19. (2.5 points)

   a. (1.5 points)

      Briefly describe the three components of the fair value of an insurance liability under U.S. GAAP purchase accounting, and propose a methodology for determining each component.

   b. (1 point)

      Describe the treatment of goodwill under each of SAP and U.S. GAAP purchase accounting.

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- RBC is more focused on risks that affect it's solvency by estimating the required capital, while IRIS looked at the financial strength of insurer including different aspects like reserve adequacy, profitability, collectability, etc.
- RBC is used to calculate a minimum amount of capital that an insurer

EXAMINER'S REPORT

The candidates were expected to demonstrate knowledge of the purpose, components, similarities and differences of RBC vs. IRIS ratios.

Part a

The candidates were expected to name an advantage and disadvantage of the RBC ratio to assess the financial health of an insurer.

A common error was to provide a response that was related to an IRIS ratio instead of RBC, such as stating that the "usual values were based experience of insurers that became insolvent".

Part b

The candidates were expected to understand the components of the RBC calculation and why the R0 component is treated differently than the other charges (R1-R5) of the RBC formula.

Common errors include:

- Stating that that R0 is completely independent of other risk charges and thus not subject to the covariance adjustment
- Stating that the risks within the square root are correlated

Part c

The candidates were expected to compare and contrast RBC and IRIS frameworks by giving one similarity and one difference.

Common errors include:

- Confusing IRIS with Solvency II and talking about minimum capital requirements under IRIS framework
- Talking about action levels for IRIS (Confusing IRIS with IFRS)
- Similarity that both measure reserve adequacy (only IRIS does this)

QUESTION 19	
TOTAL POINT VALUE: 2.5	**LEARNING OBJECTIVE: C3**
SAMPLE ANSWERS	
Part a: 1.5 points	

Sample 1

1. The nominal future cash flows of liability – use loss development factors to determine cash flow payouts
2. A reduction to recognize the time value of money and an additional load to account for illiquid nature of liability – Use risk-free rate
3. A risk margin component to compensate for risk associated with liabilities – Use cost of capital approach.

Sample 2

1. Nominal cash flows – derived from implied ratio to ultimate
2. Discount rate and illiquidity – take risk-free rate (US Treasury), determine illiquidity adjustment based on analysis of corresponding asset liquidity adjustment
3. Risk Margin – Use solvency II approach to take 99.5% VaR as the required capital

Part b: 1 point

Sample 1

SAP: Goodwill is equal to purchase price less statutory surplus of the acquired company. Goodwill is amortized up to 10 years

GAAP: Goodwill is equal to purchase price less net assets (fair value of assets – fair value of liabilities); regularly tested for impairment.

Sample 2

SAP: Cap Goodwill at up to 10% of surplus and amortized over 10 years

GAAP: Recognizes Goodwill immediately and tests periodically for impairment

EXAMINER'S REPORT

Candidates were expected to understand the three components of the fair value of an insurance liability under US GAAP accounting and propose a methodology for each. Additionally, candidates were expected to understand the treatment of goodwill under both GAAP and SAP accounting.

Part a

Candidates were expected to be able to briefly describe the three components and describe a methodology for determining each component.

Common errors include:

- List the components but not provide the methodology.
- Listing market value without any additional explanation.

Part b

Candidates were expected to describe the accounting treatment of goodwill under both GAAP and SAP standards

Common errors include:

- Reversing the SAP formula for goodwill as surplus/equity minus purchase price.
- Stating that the surplus/equity used is that of the acquiring company
- Incorrectly stating that GAAP amortizes goodwill.

QUESTION 20	
TOTAL POINT VALUE: 2.5	**LEARNING OBJECTIVE: C3**
SAMPLE ANSWERS	
Part a: 0.5 point	
Sample answers include: • US GAAP accounting is based on going-concern whereas SAP accounting is focused on solvency & liquidity concerns. • SAP Purpose: Regulators use to determine the company's ability to pay out current liabilities and protect policyholder. GAAP Purpose is to provide information to investors, creditors and other stakeholders. Look at the company on a going-concern. • GAAP: Accurate measurement of earnings. Used primarily by investors. SAP: conservative accounting rules for solvency regulation. Used primarily by regulators.	
Part b: 2 points	
Sample responses for Acquisition Cost include: • SAP: recognized immediately. This is consistent with purpose because it assumes these costs would not be recovered if the company was to go out of business. GAAP: deferred to match the recognition of income. This is consistent with its purpose because want to see the profitability of the business as time goes on. • GAAP amortized acquisition costs over the life of the asset, while SAP recognizes the acquisition costs immediately. For SAP, this could be done because the money has already been spent. For GAAP, we want to match timing of assets & liability to think of company as a going concern. • SAP Treatment: charged as expense 100% at time incurred. Purpose: All cost is paid at time business acquired and funds not available should company become insolvent. GAAP Treatment: deferred acquisition cost account established to match costs as policies earn. Purpose: recognizes matching of premium costs over time. Sample responses for Non-admitted Assets include: • US GAAP does not have non-admitted assets as all assets are used. SAP disallows certain assets from being used in valuations because of low liquidity. These assets are called non-admitted assets. • SAP – doesn't allow for non-admitted assets. Non-admitted assets cannot be liquidated in the event of an insolvency so it supports the solvency purpose of SAP. GAAP – non-admitted assets are recognized. They are still assets and of value to the company, so it supports the going-concern purpose of GAAP.	