Gentlemen:

I am pleased to acknowledge, and comment on, your Exposure Draft "Consolidated Financial Statements: Policy and Procedures" dated October 16, 1995 (the "FD"). First by way of a general observation:

The document does not, to my mind, represent a "standard"; instead, it is a book of rules endeavoring to provide a most detailed road map to account for affiliated enterprises. To the extent your promulgations provide such specificity you detract from the auditor's professional responsibility to exercise his, her or its professional judgment, and permit management, - frequently with the active participation of the independent auditors, contrive transactions which will somehow accommodate the rules -- all the while perverting economic reality.

Further, the Nation's mood presently calls for deregulation; this demands that a greater degree of responsibility for our conduct must move to the local, the particular, venue, i.e., the interface between the enterprise and the independent auditor. One might well hope that such an independent auditor would "grab the nettle" suggested by the Kirk report and accordingly demand that the "most appropriate" rather than the "merely acceptable," accounting alternative be implemented in a particular
situation.

By way of a positive observation, I am pleased to note (paragraph 29) that the ED would abort the SAB 51 Scam. My views regarding this absurdity were set forth in several contexts, e.g., my (New York) CPA Journal article "Alice's Misadventures in SAB 51's Dirty Pool (June 92)" (attachment a); it was also the subject of my critical comment in an analyses of Conseco's accountings (see, e.g., pages 12-14 of Attachment b).

Turning to the Consolidation issue generally, I suggest that, a standard, if it were truly a standard, would obviate a nexus of unfair and misleading accounting practices which would be perpetuated under your ED.

I will take as my point of departure for this commentary paragraph 54, captioned "Relevance. Reliability. and Comparability of Information," to wit:

... the Board concluded that consolidated financial statements must report as completely and faithfully as possible the "financial position, results of operations, and cash flows of a reporting entity that comprises a parent and its subsidiaries essentially as if all of the resources of the affiliates were held and all their activities were conducted by a single entity with one or more branches or divisions."

This would be entirely appropriate if all of the resources of the Parent and subsidiaries were, in fact, fungible; this, in turn, would imply that the resources of the subsidiaries were essentially freely available to the parent to meet the latter's direct obligations. This condition does not prevail where the parent is precluded from freely tapping the subsidiaries' resources where, for example when the latter is a highly regulated enterprise, or is very heavily encumbered with various debt covenants.

Thus, Taking my Conseco commentaries, (Pages 3-4 of Attachment B) I believe that inasmuch as the insurance subsidiaries resources cannot be utilized by the parent as though they were its own, consolidation should be proscribed -- even if Conseco were to own 100 percent of such subsidiaries.

In sum, the enormous pools of securities and cash flows of the
insurance enterprises cannot be tapped at will by Conseco; as a consequence
full consolidation produces information which is essentially irrelevant,
unreliable, and lacking in comparability. This was, in fact, my direct
assertion in my July 19, 1976 article in Barron’s, “Whose Deep Pocket?”
Impeaching the consolidation of Leasco with its Reliance Insurance
subsidiary. That assertion was central to the litigation against Barron’s
and myself -- terminated by summary judgment against Reliance in September
1977. Your file would undoubtedly disclose that I set forth this very
argument at the time Statement of Financial Accounts Standard No. 94 was in
gestation. Regrettably the Board determined to ignore my views.

The “control via general partner” phenomenon (Paragraph 14F) produces
a corresponding absurdity in situations like Conseco (Pages 9-11 of
Attachment B). It may well be that its general partner status gives
Conseco a key to the insurance enterprises’ vaults; Conseco might even be
able to rearrange the packets of valuables; but then, Conseco would be
constrained to walk out as empty handed as “in it went.”

Mind you, I am not oblivious of the abuses which can be perpetrated
via partnerships or other controlled-entities, with the potential for off-
balance sheet liabilities; but here I assert again, I would expect the
truly independent, truly competent, truly committed auditor to ferret out
such possibilities and thereby abort the misbegotten plans of management --
This is precisely what the CPA imprimatur implies, at least for me.

Similarly, the ED field rules for “temporary” (paragraph 16) are too
limited in their scope and implication. (e.g., Pages 7-9 of Attachment
B) Again, I point to my Conseco articles and assert that its Consolidation
practices should be proscribed because experience demonstrates that the
parent enterprise does not contemplate a “Bonding” commitment with its
acquired enterprises. The very nature of Conseco’s relationships with its
capital providing partnerships, CCP-I and CCP-II, should make the only
temporary relationship self evident; nonetheless, the ED rules would not
reach those circumstances -- and. accordingly, would produce information
which is essentially irrelevant, unreliable, and lacking in comparability.

True, the notion of temporary vs. Permanent is tenuous --
nonetheless. as Justice Potter Stewart observed regarding pornography, “I
may not be able to define it, but I believe I can recognize it when I see
it.”

Once again, I would expect the truly independent, etc., auditor, to discern the situations which are temporary and accordingly eliminated from a consolidation.

In any event, I recommend that the annual report at the very least, include a set of financial statements for the parent and all subsidiaries where the resources and cash flows are in fact fungible -- all other subsidiaries, regardless of the percentage of ownership should be accounted for under the equity method.

I would, of course, be pleased to respond to any questions or comments you may have regarding the foregoing and the related attachments. I would also welcome an invitation to present my views at any hearings that might be scheduled.

By way of a Coda:

Paragraph 26 of the ED does a very nice job of summarizing the provisions of APBO 16 insofar as a purchase transaction is concerned; this would imply that the Board has no misgivings with respect to the business combinations issue as presently implemented in practice. In my view such confidence is entirely unwarranted.

Very truly yours,

Abraham J. Briloff
Emanuel Saxe Distinguished Professor Emeritus
The Financial Scorecard: Accounting for a Sports Franchise 18
By Jerry Gorman and Richard Stein
Comparability among teams in the same sport is a rarity—between sports, forget it!

Loss Prevention: It Can No Longer Be Ignored 28
By Dan L. Goldwasser
Here are several ounces of prevention which may make a cure unnecessary! Action every CPA can take to reduce the chances of losses.

The Liquidity Crisis: Pension and IRA Assets As a Solution 38
By Lee G. Knight and Ray A. Knight
How they can be available for current use.

Alice's Misadventures in SAB 51's Dirty Pool 46
By Abraham J. Briloff
A tale that would thrill the Mad Hatter. Higher earnings per share by engaging in capital transactions.

Compilation and Review: The Standards, They Are a Changin' 50
By Steven Rubin
Proposals will significantly change reporting on reviews and compilations—the full details.

Advance Pricing Agreements: Advantageous or Not? 58
By Robert Feinschreiber
IRS approval can be obtained for transfer pricing with foreign affiliates.
Alice's Misadventures in SAB 51's Dirty Pool

By Abraham J. Briloff

**Wonderful results in increased earnings per share that can be created from ingenious transactions spawn real numbers when little or no cash is involved. A loophole big enough for Alice—large or small—and all her gang to slip through.**

I was lying under my spreading bough, brooding over AT&T's tormented endeavors to pull NCR into a pooling-of-interest when I let out with an ecstatic "Eureka!" That cry of exultation was prompted by my recognition of the spectacular consequences which can result from the linkage between the pooling accounting phenomenon and my discourse on SEC Staff Accounting Bulletin (SAB) 51 in my "Waste Management: Recycled Accounting" article in Barron's, August 6, 1990. That article included the following:

"In 1989, net income included a non-taxable gain of $70.8 million, stemming from its Chemical Waste Management subsidiaries public offering that October of five million shares of common.

"Waste Management had owned approximately 81% of Chemical Waste Management's common immediately prior to the public offering. After the transaction, it held approximately 78%, but the book value of its stake was enhanced—to the tune of $70.8 million—when Chemical Waste Management collected the proceeds of its offering.

"In fact, Waste Management's determination to book that $70.8 million imputed gain in 1989 was, in and of itself, a manifestation of liberal accounting. The company's authority for so doing is derived from the SEC's SAB 51, issued in 1983. In that instance, the SEC staff tackled the question of how a parent company might account for gains arising from a subsidiaries' sale of stock.

"The SEC had previously insisted that such appreciation be deemed part of capital and not an item to be passed through the income statement. But in 1983, the agency's staff grudgingly decided to go along with an earlier AICPA position paper that would permit inclusion of such gains in income in certain limited circumstances. Even so, the SEC stressed in its 1983 ruling that its dispensation was interim guidance only; its expectation was that the FASB would soon get its act together and conclude a long-standing project on consolidation and equity accounting that was to address this issue among many others.

"It is noteworthy that seven years after SAB 51 was promulgated and 10 years after the AICPA spoke, the FASB has yet to address the issue on which SEC staff offered interim guidance."

**The Magic of Pooling**

As it happened, I had considered pooling-of-interests accounting most intently in Barron's, October 8, 1990. That article, entitled "Muddying the Waters: Accounting's Magic Wand," dealt with the pooling proclivities of Allwaste, Inc., thus:

"What really makes Allwaste remarkable is its acquisitive bent—and the way that the company's galloping growth is reflected in its published financials. According to its 10K 'During fiscal 1989, the company acquired nine companies in transactions accounted for as poolings-of-interest . . . . Aggregate consideration consisted of 8.6 million shares of the company's stock. Yet it is via the accounting for its acquisitions that Allwaste works its magic—with tricks, moreover, that are all perfectly okay by the good book of GAAP."

