business combination.

Moreover, it is our general belief that the existing accounting for acquisition costs in a business combination is appropriate as they represent an integral component of the purchase price and should be included in the total cost of the acquisition used as a basis to measure future performance. We also note that any amounts capitalized are subject to periodic recoverability and impairment assessments and as a result if and when the performance of the acquired business is no longer expected to achieve original expectations, adjustments would be made to any

capitalized amounts during the period in which the facts and circumstances have resulted in a change in the outlook.

Question Eight - Accounting for contingencies

The BusCom ED's would require a fair value measurement of loss contingencies where no reference markets exist and where the likelihood of the contingency is considered either reasonably possible or remote. As one example, due to the nature of litigation, including multi-jurisdictional class action law suits, we believe any attempt to fair value these reasonably possible or remote exposures using existing estimation models and methodologies would produce an output estimate that would not only be unreliable but also wholly inconsistent between reporting entities and as such we would question its value to financial statement users. We also note that applying the fair value framework to loss contingencies at the acquisition date (and thereafter retaining the fair value reporting the loss contingency) would result in the potential application of two separate and distinct models to the same loss contingency in the event that an acquirer and acquiree have exposure to the same litigation risk.

We recommend that the FASB and IASB retain the existing accounting framework for contingent assets and liabilities contained in Statements 5 and in the IFRS Framework. We believe the measurement error that would manifest itself as periodic income statement volatility would outweigh any value these estimates might otherwise convey. Moreover, we believe that financial statement users would likely pro-forma out the affects of periodic adjustments for the simple reason that the estimates by their very nature would necessarily be so unreliable as make it impossible to differentiate the amount of any period to period change as being attributable to estimation error as opposed to a genuine change in facts and circumstances.

Question Ten - Recognition of 100% of the Fair Value of an Acquiree in Step-Acquisitions

The BusCom ED's would require that in a step-acquisition, when the acquirer obtains control of the acquiree, it must re-value to fair value its previous investments in the acquiree with an offsetting gain or loss recognized in the income statement. The issue here relates to the "economic unit" as opposed to "parent" view of reporting business combinations. More specifically, in current practice each acquisition of shares in an acquiree is accounted for as a discrete transaction using the relevant accounting literature (e.g. APB 18 and FAS 115, etc.) and no goodwill is recognized or reported until such time as a controlling financial interest is obtained. At the time the controlling financial interest is obtained the controlling entity is required to apply FAS 141 (IFRS 3) which currently requires the acquirer to only re-measure to fair value the portion of the assets and liabilities of the acquiree it has acquired. Goodwill is then measured as the excess of the cost of acquiring each discrete block of acquiree shares over the acquirer's interest in the fair value of the identifiable net assets acquired in each discrete transaction.

We believe the FASB and IASB should retain the existing paradigm. While we understand that it results in a mixed attribute model where the assets and liabilities of the acquiree are consolidated/reported on the acquirer's balance sheet as a mix of historical cost and current fair value, we believe the mix to be appropriate as it reflects the underlying economics of each exchange transaction as it recognizes a change in basis only as the result as of a third party exchange transaction and does not otherwise extrapolate values to assets and liabilities that are not part of a third party exchange transaction. As a result there would be no re-measurement to fair value of interests previously acquired nor would there be an re-measurement to fair value of non-controlling interests. We believe this accounting follows the economic substance of the

transactions and permits the reporting entity to reliably monitor the performance of discrete transactions without the use of pro-forma measurements.

In the event the Boards continue to require the re-valuation of interests previously held in connection with obtaining control of a target we believe it would be preferable to recognize the change in basis as a component of other comprehensive income and not reflect the basis change in income until such time as it is supported by reference to an exchange transaction with an unrelated third-party.

General Comment – Fair Valuing Insurance Contracts

Although we fully understand that FAS 141, *Business Combinations* (FAS 141) and IFRS 3, *Business Combinations* (IFRS 3) require the re-measurement of assets and liabilities to fair value in connection with recording a business combination, we believe that in practice, because there is a lack of adequate, consistent, and reliable valuation guidance and procedural valuation protocols, the result of directly applying the FAS 141 and IFRS 3 fair value requirements to insurance contracts is a value that is inconsistently determined, not objectively verifiable, non-comparable, and generally an unreliable estimate of the fair value of insurance contracts at the acquisition date. Thereafter, if reporting entities were to periodically revise their fair value estimates, they could not follow consistent methodologies as no authoritative accounting guidance regarding subsequent accounting exists.

We note that the IASB and the FASB are currently involved in a Modified Joint Project to create an international accounting standard for insurance contracts - the Insurance Contracts Phase II project. A key question for the project is the determination of a method of valuation of insurance contracts in a consistent, reliable, and understandable manner. It is our belief that until all of the significant issues the IASB is dealing with in that project are satisfactorily resolved there will be no consistent and reliable fair value methodology and framework that can be applied in the estimation of the fair value of insurance contracts. In the absence of a consistent and reliable framework to fair value insurance contracts, we do not believe the estimates that result from the fair value requirements currently existing under FAS 141 and IFRS 3 are consistent, reliable, and verifiable, and as a consequence are not useful to financial statement users. Accordingly, we recommend that the requirement to fair value insurance contracts in connection with business combinations be suspended and deferred until the conclusion of the Insurance Contracts project. In the event the FASB and IASB agree that the “fair valuing” of insurance contracts should be postponed until such time as all of the issues enumerated below are satisfactorily resolved in the IASB’s Phase II Insurance Contracts Project they will necessarily need to develop interim guidance regarding how insurance should be valued in a business combination. In this respect, while we do not have a defined GNAIE “position” on what this interim valuation methodology should be we would commit to allocating resources to work together with the FASB and IASB to develop an interim valuation approach that is consistent, reliable, and verifiable.

