

21. (3 points)

a. (0.5 point)

Identify the primary intended user of financial statements prepared under each of SAP and GAAP.

b. (1 point)

Briefly explain the accounting treatment of the following items under each of SAP and GAAP:

- Deferred acquisition costs.
- Discounting of loss and loss adjustment expense reserves.

c. (1 point)

Justify the accounting treatment of each item in part b. above given the intended users in part a. above.

d. (0.5 point)

From an accounting perspective, justify an insurer's decision to rent rather than buy furniture.

**SAMPLE ANSWERS AND EXAMINER'S REPORT**

<b>QUESTION 21</b>	
<b>TOTAL POINT VALUE: 3.00</b>	<b>LEARNING OBJECTIVE: C3</b>
<b>SAMPLE/ACCEPTED ANSWERS</b>	
<b>Part a: 0.5 point</b>	
<p>SAP</p> <ul style="list-style-type: none"> <li>• Regulators</li> </ul> <p>GAP</p> <ul style="list-style-type: none"> <li>• Investors</li> <li>• Shareholders</li> <li>• Creditors</li> <li>• Management</li> </ul>	
<b>Part b: 1.0 point</b>	
<ul style="list-style-type: none"> <li>• Under SAP, all policy acquisition costs must be recognized immediately. Under GAAP, cost can be deferred over the life of the contract. SAP does not allow discounting unless it is for work comp (tabular) or the regulator permits a non-tabular discounting. GAAP allows the SAP discount to be used, but the rate can differ from the risk free rate used in SAP.</li> <li>• DAC <ul style="list-style-type: none"> <li>SAP: not allowed</li> <li>GAAP: amortized pro-rata over policy life</li> </ul> <p>Discounting</p> <ul style="list-style-type: none"> <li>SAP: generally not allowed except tabular indemnity WC</li> <li>GAAP: allowed when the pattern is known or can be reasonably estimated.</li> </ul> </li> <li>• SAP <ul style="list-style-type: none"> <li>DAC: not allowed. All expenses charged when they incur.</li> <li>Discounting: not allowed in general (exceptions – indemnity portion of WC, where allow by regulators on an exception basis.)</li> </ul> <p>GAAP</p> <ul style="list-style-type: none"> <li>DAC: allowed. Costs associated w/ the acquisition &amp; issuance of policies are capitalized &amp; amortized as an asset over time.</li> <li>Discounting: generally not used by company. But is allowed if payment pattern is known or can be reasonably estimated.</li> </ul> </li> <li>• <u>SAP</u> <ul style="list-style-type: none"> <li>DAC – does not exist</li> <li>Discounting – allowed if tabular, if mono-med med, or have commissioner approval</li> </ul> <p><u>GAAP</u></p> <ul style="list-style-type: none"> <li>DAC – allowed to offset costs (asset)</li> <li>Discounting – allowed if payment pattern can be reasonably estimated</li> </ul> </li> </ul>	
<b>Part c: 1.0 point</b>	
<ul style="list-style-type: none"> <li>• SAP is focused more on solvency, so by recognizing all acq costs at the beginning of the contract, it reflects that the company does not have that cash available to pay claims, which is a conservative approach. GAAP allows expenses to match revenues, which is more</li> </ul>	

## SAMPLE ANSWERS AND EXAMINER'S REPORT

<p>important for investors as it more accurately reflects the business. For discounting, the use of the risk free rate in SAP is a conservative measure, giving the company the least reduction to loss reserves, focusing on solvency. In GAAP, if the company believes they can earn a different return, they should reflect it in order to give investors a better picture of the company.</p> <ul style="list-style-type: none"><li>• DAC/SAP – expense already incurred not available in liquidation DAC/GAAP – matching earning of revenue to smooth outcome Disc/SAP – Generally not allowed to provide additional cushion in liquidation Disc/GAAP – allowed if reasonably estimable. To provide more accurate picture of business</li><li>• <u>DAC</u>: SAP – more conservative, better reflects value in liquidation GAAP – better picture of the insurer's profitability <u>Discounting</u>: SAP = better consistency between firms, easier for regulators to understand insurer financial condition GAAP – better aligned w/ the underlying economics</li></ul>
<b>Part d: 0.5 point</b>
<ul style="list-style-type: none"><li>• Rental fees can be expensed, so it could reduce income tax. Furniture is a non-admitted asset, so it reduces the surplus.</li><li>• Furniture is non-admitted under SAP. Renting dramatically reduces up-front costs and avoids tying up capital.</li><li>• By renting, the insurer is realizing the cost of the furniture over several years rather than paying a lump sum for a non-admitted asset.</li></ul>
<b>EXAMINER'S REPORT</b>
<b>Part a</b>
Very few candidates received less than full credit on this part. Those that did not receive full credit generally provided answers that were too broad in their GAAP response such as "Stakeholders" and "Industry".
<b>Part b</b>
Candidates generally performed very well with respect to the DAC treatment in both SAP and GAAP. The most common mistake on this part was generalizing the loss reserve discount treatment for SAP and GAAP into a simple "Yes" or "No" response. For full credit, candidates had to recognize that there were instances when discounting is allowed, although it was not required to list each instance. In general, candidates seemed to believe GAAP allows much broader loss reserve discounting than it does. Specifically, many candidates stated that GAAP always allows, or even requires, discounting of loss reserves. Very few candidates stated that the primary difference between GAP and SAAP loss reserve discounting is the discount rate allowed. Another, less common, mistake was failing to mention the accounting treatment of loss reserve discounting altogether.
<b>Part c</b>
For full credit, a justification for both discounting and DAC, for both SAP and GAAP, was required (four statements of justification). The justification should show that the candidate understands the focus of SAP and GAAP, as well an understanding of the accounting item. Candidates that simply stated that the discounting and DAC treatment were "more conservative" received partial

## SAMPLE ANSWERS AND EXAMINER'S REPORT

credit.

### **Part d**

Candidates struggled to achieve full credit on this part more than the other parts of this question. The candidate was expected to identify office furniture as a non-admitted asset, state its effect on surplus, and state why renting is relatively beneficial. Candidates were given full credit for adequately comparing renting to buying, even without specifically mentioning “non-admitted asset” or “surplus”. While most candidates explained the effect that buying would have, the most common mistake was failing to mention the relative benefits of renting. Some candidates stated that renting was not preferable to buying, however, they were unable to adequately support their position.