"At then-prevailing market prices, the shares Allwaste exchanged for companies it acquired during fiscal 1989 were worth over $70 million. Yet—under pooling-of-interests accounting rules—Allwaste recorded only a tiny fraction of that cost on its balance sheet. And, thanks to those same accounting rules, its reported earnings doubled."

"The critical rule regarding pooling-of-interests is APBO 16. The pooling-of-interest method accounts for a business combination as the uniting of the ownership interest of two or more companies by exchange of equity securities. Ownership interests continue and the former bases of accounting are retained. Income of the combined corporation includes income of the constituents for the entire fiscal period in which the combination occurs. The reported income of constituents for prior periods is combined and restated as income of the combined corporations."

"What that means in practice is that, because its acquisitions were accounted for as poolings, the company's revised balance sheets and income statements reflect the pooled companies as though..."
they were part and parcel of Allwaste at all times during their respective lives. And the existence of that revised data permits a nosy analyst to extract a summary balance sheet, as of August 31, 1988, for the nine companies acquired and pooled by Allwaste during its subsequent fiscal year.

"Two audited balance sheets, both as of the same date, can then be placed side-by-side. In this instance, the first is the one that was certified by Allwaste's auditors and appeared in the 10K it filed for the year ended August 1988. The second is the balance sheet for the same date that was included—for comparative purposes—in the 10K Allwaste filed for the succeeding year. According to the accountants' book of rules on pooling, the second balance sheet was made to reflect the assets, liabilities and shareholders' equity, as of the fiscal 1988 year-end, of the nine companies pooled during the subsequent year.

The difference between the two balance sheets derived from this exercise indicates that the combined shareholders' equity of those nine acquisitions was only $4.3 million. For which Allwaste, as noted, issued shares worth over $70 million, but—following the dictates of pooling-of-interest accounting—the only cost entered onto Allwaste's books was the $4.3 million increase in its shareholders' equity. In other words, well over 90% of the cost of Allwaste's fiscal 1989 acquisitions got lost—and will remain so to eternity."

Stepping Through the Looking Glass

With that apprehensive base, I turn to a most exhilarating game plan, one which integrated the two distorting practices permitted by our profession's Good Book of GAAP—a combination that provides a distortion potential multiplied exponentially.

Now hold onto your hats, you're heading for a rough ride, thus:

Assume that Hypothetical Waste Management ("HWM") which owns dump sites with certified values aggregating $1 billion. HWM's historical earnings are about $50 million annually, with 10 million shares outstanding.

HWM proceeds to acquire AWM for $33.3 million of its shares (i.e., $1 billion worth of its shares) and accounts for the acquisition by applying pooling-of-interests accounting.

Now, since AWM's book value is but $100 million, that is the number entered into HWM's books as its cost. Further, under the pooling rules, HWM restates its EPS at $1.03 ($550 million of consolidated earnings divided by 533.3 million shares now outstanding). For completeness, it should be noted that the market price is correspondingly boosted to $31.

In order to obtain operating resources, AWM proceeds to a public offering of two million newly-created shares at $100 each, i.e., equivalent to the same per-share price paid by HWM. AWM's balance sheet would now sport an aggregate equity of $300 million, i.e., the original $100 million plus the $200 million of newly-garnered equity; this $300 million is represented by 12 million shares—the 10 million in HWM's hands and two million with the public.

Now, HWM's proportional stake in the $300 million amounts to $250 million. Since this amount is $150 million greater than the $100 million on its books, it follows like night follows SAB 51 that HWM's income statement scoops up a plus of $150 million. Its income now zooms to $692 million, i.e., the historical $500 million plus the SAB 51 $150 million plus $42 million (5/6 of AWM's $50 million). When that $692 million is divided by its 533.3 million shares outstanding, the EPS escalates to $1.30 per share.

But Wait, You Haven't Seen Anything Yet

Moving along, HWM finds that its subsidiary has more dump sites than might reasonably be required for their operations, whereupon AWM sells off 10% of its sites for $100 million, precisely one-tenth of the "certified" billion dollar value. Then AWM's accounting may then calculate the gain on that sale, ordinary income, of course, to be $90 million, i.e., the $100 million proceeds less $10 million, representing one-tenth of the entire cost shown by the company's books. But then that $90 million had to be scaled down by the income tax, reckoned at $30 million; the net was but $60 million.

Assuming nothing further, AWM's income would be stated at $105 million, representing $45 million (9/10 of the historic $50 million plus the $60 million booked on the sale). But wait, we have forgotten something; thus, the $200 million garnered on the public offering was invested to yield $12 million net after tax—so that its income for the fiscal period is really $117 million, since there are 12 million shares outstanding, AWM's EPS is now $9.75. Wall Street's Gnomes remember AWM's P/E of 20 and therefore put a price of $195 on the company's shares.

Let us now shift our focus to HWM's consolidated income statement for the year, factoring in the foregoing. Thus, its income would be $747.5 million determined as follows (in $ millions):

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Its basic income</td>
<td>$500.00</td>
</tr>
<tr>
<td>The SAB 51 injection</td>
<td>150.00</td>
</tr>
<tr>
<td>5/6 of AWM's income of $117 million</td>
<td>97.50</td>
</tr>
<tr>
<td>Total</td>
<td>$747.50</td>
</tr>
<tr>
<td>Its EPS would be</td>
<td>$1.40</td>
</tr>
</tbody>
</table>
That $1.40 is a dramatic increase over the $1 per share earned historically; but even if the P/E is not revised a single iota, the market price for HWM's shares would escalate to $42.

With that kind of coin available for circulation, why HWM could repeat the foregoing cycle time and time again. In addition, since the share price of its AWM lode is also on an upward trajectory, that subsidiary can proceed with further public offerings all to the added glory of HWM's bottom line—thanks to SAB 51.

Before concluding this glorious entertainment, let us go back to AWM's sale of the tenth of its dumpsites, the transaction which induced a $60 million profit—of which $50 million floated upward into HWM's income statement. A moment's reflection would inform us that there was, in fact, an economic loss. Note that the portion sold generated $70 million in net proceeds, i.e., the $100 million minus the $50 million tax. This means that the entire property had a net cash flow value of $700 million—something for which HWM paid with its own stock worth $1 billion. Clearly, HWM either ignored or overlooked the fact that its billion dollar outlay notwithstanding, the tax basis of the property acquired remained $100 million. As a consequence, the $60 million AWM gain, but even more so, the $50 million portion which was consolidated into HWM's bottom line, were most incongruous and were nought but distortions of logic.

Intentional Absurdity!

This SAB 51 pooling parable, is of course, absurd. This was intentional! It is hoped that by this *reductio ad absurdum*, the SEC staff will see fit to abort its misbegotten SAB 51 and, even more hopefully, that the solons at the FASB will consign the pooling-of-interests accounting ploy to one of the March Hare's holes. Ω

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Myth vs. Reality
Conseco vs. Briloff
and vice versa

A Critique of Conseco, Inc. Standards of Accounting and Accountability

by

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Bernard M. Baruch College/CUNY
Prepared for
An Accounting Finance Seminar
School of Management
Binghamton University
October 26, 1994
Introduction

"Myth vs Reality", the title theme etched on Conseco's 1993 annual report is, like all that emanates from the company's ministry of shareholder relations, inspired. By that rubric Conseco set out to quote "... demystify Conseco. We're not, as some zealots believe; 'rocket scientists or visionaries'. Nor are we, as others suspect, 'accounting alchemists' or 'risk-takers'.” In fact, in this regard at least, it may be that the myth closely approximates reality. My study of the array of bottom-line boosters contrived for Conseco’s book of GAAP I have long suspected that Conseco’s CFO was really a rocket scientist disguised by his CPA green eye shade.

11 - Myth vs. Reality

In the absence of hard information, certain myths about Conseco have been perpetuated. Some of these myths are positive, some are negative, but all of them make it more difficult for investors to understand the real company.

That is, of course, a most laudable objective, and most laudably did Stephen Hilbert proceed to the exposition of Conseco’s realities and the exorcism of any discernible myths. But then it should be noted that the myth-reality dichotomy is somewhat tenuous. Experience informs us that that which might be deemed reality by one person, group or even the universe at any "point in time" can, in retrospect, be seen as a myth. We know this is so in our interpretation of history, our notions regarding the structure of the universe (remember Galileo) and the atom (note Heisenberg's uncertainty principle). And then we have the quintessential manifestation of the myth-reality dichotomy. Hans Christian Andersen's saga of the "Emperor's New Clothes." And on a far less awesome scale, those who hold fast to the notion that GAAP, cum GAAS produces a picture of reality can be seen to have
swallowed a myth.

There is no question but that the message in the annual report sets forth Conseco's realities and mythology as Stephen Hilbert and his cohorts see them: but that which they have proposed as myth is reality invites others to interpose their views as to where reality turns to mythology in the Conseco ambit.

That which follows, then, is this observer's response to that challenge.
Cash Flow and Consolidation

The most pervasive of the realities sought to be disseminated by the company is that Conseco is wallowing in enormous pools of readily available resources and cash -- at least those are the realities as conveyed by the financial statements developed according to the hallowed precepts of GAAP.