Following is a list of issues that we believe must be addressed and/or resolved in the IASB’s Insurance Contracts Phase II Project prior to requiring the fair valuing of insurance contracts in a business combination:

- They are private contracts with no reference or secondary market where they can be settled with the exception of certain life contracts that can be monetized as viatical settlements, however, even here the terms vary greatly between settlement companies.
- The estimates of fair value rely on the use of modeling techniques with non-observable entity-specific model inputs such as benefit utilization rates, which have a material impact on the fair value estimate.
- Need to determine whether to include the credit rating of the issuer and changes therein on the fair value estimate. We believe reflecting the credit rating of the insurer in the fair value estimation process is not appropriate as there is no practical way to measure its impact on fair value nor do we believe this theoretical value to be “realizable”. Stated differently, an insurer that is downgraded could “theoretically” respond by opportunistically buying back debt it previously issued when it had a higher credit rating, however, practically speaking one must assume the entity is being downgraded for a reason that would generally preclude an aggressive repurchase of previously issued debt. In addition, with respect to insurance contracts previously written, the insurer generally has no ability to call or otherwise extinguish the contracts prior to their designated maturity, if any.
- Need to address what to do about renewal premiums where contracts are guaranteed renewable. It is unclear whether they should be included in the fair value estimate even though the contractholder has no obligation to continue to make future payments?
- Need to provide guidance on how contracts should be grouped for basis of valuation. Reliable measurements are usually only possible for groups of similar contracts.
- Need to determine how to model policyholder behavior. More specifically, contractholders can generally exit the contract at any time and receive their accumulated benefits in a lump sum or in the form of a pay-out annuity that may or may not be life contingent. Accordingly, should the reporting entity model policyholder behavior based on an assumption that all policy and contractholders make optimal decisions to maximize their economic returns even though in practice we know this is not the case?
- How to develop a market measure of mortality and morbidity exposure.
- Need to obtain market-based estimates for long-term reinvestment rates for liabilities whose duration exceeds the duration of assets available in the marketplace (e.g. structured settlements) must be obtained.
- Need to develop methods to value embedded guarantees including assumptions about usage.
- Need to develop methods to generate market-based estimates of margins. These estimates should combine both an expected rate and a risk load.

We believe the above issues need to be satisfactorily resolved before the fair value of insurance contracts can be consistently and reliably measured in a business combination. We further note that the IASB is considering all of the above issues in its Phase II project on insurance contracts and we therefore believe we should defer to the conclusions reached in that project and suspend the fair valuing of insurance contracts in the absence of clear definitive answers to the questions noted above to avoid a mosaic of valuation approaches and methodologies that will not prove to be consistent, comparable or reliable and therefore not useful to financial statement users.

Other General Comments

Premium Deficiencies

The requirement to include the fair value of intangible assets in assessing a premium deficiency for short-duration contracts should be revised to specify that certain intangible assets related to insurance contracts should not be included in the measurement of a premium deficiency. More specifically, in the Amendments to Existing Pronouncements section, paragraph D13, FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises (FAS 60), states: “A premium deficiency shall be recognized if the sum of expected claim costs and claim adjustment expenses, expected dividends to policyholders, unamortized acquisition costs, intangible assets recognized for acquired contracts, and maintenance costs exceeds related unearned premiums.” In the case of short-duration insurance contracts, in addition to the intangible asset recognized for the difference between the FAS 60 insurance claim and claim adjustment expense reserve and its measurement arrived at through purchase accounting, intangible assets are recognized for customer lists/renewal rights. Intangible assets related to future insurance contracts, including renewals, should not be included in the measurement of a premium deficiency.

Equity-method Investments

In the Amendments to Existing Pronouncements section, paragraph D5 APB Opinion No. 18 states “*The investment, results of operations (current and prior periods presented), and retained earnings of the investor should be adjusted retroactively as if the equity method had been in effect during all previous periods in which the investment was held*”. We do not believe this restatement would appropriately portray the ownership interest in the previous periods. Moreover, we do not believe the adjustment would be practical to implement for many reporting entities nor do we believe the perceived benefit to be gained by financial statement users would outweigh the costs to implement this requirement.

The Group of North American Insurance Enterprises (GNAIE) consists of the Chief Financial Officers of twelve leading insurance companies including life insurers, property and casualty insurers, and reinsurers. GNAIE members include companies who are the largest global providers of insurance and substantial multi-national corporations. All are major participants in the US markets.

The goals of GNAIE are to influence international accounting standards to ensure that they result in high quality accounting standards for insurance companies and, to that end, to increase communication between insurers doing business in North America and the International Accounting Standards Board and the US Financial Accounting Standards Board.

GNAIE works to meet its goals through modeling of proposed accounting standards, analysis, comment, and coordination with various end users of financial reports.



We appreciate the opportunity to provide comments on the proposed Exposure Drafts and would be willing to make ourselves available to discuss our comments and recommendations in more detail.

Respectfully submitted,

A handwritten signature in black ink that reads "Douglas Wm. Barnert". The signature is written in a cursive style with a long horizontal flourish at the end.

Douglas Wm. Barnert
Executive Director

DWB:KS:mtf