

EXAM 6 – UNITED STATES, FALL 2017

9. (3.5 points)

The following excerpts are from a company’s 2016 Annual Statement (all figures are in thousands of dollars):

LIABILITIES, SURPLUS, AND OTHER FUNDS		
	Current Year	Prior Year
Provision for reinsurance	220	211
Surplus notes	75	74
Gross paid-in and contributed surplus	7,600	2,000
Surplus as regards policyholders	52,400	33,650

EXHIBIT OF NONADMITTED ASSETS			
	Current Year Total Nonadmitted Assets	Prior Year Total Nonadmitted Assets	Change in Total Nonadmitted Assets
Totals	810	450	(360)

EXHIBIT OF CAPITAL GAINS (LOSSES)					
	Realized Gain (Loss) on Sales or Maturity	Other Realized Adjustments	Total Realized Capital Gain (Loss)	Change in Unrealized Capital Gain (Loss)	Change in Unrealized Foreign Exchange Capital Gain (Loss)
Totals	55	3	58	92	0

Dividends to policyholders 47
 Dividends to stockholders 2,184

During 2016, the company began recording unpaid losses net of salvage and subrogation. The cumulative effect of this change in accounting principle is 1,500.

a. (2.5 points)

Calculate the 2016 statutory net income.

b. (1 point)

Identify a user for each of the following and briefly describe how the exhibit satisfies a need of the user:

- i. Balance Sheet
- ii. Income Statement

Part d

Candidates were expected to fully develop arguments for and against including wind damage on a NFIP policy.

Common errors include

- As an argument against including wind coverage, saying the tax-burden will be increased without explaining why (i.e. more uncertainty around pricing)
- As an argument for, claim that wind insurance is not available when in fact it is available in all jurisdictions through standard homeowners or residual market plans.

QUESTION 9**TOTAL POINT VALUE: 3.5****LEARNING OBJECTIVE: C1****SAMPLE ANSWERS****Part a: 2.5 points**Sample 1

Current Surplus = Prior Surplus + Net Income + Direct Charges to Surplus

$$52,400 = 33,650 + \text{Net Income} + (211-220) + 92 - (810-450) + 1,500 - 2,184 + (7,600-2,000) + (75-74)$$

$$\text{Net Income} = 52,400 - 33,650 - 4,640 = 14,110$$

Sample 2

Change in Surplus = Net Income + Direct Charges to Surplus

$$18,750 = \text{Net Income} + 5,600 + 1,500 + 1 - 360 - 9 + 92 - 2,184$$

$$\text{Net Income} = 18,750 - 4,640 = 14,110$$

Sample 3

Net Income = Change in Surplus - Direct Charges to Surplus

$$= 18,750 + (220-211) - (75-74) - (7,600-2,000) + (810-450) - 92 + 2,184 - 1,500$$

$$= 14,110$$

Sample 4

$$\text{Net Income} = 18,750 + (220-211) - (75-74) - (7,600-2,000) + (810-450) - 92 + 2,184 - 1,500$$

$$= 14,110$$

Sample 5

$$\text{Net Income} = 18,750 + (220-211) - (75-74) - (7,600-2,000) + (810-450) - 92 \cdot .65 + 2,184 - 1,500$$

$$= 14,142.2$$

Candidates may have done the above calculations in a different order

Part b: 1 point

Balance Sheet Users:

- Regulators
- Actuary
- Company Management
- Shareholders/Investors
- Auditors
- Policyholder/Insured
- Board of Directors
- Rating Agency

Balance Sheet Uses:

- They use it to see whether the insurer has enough assets to fulfill its obligations to policyholders. Being able to see the surplus (admitted assets in excess of liabilities) gives them a tool to easily monitor the financial status of the insurer at a given time.
- Exhibit can be used to look at the strength of a company's capital and whether the capital meets capital requirements.
- To verify the components of policyholder surplus for the evaluation of solvency of the insurer.
- Based on the non-admitted assets, they can get a sense of how much assets will be liquid/available in the event of insolvency.
- The actuary can examine the reserves held when assessing the reasonableness of reserves.

Income Statement Users:

- Investors
- Regulators
- Company Management
- Shareholders
- Board of Directors
- IRS/Auditors
- Policyholder/Insured
- Competitors
- Actuaries
- Rating Agency

Income Statement Uses:

- They can use this to understand the changes to their surplus in a given time period. They can see to what extent this change was impacted by underwriting income, investments, dividends, taxes, or others.

- User can see if the company is making a profit and how high its expenses are to help with decision on whether to purchase coverage from the company.
- See if company is making profit as evaluation of insufficient or excessive premiums.
- They want to verify the earnings power of the insurer and the profitability.
- Can see the expenses and revenue to determine if it matches their expectations.
- Use the income statement to compare to their own income statement to see where they could be performing better (loss ratio & investments)
- They can use it to see how profitable the insurer was over the past year and use that to determine what kind of rating the insurer deserves based on its income.

EXAMINER'S REPORT

Candidates were expected identify the components of and calculate net income. Candidates were also expected to know common users and uses of the balance sheet and income statement.

Part a

Candidates were expected to know that net income can be derived by removing direct charges to the capital & surplus account (i.e., items that don't go through the income statement) from the change in surplus.

Common mistakes included the following:

- Getting the sign of the charge to surplus incorrect (e.g., thinking the charge increased surplus when it actually decreased surplus). Many candidates had all of the charge components identified correctly but mistakenly added the charge when they should have subtracted (or vice versa).
- Including extraneous amounts in the calculation of charges to surplus. Examples of these extraneous items included policyholder dividends and realized capital gains, as these items are already included in net income.
- Treating the "Gross paid-in & contributed surplus" for the current year as the additional capital contribution in the current year rather than the cumulative amount to date. The difference between the current and the prior amount should have been used as the charge to surplus.
- Failing to include the cumulative effect of the change in accounting principle (1,500) in the charges to surplus, or using the wrong sign.
- Applying an assumed tax rate (e.g., 35%) to the change in unrealized capital gains.

Part b

The candidates were expected to identify users of the balance sheet and income statement and explain how those users would use the information in the exhibits to satisfy a particular need they would have.

Common mistakes included the following:

- Providing facts about the exhibits (e.g., the balance sheet shows assets, liabilities and surplus) rather than an explanation how the identified user would use the information in the exhibit to satisfy a particular need.
- Not providing users or how the exhibit satisfied the user's needs.
- Misidentifying items as in the exhibit when in fact they were in the exhibit (e.g., taxable income can be found in the income statement).

QUESTION 10

TOTAL POINT VALUE: 2.5

LEARNING OBJECTIVE: C1

SAMPLE ANSWERS

Sample 1

Net Income =

575	EP
-415	Loss
-100	LAE
-125	Other
+60	Investment Income Earned
+12	Realized
+8	Other Income
-6	Div. to PHs
-7	Federal and Foreign Taxes Incurred
<hr/>	
2	

Surplus =

625	
+2	
+(28 - 24)	Δ DTA
-(9 - 11)	Δ Provision
-(120 - 75)	Δ Nonadmitted
-23	Dividends to stockholders
+(70 - 90)	Δ Unrealized gains/losses
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\$545,000,000	

The tax effect of unrealized gains/loss already included in Δ DTA.

Sample 2

$$625 + 575 - 415 - 100 - 125 + 60 + 12 + (70 - 90) + 8 - 6 - 23 - 7 - (28 - 24) - (9 - 11) - (120 - 75) = 537$$