Thus, the certified 1993 financial statements show that at year end Conseco was possessed of almost $10 billion in actively managed fixed maturity investments and enjoyed an operating cash flow of over a billion dollars. All of that, in the view of this observer is a myth. Thus, of the bond portfolio over $7 billion were those of Western National and over $2 billion of Bankers Life; essentially all of the remaining $400 million belonged to another of Conseco's insurance subsidiaries, Bankers National Life. These resources do not belong to Conseco qua Conseco: they are sequestered for the benefit of the policyholders and annuitants of the respective insurers and can be upstreamed by Conseco only to the extent of dividends permitted by the various regulatory agencies or, as occurred in February, 1994, when Conseco sold off 60 percent of its stake in Western National, by a disposition of its investment in its subsidiaries.

Insofar as the cash flow phenomenon is concerned, the 1993 certified report, as noted, disclosed the cash flow from operations of $1026.6 million; after deducting dividends of $23 million, the net would be a tad over a billion. But then, in its 1993 filings with the SEC, as Schedule III to its Form 10-K, Conseco acknowledged that on a "parent-only" basis, that is, Conseco in and of itself, experienced an actual deficit in cash flow from operations of $23.1 million, to wit:
Provided by operating activities:
Net income for the year .................................................. $297.0

Adjustments
  Equity in undistributed earnings of consolidated subsidiaries ........... (208.0)
  Equity in undistributed earnings of equity investments .................. (36.6)
  Gain on sale of stock by subsidiaries ................................ (101.5)
  Incentive earning allocation ........................................ (36.6)
  Other ........................................................................... 63.0

Net cash used by operating activities ......................................... (23.1)

If we were to deduct the dividends paid for the year on its common and preferred stock the deficit from the ebb and flow of funds was $46.1 million.

This dismal conclusion is consistent with that which evolves from the data provided at page 34 of the Myth-Reality discourse, thus:

(in $ millions)

| Description                                         | Amount  
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividends from subsidiaries</td>
<td>$ 3.8</td>
</tr>
<tr>
<td>Taxes collected from subsidiaries in excess of payments</td>
<td>10.8</td>
</tr>
<tr>
<td>Fees received</td>
<td>54.1</td>
</tr>
<tr>
<td>Parent company costs</td>
<td>(62.9)</td>
</tr>
<tr>
<td>Parent company interest</td>
<td>(32.3)</td>
</tr>
<tr>
<td><strong>Deficit from operations</strong></td>
<td>(26.5)</td>
</tr>
<tr>
<td>Dividends paid</td>
<td>(23.0)</td>
</tr>
<tr>
<td><strong>Cash deficit from operating cycle</strong></td>
<td>(49.5)</td>
</tr>
</tbody>
</table>

Because it will be relevant in subsequent contexts, it is noteworthy that for years prior to 1993, Conseco was able to get some relief from this adverse cash flow condition by the receipt of payments on account of principal and interest from its subsidiaries on so-called surplus debentures. But then, as of December 31, 1992, at the behest of the insurance regulators, Conseco was constrained to contribute those debentures to the capital of its Bankers National subsidiary -- thereby foreclosing any receipts from that source. It
only most limited resources of the parent presents a distorted picture of the enterprise.

That this condemnation was not fashioned in response to my study of Conseco can be demonstrated by my writings more than a score of years ago making the exact same argument against Saul Steinberg's Leasco-Reliance Insurance (later his Reliance-Reliance Insurance) empires*. The same argument would be directed against, for example, First Executive-Executive Life, American Continental, Lincoln S&L, etc.

I here intend an invidious distinction from those situations involving a richly-endowed parent which is, in fact positioned to support the operations and financial condition of its subsidiaries, e.g., Transamerica, ITT, GE.

So it is that even if Conseco, et al., might be able to rationalize their practices as real in accordance with GAAP, I assert they are a myth when measured by the standard of economic reality.

But I now want to move my critique of Conseco's consolidation practices to a higher level: I maintain that the company has been and is violating the objectives of the financial reporting process by the ways in which it has been and is implementing GAAP. And for this I will be relying on the company's admissions and caveats which are set forth in various contexts.

Last October in a press release with limited dissemination the company conceded that its statements lacked consistency and comparability; this, they said, was because the company's business strategy is the acquisition of companies, building value and recognizing that value as majority interests are spun off.

*see. e.g. "Whose Deep Pocket?". Barrons. July 19, 1976.
By such an admission of a lack of comparability they have conceded that the statements, as presented lacked understandability -- the keystone for the financial reporting process.

The various twists and turns in the company's ownership of underlying enterprises leads to yet another "article of impeachment," thus: to the extent the company may have a stake otherwise warranting consolidation, the interest must be deemed other than temporary to permit such consolidation. Now, according to the company, the chronology of its twists and turns reads as follows (from the Kemper prospectus):

Conseco, both directly and through CCP-I, has effected several transactions during the periods covered by the historical financial statements included and incorporated herein that significantly affect the comparability of the financial information presented. Such transactions include (i) the initial public offering of WNC on February 15, 1994, which reduced Conseco's ownership interest therein to 40% and caused WNC to be included in Conseco's financial statements on the equity (rather than consolidated) basis since the first quarter of 1994. (ii) the acquisition of Bankers Life and Casualty Company ("Bankers Life") by CCP-I as of November 1, 1992 (the "November 1992 BLH Acquisition"), the initial public offering of BLH in March 1993 and the subsequent acquisition by Conseco of 13.3 million additional shares of BLH common stock in September 1993 (the "September 1993 BLH Stock Purchase"), all of which resulted in the inclusion of BLH and its subsidiaries in Conseco's financial statement on a consolidated basis since November 1, 1992. (iii) the acquisitions of Great American Reserve Insurance Company, Jefferson National Life Insurance Company and Beneficial Standard Life Insurance Company by CCP-I on June 27, 1990, November 27, 1990 and April 24, 1991, respectively, and (iv) the formation, as of June 30, 1992, of CCP Insurance to act as the holding company for the insurance companies previously acquired by CCP-I, and CCP Insurance's initial public offering, which transactions caused CCP Insurance to be included in Conseco's financial statements on the equity (rather than the consolidated) basis since July 1, 1992, and the purchase by Conseco of 2.0 million additional shares of 1993 CCP Insurance Stock
Purchase"), which increased Conseco's ownership interest therein to 40%.

So where's the beef? Well, back in 1959 the AICPA's Committee on Accounting Procedure adopted Accounting Research Bulletin No. 51. That promulgation included the following included as paragraph C51.102 of the accounting profession's most awesome book of rules:

The usual condition for a controlling financial interest is ownership of a majority voting interest, and, therefore, as a general rule ownership by one enterprise, directly or indirectly, of over fifty percent of the outstanding voting shares of another enterprise is a condition pointing toward consolidation. However, there are exceptions to this general rule. A majority-owned subsidiary shall not be consolidated if control is likely to be temporary.

In light of the foregoing historical narrative relating to Conseco's only transient relationships with the enterprises coming under its sway, how is it able to overcome the foregoing prohibition against the consolidation of "temps"? Once again, the company is pursuing a practice which at this very juncture is up for consideration and comment by the accounting philosophers.

Thus, from FASB's preliminary views on major issues related to consolidation policy (August 1994):

A controlling entity should consolidate entities that it controls unless that control is temporary at the time it is obtained (paragraph 7). An assessment of whether control is temporary should be based on circumstances that exist at the date an entity becomes a subsidiary, and once consolidated, a subsidiary should continue to be consolidated until the parent ceases to control it. Control of a new subsidiary should be considered temporary if at the time it is obtained the parent is obligated to relinquish control within a certain period of time or if the parent has otherwise relinquished
control before the balance sheet date for financial statements that are for the period that control was obtained. For example, control is temporary if an investor is required by antitrust laws or regulatory authorities to relinquish control of a newly acquired subsidiary or if it obligated itself through contractual agreements to sell certain subsidiaries in a newly acquired group.

It would appear then that Conseco is able to avoid the temporary precept by taking hold of a FASB "preliminary view."

But now, going back in time, my June 1992, Barron's article criticized Conseco's consolidation with the nexus of insurance entities acquired under the aegis of CCP-I. My criticism was rooted in the fact that Conseco had but minority stakes in those entities. Nonetheless, the company asserted its right to thus consolidate because it was the general partner in the CCP partnership and, accordingly, had what it deemed to be unfettered control. It should here be noted that neither the FASB nor the SEC objected to that procedure even after they were requested to review it most deliberately by a committee of the U.S. House of Representatives.

Conseco was intent on perpetuating the consolidation even after the CCP Insurance IPO in mid 1992: that notion was shot down by the SEC, so that the CCP insurance stake was subsequently carried on the so-called equity basis of accounting. Sic Transit!

But now to prove that "that which goes around comes around" we find that Conseco has resurrected its full consolidation via control via its general partner status with its 1994 CCP-TT cohorts. Thus, from the proxy material included in the September S-4 filed in connection with its Kemper foray:

Conseco expects to effect certain future acquisitions through CCP-II, an investment partnership for which a wholly-owned subsidiary of Conseco is acting as sole general partner.
Because a subsidiary of Conseco is the sole general partner of CCP-II, Conseco unilaterally controls CCP-II. Accordingly, Conseco's consolidated financial statements will include... all financial information of CCP-II and the companies owned by CCP-II... Conseco does have unfettered control over CCP-II; but control to warrant the ability to presume that it has control over the rich lodes of the Statesman - Kemper assets is unmitigated bunk! Insofar as those resources are concerned Conseco's hands are tightly manacled. Remember, those hands must first reach the respective holding companies which own the shares and surplus notes of the underlying insurance enterprises. And then, even if Conseco's hands can reach the holding companies before it could get its fingers on the underlying assets they would first have to get the consent of various regulatory bodies and various covenants in the surplus notes and other covenants of the layer upon layer of the corporate pyramid.

Putting aside the company's rhetoric and getting at the realities of the financial reporting. As noted, the FASB Solons are presently agonizing over the consolidation issue. it is now something of a mantra that the objective of the financial reporting process is:

Potential users of financial information most directly concerned with a particular business enterprise are generally interested in its ability to generate favorable cash flows because their decisions relate to amounts, timing, and uncertainties of expected cash flows. To investors, lenders, suppliers, and employees, a business enterprise is a source of cash in the form of dividends or interest and perhaps appreciated market prices, repayment of borrowing, payment for goods or services, or salaries or wages. They invest cash, goods or services in an enterprise and expect to obtain sufficient cash in return to make the investment worthwhile. They are directly concerned with the ability of the enterprise to generate favorable cash flows and may also be concerned with how the market's perception of that ability affects the relative prices of its securities.
The concept of control: that "Preliminary Views" monograph includes the following:

Control of an entity is power over its assets—power to use or direct the use of the individual assets of an entity to achieve the objectives of the controlling entity. Specific objectives of individual entities vary, but both business enterprises. Resources or assets are the lifeblood of both business enterprises, and their resource processing and distributing activities are not only the means by which they provide goods and services to members of society but also the reason they obtain, through exchanges or gifts, the cash and other assets with which to buy the goods and services they need to carry out those activities. For purposes of this definition, the objectives can be summarized by focusing on the indicators of their success—the objective of a business enterprise is to provide net cash inflows to its owners by enhancing the value of the enterprise or by distributing cash or other assets to its owners.

Conseco's astute accounting people have, at least thus far, rationalized their consolidation practices as coming within that tenuous notion. But I now ask all those responsible for providing critical judgement calls regarding Conseco's accountings, in this regard at least. Is it Myth or Economic Reality?
Bankers Life IPO-ICH

Included in the certified statement of operations presumed to be the reality according to GAAP there was $101.5 million representing income enjoyed by Conseco as a gain on the sale of stock by a subsidiary. That figure came about because after the Bankers Life early-1993 IPO Conseco's proportionate share of Bankers' shareholders' equity was increased by that $101.5 million. Thus, prior to the IPO Conseco's 50 percent proportion share of Bankers shareholders' equity may have been about $25 million; after the IPO Conseco's percentage was reduced to 31 percent -- but it was 31 percent of a much bigger sum i.e., over $400 million. The difference between the before and after was reckoned at the $101.5 million which entered into Conseco's 1993 statements of operations.

Those operating statements picked up some additional pluses derivative from the Bankers IPO. to wit: "incentive earnings allocation from the partnership, $36.6 million." When these numbers were incorporated into Conseco's initial 1994 quarterly reports, they were identified as "Merchant banking income - $138.1 million" (This ostentatious line item was then used to reflect the $65.3 million profit recognized on the Western National IPO).

This is most certainly GAAP permissible -- and if that reflects reality, then so be it. For me, this inclusion as income is naught but mythical.

In fact, Conseco's determination to book that $101.5 million imputed gain in 1993 was, in and of itself, a manifestation of liberal accounting. The company's authority for so doing is derived from a Securities and Exchange Commission staff accounting bulletin, SAB No. 51, issued in 1983. In that instance, the SEC staff tackled the question of how a parent company might account for gains arising from a subsidiary's sale of stock.
The SEC had previously insisted that such appreciation be deemed part of capital and not an item to be passed through the income statement. But in 1983, the agency's staff grudgingly decided to go along with an earlier American Institute of Certified Public Accountants position paper that would permit inclusion of such gains in income in certain limited circumstances. Even so, the SEC stressed in its 1983 ruling that its dispensation was interim guidance only; its expectation was that the Financial Accounting Standards Board would soon get its act together and conclude a long-standing project on consolidation and equity accounting that was to address this issue among many others.

Two points are of special interest here. First, investors should note that Conseco's inclusion in its income of the $101.5 million gain on the value of its subsidiary's shares is permissive—not mandated. And second, of significance, at least to accountants, is that more than a decade after SAB No. 51 was promulgated and 14 years after the AICPA spoke, the FASB has yet to address the issue on which SEC staff offered "interim guidance."

To be sure, the AICPA and the SEC staff, however gingerly, have accepted the inclusion in income of paper gains such as Conseco's. But, with all due deference to their collective wisdom, in this context, they have done violence to some very basic accounting concepts:

- One is the fundamental accounting precept that we do not recognize income unless and until it is realized (except possibly in the extractive industries). Certainly, in this instance, Conseco did not realize any increase in its spendable funds—there was only an unrealized appreciation in the value of its investment in Bankers Life.
Further, the underlying precept in FASB Statement 12, dealing with investments in equity securities, is that while the balance sheet may, under certain circumstances, reflect unrealized appreciation—such amounts are not to be reflected in the income statement.

It is noteworthy that in their deliberations leading to the August, 1994 promulgation "Preliminary Views" on consolidations, the FASB appears to have been entirely oblivious of the SAB-51 issue.

But there is yet another chapter to this Bankers saga which makes the $101.5 million especially mythical in the Conseco circumstances. Thus, as of September 30, 1993, Conseco acquired ICH's 13.3 million share stake in Bankers for $288 million or $21.50 per share. That $288 million exceeded the book value of these shares by some $160 million. I could have predicted it, considering the way in which Conseco's calculus is geared, -- in goodwill to be amortized, again I would have predicted it, over 40 years, again, predictably, on a straight line basis.

Take Note: A proper symmetry would imply that if there is an excess of the proportion of the underlying book value over the carrying value is booked as income then a proper symmetry, approaching reality, dictates that where the cost exceeds the underlying book value it should be booked, at the very least, as an offset against the previously booked income.

But who said a fair symmetry is an essential precondition to Conseco's application of GAAP?

The September 30 acquisition of ICH's stake in Bankers is intriguing from another perspective. According to the official version of the
realities, i.e., the rhetoric in the annual report: "In the third quarter of 1993, we were presented with an unexpected opportunity to increase our stake in BLH. We didn't hesitate. We purchased 13.3 million additional common shares for $288 million."

To begin with this observer is surprised that chairman Hilbert was surprised that the 13.3 million shares were available so that Conseco could increase its holdings to a majority in what he presumed to be such a rich lode. After all the price paid to ICH was the same as Conseco would have had to have paid if it acquired the 13.3 million shares in the early-1993 17 million share IPO. In fact, had it chosen to do so they could have avoided a substantial portion of the cost involved in that offering. Then why didn't it? Here, of course, not being privileged to have been a participant in structuring the presumed realities. I am constrained to engage in conjecture -- leading to a number of hypothetical scenarios, for example:

- Conseco did not have the funds required to make the acquisition as of the time of the IPO and, accordingly, had to await the ripening of the sale of the 60 percent interest in Western National -- a transaction announced simultaneously with the announcement of the ICH deal.

This scenario then segways to the possibility that the ICH deal was anticipated from the outset, possibly involving a "gentleman's understanding" of a reciprocal put and call -- tied to accommodate Conseco's ability to arrange the financing, i.e., via the Western National offering.

- Had Conseco acquired the 13.3 million shares on the IPO it could not conceivably have been permitted to book that
$101.5 million gain via the SAB-51 dispensation; even the most accommodating CPA could not have swallowed such an incestuously-induced plus.

It may be that Conseco felt constrained to acquire the ICH shares, having determined to dispose of the majority interest in Western National. You see, unless it could have a significant subsidiary with which to consolidate, post-partum Western National disposition, the numbers cranked out by Conseco would have been scrawny indeed, i.e., much the way in which the parent-only statements come forth.

Not readily discernible is that by Conseco's so-called step acquisition accounting for the 13.3 million share acquisition it was able to scoop up an additional $118.4 million into the Cost of Policies Purchased hopper.

It should be emphasized that all of these scenarios are conjectural, as mythical interpretations. The reality is that set down in hard type in Conseco's annual report -- at least that is the reality as Stephen Hilbert sees it.

As a consequence of Conseco's calculus for booking its Bankers Life investment, it comes up with a carrying value of $518.8 million for its 56 percent stake as of December 31, 1993. Inasmuch as the entire Bankers shareholders' equity as of the year end amounted to $540.9 million, 56 percent would work out to $302.9 million, or $215.9 million, less than Conseco's carrying value for its Bankers Life investment. The excess carrying value is attributable principally to the goodwill established on the ICH deal.
The Exercise, Redemption and Reset Ploy

Last February, according to its SEC filing for its initial 1994 quarter, Conseco induced its executives to exercise options for some 3.6 million shares to permit the company to enjoy a $200 million tax deduction; according to that filing:

Changes in Capital Stock

In February 1994, Conseco implemented an option exercise program under which its chief executive officer and four executive vice presidents exercised outstanding options to purchase approximately 3.6 million shares of the Company’s common stock. The options would otherwise have remained exercisable until the years 1999 and 2000. As a result of the exercise, the Company realized a tax deduction equal to the aggregate tax gain recognized by the executives as a result of the exercise. The tax benefit of $67.5 million. The Company withheld sufficient shares to cover federal and state taxes owed by the executives as a result of the exercise transactions. Net of withheld shares, the Company issued approximately 1.8 million common shares to the executives.

By way of Background:

The options here involved were so-called "nonstatutory, nonqualified" and, which did not have an ascertainable fair market value as of the time they were granted to the anointed executives: accordingly, they were not taxed as of the time of the grant. When in February the options were exercised the executives were deemed to have received additional compensatory income, i.e., executive salaries, to the extent the value of the shares received exceeded the cost...the $200 million figure.

So important was this deal for the company that it gave the loyal
executives a special inducement, to wit:

The Company also granted to the executive officers new options to purchase a total of 3,016,000 shares of the Company's common stock at $59.25 per share (the market price at the date of such grant) under the 1994 Stock and Incentive Plan to replace the shares surrendered for taxes and the exercise price on these and other recent option exercises.

As an active practitioner and writer over the past half century in the esoteric area of taxation the discourse about the tax consequences of the exercise of nonqualified stock options is entirely comprehensible. In fact during the past "tax season" I had occasion to reflect such transactions on the returns of several clients. There is, accordingly, no gainsaying that which the company reported so meticulously. Nonetheless, some questions come to this observer's mind, including:

- In each of my client's circumstances the shares were received and then sold on the open market - thereby incurring the transaction cost incidental to such sales. The company's determination to buy in half the shares thus acquired and pay out over $100 million raises the question: Is not such an insider deal contrary to the notion of a free and open market in securities? Did not those executives get a higher price than they would have garnered from the market place?

- Putting that aside, and accepting the notion that a $200 million tax deduction would be
useful for Conseco. what was the hurry? Remember there were still ten months between February and year end. Who knows. Conseco might have found it possible to garner some tax losses to offset the Western National gain by other tax maneuvers. Also conceivable is that the accommodating executives might have wanted to cash in on their options even without the special inducements -- Conseco would have then gotten the tax benefit in any event.

Even putting the best gloss on the Conseco explanation, it should be noted that the company thus parted with over $100 million in cash whereas the tax saving as measured by Conseco would involve no more than about $68 million in funds. Since the parent company’s operations do not generate a surfeit of cash then one is led to question the wisdom of the deal as a matter of company policy.

There is yet another gnawing aspect to the $200 million gain. Thus, according to the IPO prospectus as an incident to the contemplated restructuring Western National effected a $150 million distribution as a dividend. That dividend took the form of a note which was satisfied through subsequent refinancing. That
is noteworthy that during 1992 the parent realized $41.4 million and $36.9 million of principal and interest, respectively, from those surplus debentures. For 1991 the sums were $12.4 million and $38.8 million.

The surplus debentures here involved were issued by Bankers National to Conseco principally as an incident to the 1987 acquisition of Western National ($240 million) and other subsidiaries ($134 million). As of December 31, 1992, the $269 million balance was required to be contributed by Conseco to the capital of Bankers National.

The critical relationship between the holding company's liquidity and its affiliates' surplus debentures was spelled out most explicitly in a Bankers Life filing thus:

**Holding Company Structure**

As a result of the Company's holding company structure, its ability to pay dividends to stockholders and make required debt service payments will depend upon the cash flow generated by Bankers' operating activities and the ability of Bankers to pay dividends to enable Bankers Life Insurance Company of Illinois, a wholly-owned subsidiary of the Company ("BLI"), to make (i) permitted principal and interest payments on its $500 million principal amount surplus debenture due 2003 (the "Surplus Debenture") issued to the Company...

In concluding this segment it must be emphasized that my consideration of Conseco's consolidation practices is not unique to that entity. Indeed, I would direct a corresponding obloquy against any situation where the parent company is essentially bereft of its own, independent resources and liquidity and is, as a consequence, heavily dependent on its subsidiaries and where such subsidiaries are regulated so that their resources and liquidity are sequestered for the benefit of their constituents. The critical point is that by the homogenizing of the enormous resources of the subsidiaries with the
the company's statement of operations?

Add to that 1.8 million share deal there is the transaction where Conseco turned its not-so-deep pocket inside out to help its chairman resolve his domestic responsibilities. Thus: Then again, Hilbert also takes pains in the annual to point out that Conseco views sinking spells in the stock as "special opportunities." Noting an ongoing share repurchase program, under which about 1.4 million shares were bought back between November and the end-of-March press deadline of the annual, Hilbert vows, "As before, when we believe our shares are undervalued, we will not be shy about using our available cash to buy them back from investors who don't share our confidence in Conseco's long-term prospects."

What the annual didn't point out is that nearly half of the shares that Conseco had recently repurchased, at roughly $59 per, came from the marital estate of Hilbert and his ex-wife, a deal which permitted "settlement of the Hilberts' recent divorce proceeding, without adversely affecting the market for the stock." For that intelligence, a shareholder had to catch a press release the company issued back in February.
The Western National IPO

Let us consider the February, 1994. Western National IPO pursuant to which Conseco disposed of 60 percent of its wholly-owned flagship insurance operation for $388 million (Exclusive of a $150 million upstream dividend prior to the IPO). According to Conseco's reality, the sale was explained thus:

The WNC transaction is another example of Conseco's strategy for building value in its acquired companies ... Western's independence, we firmly believe, will allow it to complete even more successfully in its own markets by establishing its own identity, its own capital structure and its own access to the capital markets.

This might very well be the case; Nonetheless, some other, or additional, motivation may have prevailed.

Thus, mention was made previously of the fact that the surplus debentures which provided the funding mechanism for the Western National acquisition in 1987 could no longer provide a source for upstreaming cash to Conseco, per se. Further. Conseco had to find the cash to repay the $200 million borrowed to acquire the ICH shares in Bankers Life to say nothing of the funding of the 2.5 million shares repurchased from the executive suite.

That there may have been some urgency regarding the consummation of the IPO might be inferred from the pricing of the shares at $12, leaving a bit over $11 per share for Conseco. This was at the very low end of the price range anticipated on the eve of the offering. But probably more indicative of the pressures is that in its prospectus the figure $16 per share, was used in the pro forma reckonings.

And then there is yet another gnawing question that arises when one
begins to probe for hypothetical revisionism. Thus, according to Conseco’s 1994 first quarter report the company booked a pretax profit of $65.3 million on its disposition of 60 percent of Western National; this means that it realized a gain of about 15 percent over its carrying value, i.e., Western National’s book value. Without pretending to the expertise in the valuation of insurance companies I find it impossible to recall any successful enterprise, insurance or other, which was sold at a premium of but 15 percent over book value. Some possible explanations, are hypotheticals:

- The book value, and related carrying value, were excessive implying that profits may have been booked overly optimistically over the years;

- The “point in time” when the shares went to market was most inopportune for the seller -- who may have had no alternative but to go through with the offering.

- And this leads us right back to the 2.5 million shares reacquired from the favored few in the wake of the IPO.
Conseco's Money Management Record and The Kemper Deal

In early July Conseco and an affiliated partnership entered into an agreement to acquire Kemper Corporation for about $2.8 billion -- 80 percent in cash, 20 percent in Conseco shares. If the acquisition is eventually consummated it would mean that Conseco's chief honchos would get operating control over Kemper's galaxy of insurance, mutual and money market funds, thereby adding about $70 billion to funds under its stewardship. This power over enormous pools of "other peoples money" calls for a response to the question, "How well is Conseco performing as the guru for the $19 billion presently under its management?"

To respond to the question let us turn to the experience regarding its present funds, e.g., Western National's, during the initial 1994 quarter.

As of December 31, 1993, the company's portfolio of actively managed fixed-maturity investments had an amortized cost of $6892.7 million and a market value of $7129.6 million -- hence, an unrealized appreciation of $231.9 million. Three months later the first two factors were $7092.8 million and $7029.8 million, respectively -- so that there was, in fact, an unrealized loss on that portfolio of $63.0 million.

This means that during the quarter this Western National's portfolio suffered a loss of $294.9 million: when we offset that by the realized gains of $5.8 million we come up with a net loss during this quarter of $289.1 million -- a tad over 4 percent of the approximate $7 billion portfolio.

Nor does Conseco play favorites. A corresponding adverse result was experienced by CCP Insurance. The reckoning for that entity's actively-managed, fixed-maturity portfolio follows: (in $ millions):
<table>
<thead>
<tr>
<th></th>
<th>March 31, 1994</th>
<th>December 31, 1993</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed Maturity Investments</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Cost</td>
<td>$3,851.8</td>
<td>$3780.2</td>
</tr>
<tr>
<td>Total Market</td>
<td>3,872.0</td>
<td>3963.0</td>
</tr>
<tr>
<td>Unrealized appreciation</td>
<td>20.2</td>
<td>182.0</td>
</tr>
<tr>
<td>Reduction in unrealized gain</td>
<td>$162.6</td>
<td></td>
</tr>
<tr>
<td>Realized gains</td>
<td>11.5</td>
<td></td>
</tr>
<tr>
<td>Net adverse result</td>
<td>$161.1</td>
<td></td>
</tr>
</tbody>
</table>

Hence: over 4 percent of portfolio

For Bankers Life the Corresponding calculus follows:

<table>
<thead>
<tr>
<th></th>
<th>March 31, 1994</th>
<th>December 31, 1993</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed Maturity Investments</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Cost</td>
<td>$2,339.7</td>
<td>$2,265.5</td>
</tr>
<tr>
<td>Total Market</td>
<td>2,261.5</td>
<td>2,298.6</td>
</tr>
<tr>
<td>Unrealized appreciation (loss)</td>
<td>(78.5)</td>
<td>33.1</td>
</tr>
<tr>
<td>Reduction in unrealized gain</td>
<td>$111.3</td>
<td></td>
</tr>
<tr>
<td>Realized gains</td>
<td>1.4</td>
<td></td>
</tr>
<tr>
<td>Net adverse result</td>
<td>110.9</td>
<td></td>
</tr>
</tbody>
</table>

110.9 + 2280.05 (market) = 4.8%

To evaluate this negative performance during the initial 1994 quarter, I reviewed the corresponding data for the Chubb Corporation, in which I have been an investor for over a score of years, with the following results (in $ millions):

<table>
<thead>
<tr>
<th></th>
<th>March 31, 1994</th>
<th>December 31, 1993</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed Maturity Investments</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Cost</td>
<td>$9,918.6</td>
<td>$10,186.5</td>
</tr>
<tr>
<td>Total Market</td>
<td>10,255.6</td>
<td>10,922.9</td>
</tr>
<tr>
<td>Unrealized Appreciation</td>
<td>337</td>
<td>736.4</td>
</tr>
<tr>
<td>Reduction in Unrealized gain</td>
<td>399.4</td>
<td></td>
</tr>
<tr>
<td>Realized Gains</td>
<td>15.3</td>
<td></td>
</tr>
<tr>
<td>Net Adverse result</td>
<td>$384.1</td>
<td></td>
</tr>
</tbody>
</table>

$384.1 + $10,500 (market) - 3.7%

Clearly, Conseco's performance during that first quarter was "on target." assuming that Chubb provides an appropriate index.

Updating the foregoing data for the second quarter's developments we find: re Western National: as of June 30, the unrealized loss on the fixed maturity portfolio increased to $383.3 million (cost - $7,376 million. market
- $6,992.7 million). an increase of $320.3 million in the deficit; an amount exacerbated by $2.3 million realized loss -- hence an aggregate deterioration of $322.6 million about 4.6 percent of the $7 billion portfolio.

For the six month span the aggregate deterioration of $611.7 million represented about 8.7 percent of the $7 billion portfolio.

re CCP: As of June 30, the unrealized loss in the fixed maturity portfolio amounted to $161.9 million (Cost $3,774.3 million, market $3,612.4 million), an increased deterioration of $182.1 million, offset by $9.4 million realized gain produces a net of $172.7 million during the quarter.

For the six month span the aggregate deterioration of $333.8 million represented about 8.7 percent of the approximate $3.7 billion portfolio.

re Bankers Life: As of June 30, the unrealized loss in the fixed maturity portfolio amounted to $194 million (cost $2,582.2 million, market - $2,388.2 million), an increased deterioration of $115.8 million, offset by $.3 million realized gain produces a net of $115.5 million during the quarter.

For the six month span the aggregate deterioration of $226.4 million represented about 9.8 percent of the approximate $2.3 billion portfolio.

Insofar as Chubb is concerned, as of June 30, the unrealized gain in its fixed maturity portfolio amounted to $96.0 million (cost - $10,430.3 million, market - $10,526.3 million), indicating a deterioration of $241 million during the second quarter, offset by 15.3 realized gain produces a net of $225.7 million; hence a deterioration of about 2.2 percent on the approximate $10.3 billion portfolio.

For the half-year span the aggregate deterioration of $609.8 million represented about 5.7 percent of the $10.75 billion portfolio.

If then, Chubb were to represent the standard for the second quarter as
well, it is clear that Conseco's record was about twice as dismal as that reflected by Chubb.

The juxtaposing of Western National's and Chubb's investment practices produces some intriguing contrasts. Thus, of the former's year-end 1993, $6.9 billion of fixed maturity investments a mere $70 million, 1.1 percent were in tax exempts. For Chubb the corresponding data are $5.5 billion and 54.3 percent, respectively. (Complementing the divergence in the tax-exempt category, Western National's portfolio comprised 67 percent corporate and 31 percent mortgage-backed bonds; for Chubb the percentages were 21 and 15, respectively.) There may, of course, be other explanations for this phenomenon: the one which evolves for this observer proceeds as follows: As noted in the discourse regarding Conseco's cash flow, it had collected $10.8 million in income taxes from its life subsidiaries in excess of the amount required to be remitted ($101.9 million collected, $91.1 million remitted).

This implies that the insurance companies passed upwards through the chain of affiliation. the taxes calculated on the basis of their separate returns. To the extent such separate-return determinations produce a higher tax that much more is required to be remitted upstream. So it is that to the extent, the life insurance subsidiaries are heavily invested in taxable securities, the resultant tax liability is increased, and the cash flowing upwards is enriched. To the extent that the enter prices at the top of the chain have offsetting minuses, they are able to retain the amounts derived from the underlying life insurance subsidiaries.

These dismal performances are especially relevant in view of the contemplated Kemper deal. By this thrust Conseco would capture managerial control over some $70 billion of investment funds and to be importantly
compensated for its stewardship. This should demand that Conseco demonstrate to all those who will be affected by any shifts in Kemper’s portfolio management: based on what we see in the record Conseco’s performance in this area would assign it a ranking no better than mediocre.

And here it should be remembered that as of the third 1992 quarter Conseco switched the status of the various fixed maturities investment pools from the “held to maturity” to “actively managed.” By so doing Conseco was telling the world that it was putting all of those bond portfolios “into play,” and to be judged continuously by their investment acumen. This should presume an undertaking on the part of the Conseco wise men to “outperform the averages”; I will leave it to them to inform the world as clearly as, say, Scudder Stevens would, as to how well they did thus deal. And then I will leave it to all the financial houses and their gurus to tell the world in their newsletters as to just why Conseco should be permitted to get its hands on Kemper’s $70 billion. I also charge Citicorp and Morgan Stanley as to why they are prepared to aid and abet this Conseco thrust by agreeing to lend $1.2 billion and arranging a $750 million junk-bond offering, to fund the takeover.
<table>
<thead>
<tr>
<th>Portfolio</th>
<th>Portfolio loss</th>
<th>Percent</th>
<th>Portfolio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Western National</td>
<td>611.7</td>
<td>8.7%</td>
<td>7 billion</td>
</tr>
<tr>
<td>CCP Insurance</td>
<td>333.8</td>
<td>8.7%</td>
<td>3.7 billion</td>
</tr>
<tr>
<td>Bankers Life</td>
<td>226.4</td>
<td>9.8%</td>
<td>2.3 billion</td>
</tr>
<tr>
<td>CONSECO - Deconsolidated, i.e., Bankers National</td>
<td>127.4</td>
<td>10%?</td>
<td>3.5 billion down to 400 million</td>
</tr>
<tr>
<td>Chubb</td>
<td>609.8</td>
<td>5.7%</td>
<td>10.75 billion</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Portfolio Analysis</th>
<th>Tax Exempt</th>
<th>Corporate</th>
<th>Mortgage Backed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Western National</td>
<td>1%</td>
<td>67%</td>
<td>31%</td>
</tr>
<tr>
<td>Chubb</td>
<td>54%</td>
<td>21%</td>
<td>15%</td>
</tr>
</tbody>
</table>
The Statesman-Kemper Numbers Caper

"Reductio ad absurdum"

The accompanying pro forma balance sheet, derived from that included by Conseco in its September - Form S-4 filing of the proposed Kemper proxies, should demonstrate most vividly, even for an opaque eye, the absurdities of the Conseco mythology, however rooted in GAAP, for example:

- Increases in goodwill were booked re Statesman $244 million and Kemper more than $1.5 billion so that that intangible was pumped up to $2.1 billion, whereas Conseco’s common stock equity would be increased to but a tad over $1 billion.

- And this so-called Goodwill, its substance or lack thereof will be considered presently, would be booked despite whopping increases in other intangibles, i.e., in: The Cost of Policies purchased over the amounts previously booked as the Deferred Acquisition Costs $686 million.

- The enormous increases in the pool of fixed maturity investments, from $2.8 billion to $11.9 billion despite the only tenuous, i.e., minority stake in the contemplated CCP-II acquisitions (see the discourse under Consolidation.)

The most glaring of the disparities discernible from the balance sheet is the enormity of the excess of the Goodwill (over $2 billion) over the common shareholders' equity (as noted, $1 billion). When a corresponding imbalance was noted about a decade ago in the wake of the ICH acquisition of Bankers Life & Casualty it evoked a January 14, 1985, article in Barron’s, "The Black Hole in ICH." (It does appear that some myths never die; even the characters somehow manage to survive, however discredited.)
retelling: Goodwill is nought but a number required to make the debits equal the credits when a business combination is booked under purchase accounting; it has no substance in and of itself.

For example: assume that X Corp. agrees to buy all of Y corp for $100. X’s top brass had assumed that Y’s real hard assets net of liabilities would come up to $100. After the acquisition X’s CFO determines that Y’s inventories were worth $10 less than what was contemplated so that there are only $90 of net real assets; no stew -- the CFO produces an asset (sic!) $10 of Goodwill.

But. alas. an EPA liability crawls out of the ground, so that Y’s real net assets are only $80. Abracadabra! The Goodwill is now $20. At all times the debits will equal the credits -- and for some my colleagues, in these circumstances that is all they know on earth, and all they need to know.
(Sadly, truth and beauty are beyond their senses.)

Lest you fancy that this was woven out of the realm of myth, let us take note of what is presented by Conseco’s financial people as reality in connection with the Statesman acquisition

Last July a “red herring” prospectus was filed with the SEC for a senior subordinated note issue by the American Life Holding corporation (the corporate vehicle involved in the Statesman Acquisition). The document included the development of a pro forma balance sheet as of March 31, 1994, including the following (in $ millions):

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Assets (excluding goodwill)</td>
<td>$4,712</td>
</tr>
<tr>
<td>Total Liabilities (including Redeemable Preferred)</td>
<td>4,754</td>
</tr>
<tr>
<td>Common Stock</td>
<td>$90</td>
</tr>
<tr>
<td>Excess - Goodwill</td>
<td>$132</td>
</tr>
<tr>
<td>Excess - Goodwill</td>
<td>$132</td>
</tr>
</tbody>
</table>
Comes now, the definitive prospectus, September 23, providing us with the updated, June 30, pro forma balance sheet, leading to the following:

Total Assets (excluding Goodwill and a related asset, considered below) $4,787
Total Liabilities (including Redeemable preferred) $4,984
Common Stock 102 5,086
Excess $299

For this latter period the Goodwill factor was split between Deferred Income Tax ($69 million) and Goodwill ($230 million); presumably these two factors were subsumed in the March 31 $132 million number.

The point is that despite the absence of any identifiable event which might have warranted any increase in that most tenuous asset, it more then doubled, from $132 million to $299 million. Nonetheless, as the foregoing demonstrates, the debits do absolutely and unequivocally equal the credits -- and they do so for both periods.

The foregoing is intended more as an expression of outrage at what passes for GAAP than for this particular analysis. Because, as we will see, $132 million or $299 million are mere pittances.

If the Statesman-Kemper acquisition represented rich lodes of income, to say nothing of super-rich income, well, then. the $1.7 billion of added Goodwill might well be good. But now let's look at the record as it has been cast up for us by the S-4.

Had the acquisitions occurred as of the start of 1993, Conseco's net would have been boosted by a whopping $9.4 million ($4.5 million from Statesman. $4.9 from Kemper.) Even including the super-majority portion inuring to the credit of what the Conseco accountants call the "minority
interests" the income for all of 1993 would be less than impressive, i.e., $59 million ($14.4 million from Statesman, $44.6 million from Kemper.) Is this the stuff that $1.7 billion of Goodwill is supposed to produce?

For the first half of 1994 the consequences of the acquisitions were, to put it mildly, incredible. Thus, Conseco's pro forma net was shown to have suffered an actual reduction of $22.2 million (from a Kemper minus of $24.8 million, offset by a $2.6 million Statesman plus.)

If we were to include the interests in the profits inuring to the credit of the minorities (sic!) the six month net would be all of $2.5 million resulting from a $9.4 million Statesman plus, less a $6.9 million Kemper minus.

Again, for that the Conseco financial people plugged in a Goodwill of $1.7 billion and appear not to have turned red with embarrassment?

But the foregoing data, however dismal, do not reveal the full measure of Conseco's resultant devastation on an "as if" basis for the respective periods. For the full story we must be reminded that in the wake of the Kemper acquisition there would be an additional 8.1 million shares of Conseco outstanding (assuming that Conseco's stock price for the payout were about $52 a share).

As a consequence of the resultant dilution Conseco's earnings per share before discontinued operations would have been reduced from $4.62 to $3.94 for 1993; and from $2.07 to 98 cents for the 1994 half year.

But the booking of that $1.7 billion blob of Goodwill is not the quintessential absurdity. Instead, that doubtful distinction belongs to Steve Hilbert's and his colleagues determination to spread that grotesque sum over 40 years and then, mind you, on a straight line. I wish them well, may these
wise men "live so long" and even longer.

Given Kemper's most erratic pattern of earnings, or lack thereof, by what standard could Conseco deem that $1.7 billion cost logically associated with a two-score stream of revenues on a straight line.

Assuming that Hilbert, et al., could see the exquisite fabric that could be woven from that $1.7 billion investment, then, I assert he and his cohorts should determine how much of that $1.7 billion of gold (sic!) should be charged to each year's output of that most bedazzling expectation of year-to-year revenues.

I presume, or at the least hope, that all of the numbers and their implications were laid bare to the correspondingly wise men at Citicorp and Morgan Stanley who determined that $2 billion of moneys could be provided by them to bring the Kemper expedition to fruition. But then I cannot avoid recalling the Hans Christian Andersen saga of the Emperor's New Clothes. There we were told the wise counsellors doubted the existence of the glorious raiment; nonetheless, they went along because they were told the fabric was so bedazzling that only persons with the ultimate of wisdom could see it. Clearly, they could not compromise their wisdom.

Is it at all conceivable that Citicorp, Morgan Stanley, et al., should seek "the child"?
$150 million was included by Conseco when calculating the proceeds and profit from the IPO. Now then, as such a dividend Conseco should be entitled to an 80 percent deduction, thereby insulating $120 million from any gain which might otherwise be attributed to the Western National IPO. Mind you, I do not pretend to expertise regarding Conseco's unaudited convoluted tax strategy -- I am here relying on what might be presumed to be "common knowledge."

Adding to this observer's misgivings regarding the proposed objective our motivation of the exercise - redemption - reset ploy was a statement by the Conseco's CFO during a July 28 Teleconference, that the company had a $150 million net operating loss available. And when one puts all of these questions together, the conclusion is inevitable, the deal was intended to accommodate the executives' objectivities rather than those of the company.

Continuing in this mood, as we are aware the accounting profession and even the Congress are wrestling with the question relating to the fair accounting for stock options. In this case $200 million of compensatory income was realized by the executives. Presumably, that compensatory income matches a $200 million expense for Conseco. Why should that expense escape
### Conseco - Statesman/Kemper
**Pro Forma Consolidated Balance Sheet**
*As of June 30, 1994*

<table>
<thead>
<tr>
<th>Description</th>
<th>Conseco As is</th>
<th>Effect of Statesman/Kemper</th>
<th>Conseco/ Statesman/Kemper</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liabilities</td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Insurance Liabilities</td>
<td>3.528</td>
<td>12.558</td>
<td>16.086</td>
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<tr>
<td>Sundry Liab</td>
<td>510</td>
<td>3.287</td>
<td>3.797</td>
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<td>Conseco Direct Debt</td>
<td>231</td>
<td>1.804</td>
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<tr>
<td>CCP-II Debt</td>
<td>-</td>
<td>1.067</td>
<td>1.067</td>
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<tr>
<td>Bankers Life Debt</td>
<td>280</td>
<td>-</td>
<td>280</td>
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<tr>
<td>Total Liabilities</td>
<td>4.549</td>
<td>18.716</td>
<td>23.265</td>
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<tr>
<td>Minority Int.</td>
<td>106</td>
<td>748</td>
<td>934</td>
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<tr>
<td>Conseco Preferred Stock</td>
<td>287</td>
<td>- 0 -</td>
<td>287</td>
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<tr>
<td>Conseco Common Equity</td>
<td>577</td>
<td>429</td>
<td>1.006</td>
</tr>
<tr>
<td>Total Liab &amp; Sh Equity</td>
<td>5.599</td>
<td>19.893</td>
<td>25.492</td>
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## Conseco Inc. - Pro Forma Income Selected Data
- 1993 -

### Amount in Millions

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</thead>
<tbody>
<tr>
<td>CNC - Historical</td>
<td>313.6</td>
<td>214.6</td>
<td>56.3</td>
<td>158.3</td>
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<tr>
<td>Statesman - Hist</td>
<td>68.5</td>
<td>46.0</td>
<td>8.8</td>
<td>37.2</td>
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<tr>
<td>Statesman - Adj</td>
<td>(44.6)</td>
<td>(31.6)</td>
<td>1.1</td>
<td>(32.7)</td>
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<tr>
<td>Conseco &amp; Statesman Adj</td>
<td>337.5</td>
<td>229.0</td>
<td>66.2</td>
<td>162.8</td>
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<tr>
<td>Kemper Hist</td>
<td>(109.1)</td>
<td>(89.4)</td>
<td>-</td>
<td>(89.4)</td>
</tr>
<tr>
<td>Kemper Adj</td>
<td>172.3</td>
<td>134.0</td>
<td>39.7</td>
<td>94.3</td>
</tr>
<tr>
<td>Cons. &amp; Stats. &amp; Kemper</td>
<td>400.7</td>
<td>273.6</td>
<td>105.9</td>
<td>167.7</td>
</tr>
</tbody>
</table>

### Per Share Data:

#### Historical
- **158.3** \(\div\) **33.4** \(=\) **4.62**

#### Proforma
- **167.7** \(\div\) **41.6** \(=\) **3.96**

### Six Months Ended June 30, 1994

<table>
<thead>
<tr>
<th></th>
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<tr>
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<td>126.4</td>
<td>88.7</td>
<td>22.6</td>
<td>66.1</td>
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<td>21.8</td>
<td>4.5</td>
<td>17.3</td>
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<tr>
<td>Statesman - Adj</td>
<td>(17.8)</td>
<td>(12.4)</td>
<td>2.3</td>
<td>(14.7)</td>
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<tr>
<td>Conseco &amp; Statesman Adj</td>
<td>140.7</td>
<td>98.1</td>
<td>29.6</td>
<td>68.7</td>
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<tr>
<td>Kemper Hist</td>
<td>119</td>
<td>75.1</td>
<td>-</td>
<td>75.1</td>
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<tr>
<td>Kemper Adj</td>
<td>(112.0)</td>
<td>(82)</td>
<td>17.9</td>
<td>(99.9)</td>
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<tr>
<td>Cons. &amp; Stats. &amp; Kemper</td>
<td>147.7</td>
<td>91.2</td>
<td>47.3</td>
<td>43.9</td>
</tr>
</tbody>
</table>

### Per Share Data:

#### Historical
- **66.1** \(\div\) **31.9** \(=\) **2.07**

#### Proforma
- **43.9** \(\div\) **40** \(=\) **.98**
Coda

On July 28, Conseco arranged for a teleconference to which the presumptive loyal followers of the company's fortunes were invited. I was not among those favored few; nonetheless. I was provided the access code and. accordingly, qualified as an "eavesdropper." Inquiry of Conseco's PR people informed me that no transcript was retained. accordingly, herewith some impressions:

- At times the company's chief spokesman sounded more like a huckster than the chief executive officer of a company responsible for a management of tens of billions of dollars of other people's money -- and reaching out to get control of many times that amount.

- But even more disconcerting was the listening in on the Q&A with the invitees to those proceedings. presumably the sophisticated professional followers of Conseco's fortune. The questions were essentially superficial. the answers sometimes evasive. regularly followed by an obsequious thank you. Little wonder that the show was followed by a short-lived boomlet in Conseco's shares.

- Hilbert proclaimed that the share prices of the several insurance affiliates were severely undervalued. In fact prices of $22 a share and higher were alluded to for Western National. All this was especially surprising in view of the fact that on that date Western National was selling at 15. fully, 33 percent over the price realized by Conseco less than six months previously when it sold off a 60 percent stake in that entity. This listener to the
teleconference was left with the sense that the undervalued talk was either hype, or else that Conseco had engaged in a "Fire sale" last February.

Nor do I recall any of the invited conferees challenging the Conseco spokesman regarding their dismal performance in managing the bond portfolios. There was some question regarding changes in interest rates and their effect on Conseco. These questions where finessed by "references to spreads"; but no one seemed to want to inquire of Conseco as to why they did not move ahead of the curve, and thereby to avoid those high portfolio losses when measured on the mark-to-market basis adopted by Conseco.

But for the most part the discussion revolved around the "for sale" sign which Conseco was putting on its stakes in Bankers Life, Western National and CCP. This was because the effective consummation of such dispositions would be the company's presumed ability to increase the cash portion of its tender offer for Kemper and, as a consequence, reduce the extent to which it would have to pay in real gold, i.e., Conseco's common stock. The proceeds at then prevailing market prices would aggregate about $1.1 billion. There were questions relating to the carrying values and tax bases for these investments: my recollection is that the responses were anything but responsive. My "best shot" counting of the carrying values indicated an aggregate of about $900 million: the company is, of course, privy to the tax figure.

But all this did not stop the astute loyal Conseco followers from racing to the Dow Jones wires with their glad tidings, thus:

New York - DJ - Conseco Inc. (CNC) is considering raising the cash portion of its $67-a-share offer for Kemper Corp. (KEM).

Currently, Conseco is offering $56 in cash and $11 in Conseco
stock for each of Kemper's 40 million shares.

Conseco disclosed the possibility of raising the cash component in its second-quarter earnings statement, released earlier today. Chairman Stephen C. Hilbert reiterated the point in a conference call with analysts, indicating that the company is also considering an all-cash offer.

The determining factor will be Conseco's sale of equity stakes in two of its insurance subsidiaries and one affiliate.

"We are actively evaluating using proceeds from any such sale to eliminate all or a significant portion of the public debt and/or Conseco equity which otherwise would be issued in connection with the Kemper merger." Conseco said in a written statement.

The news overshadowed Conseco's weak second-quarter performance and has forced up the company's shares 2 1/2%, or 4.7%, to 50 1/4. Volume on the NYSE-listed stock is 301,800 shares, compared with average daily volume of 267,800.

NYSE-listed Kemper's shares also rallied, gaining 1, or 1.7%, to 61 on volume of 487,200, compared with average daily volume of 359,600.

Analysts reacted positively to the possibility of more or all-cash in the Kemper deal.

Ladenburg Thalman & Co. insurance analyst Stanley J. Goldring said a higher cash offer by Conseco for Kemper would reduce earnings dilution for the post-merger company. An all-cash offer, it made, would mean the company would have about 30 million fully diluted shares outstanding as opposed to about 40 million, he said.

"People are beginning to appreciate what's going on with Conseco's acquisition of Kemper." Goldring said.

Conseco revealed earlier this month that it was considering selling some of its insurance holdings to pay off part of the debt it would take on in the acquisition. As now structured, Conseco would spend $2.68 billion and would be financed by a loan from Citibank, junk bonds and money from an investment fund Conseco manages.

"The marketplace realizes (Conseco) has a lot of alternatives and isn't locked into subordinated debt" to finance the deal, noted Michael A. Lewis, an analyst with Dean Witter Reynolds. "They're getting a good response."
Conseco is considering selling its holdings in Bankers Life Holding Corp. (BLH), Western National Corp. (WNH) and CCP Insurance Inc. (CCP). It holds a 57% stake in Bankers Life, 40% of Western National and 42% of CCP.

Conseco has said any of the sales would be subject to it receiving "fair value" but noted in its release today that "a sale at fair value at this time would allow us to realize the value we have created in those companies, increase our financial flexibility and provide growth capital to more rapidly increase the value of the Kemper organization."

Based on yesterday's closing prices, the market value of Conseco's equity stakes in the three companies was $1.3 billion.

Ladenburg Thalman's Goldring said that if Conseco changes the terms of its Kemper acquisition to an all-cash offer, he would raise his 1995 estimate to $8.50 a share from the current $7.00 to $7.25.

"Obviously, it's a dramatic impact," he said.

A spokesman said Conseco has bought $15 million worth of Kemper shares to date, at $59 to $60 each. That would work out to about 252,100 shares based on an average price of $59.50 a share.

A few days later Merrill Lynch put out another 1.1 rating for Conseco, informing its customers that the stock is an "aggressive buy."

Now readers of my stuff over the past quarter of a century are well aware of my ongoing campaign against my accounting colleagues involving themselves in critical conflict of interest where they are found out rendering consultant services to clients for whom they are also performing the ostensibly independent audit function.

Now, as it happens, Merrill Lynch, Dean Witter and Ladenburg Thalman have regularly allied themselves as underwriters of Conseco's public offerings. I maintain that representations of those firms should be prohibited from disseminating market analyses of Conseco's securities. The halls of Congress have recently been reverberating with allegations of "conflicts of interest" and calls for "recusal": why should not the canyons
of Wall Street be reverberating correspondingly?

While I might understand those firms avoiding exposing their negative analyses, I do take umbrage at their bull hypes. And here I want it emphasized that this position is not limited to Conseco; it is a statement of principles as I see it.

I now want to move my precepts of principle to another related aspect of the responsibilities of the financial community. I believe all persons responsible for managing pools of other people's money should be required to make public the records of their own securities trading. Thus, the managers of pools of billions of dollars of insurance or mutual fund portfolios are in an enviable position to get special treatment from the firms with which their funds do business. These favors may involve but IPOs or as we saw in the recent exposures in the Guarantee Security Life Insurance saga, "equity stripping." Reciprocally, the account executives of the firms which grant such favors should be required to disclose the transactions.

But now let us sing a hymn of praise for Merrilly Lynch: take note of an article in the October 13, 1994 Wall Street Journal captioned "Conseco Fires Merrill Lynch As Underwriter."
### Conseco - Statesman/Kemper
Pro Forma Consolidated Balance Sheet
As of June 30, 1994

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<thead>
<tr>
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<th>Conseco/Statesman/Kemper</th>
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</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
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<tr>
<td><strong>Investments</strong></td>
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</tr>
<tr>
<td>Fixed Maturity</td>
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<td>9.123</td>
<td>11.909</td>
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<tr>
<td>Equities</td>
<td>15</td>
<td>169</td>
<td>184</td>
</tr>
<tr>
<td>Mortgage &amp; Real Estate</td>
<td>77</td>
<td>893</td>
<td>970</td>
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<tr>
<td>Other</td>
<td>788</td>
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<td>3,987</td>
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<td>Total Investments</td>
<td>3,666</td>
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<td><strong>Intangibles</strong></td>
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<td>Cost of Policies Purch.</td>
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<td>1,676</td>
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<tr>
<td>Produced</td>
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<td>217</td>
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<tr>
<td>Goodwill</td>
<td>316</td>
<td>1,777</td>
<td>2,093</td>
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<tr>
<td>Total</td>
<td>1,155</td>
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<td>4,608</td>
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<tr>
<td>Equity in CCP Insurance</td>
<td>218</td>
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<td>218</td>
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<tr>
<td>Western National</td>
<td>193</td>
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<td>193</td>
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<tr>
<td>Other Assets</td>
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<td>Total Assets</td>
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