19. (3.5 points)

a. (0.5 point)

Identify one intended user of U.S. GAAP financial statements and one intended user of SAP financial statements.

b. (1 point)

For each intended user identified in part a. above, describe how the accounting framework aligns with the user's interests.

c. (1 point)

Briefly describe four differences between U.S. GAAP and SAP accounting in their treatment of balance sheet assets.

d. (1 point)

For any two of the items listed in part c. above, describe how the difference supports or does not support the philosophical differences underlying the two accounting standards.

CONTINUED ON NEXT PAGE

Common errors include: • Using something other than Net Written Premium to calculate R_5 • Using Policyholder's Surplus to calculate the RBC ratio • Omitting the 50% in the RBC ratio (using the RBC and not the ACL).
Part b
Candidates were expected to know the action levels that correspond to the appropriate RBC ratio from part a and the actions associated with this level for both the company and the regulator. Common errors include: • identifying the wrong action level • Misstating the name of the action level • Omitting any comments on the actions required by the regulator
Part c
Candidates were expected to know the usual range of both Iris Ratios 1 & 2 and know why a regulator would be concerned with these specific values, one of which is unusual. Common errors include: • Identifying over-reliance on reinsurance without commenting on the usual values of Iris ratios or not commenting on why a regulator would be concerned with over reliance on reinsurance (i.e. collectability). • Identifying concerns that correspond to other Iris ratios (e.g. rapid growth, surplus aid, reserve risk).

FALL 2018 EXAM 6US, QUESTION 19	
TOTAL POINT VALUE: 3.5	**LEARNING OBJECTIVE: C3**
SAMPLE ANSWERS	
Part a: 0.5 point	
GAAP • Investors • Creditors • Company • Board of directors • Investors in the company • Company management • Company's Management Team • Investor from other industry • Financial analysts (wall street) • Stakeholders • Stakeholders in the company • Shareholders • Firms looking to invest in publicly traded companies	

- SEC
- Hedge fund manager
- Company stockholders
- Stockholders
- A large insurance group wants to purchase another insurance company

SAP

- Insurance regulators
- Regulators
- Company
- Board of directors
- Regulators in the state where insurance company is domiciled.

Part b: 1 point

Sample 1

U.S GAAP applies going-concern principle and focus on profitability of the company. It expects the company to operate indefinitely and provides a better estimate on income and expense matching, and profitability. For investors, what they concern the most is the return on equity, thus the profitability. So the focus and framework of US GAAP fits their need.

SAP is more focused on the solvency that is the company's ability to meet all its obligations of payments. For regulators, they have to protect public interests, i.e. the policyholders and claimants. Thus SAP, focusing on the solvency, fits the target of regulator.

Sample 2

GAAP shows on a "going concern" basis – likely financial situation of the company. This is the type of informational view that investors use to decide whether or not to invest.

SAP shows on a "liquidation" basis – focus on solvency, which is the concern of regulators.

Sample 3

Investors are likely concerned with the current state of the company to get a view of current financial health. GAAP principles are on a going concern basis, which will show the current view of the financials.

Regulators are concerned with protecting policyholders from insurer insolvency. SAP provides a more conservative view of the company's financial health, which may result in an earlier detection of potential insolvency.

Sample 4

GAAP is focused on presenting results on an on-going basis which is what investors are concerned about in evaluating a company's profitability and earnings.

SAP has more conservative standards which aligns w/ regulator's view ensuring solvency and protecting policyholders.

Sample 5
The GAAP accounting framework matches revenue and expenses. This aligns with investor concerns regarding profitability.

The SAP accounting framework emphasizes conservatism, aligning with regulator concerns regarding solvency.

Part c: 1 point

Any four of the following responses:

- *Nonadmitted assets*
  - SAP does not include nonadmitted assets in surplus calculation. GAAP includes all assets in surplus calculation (note GAAP has equity not surplus)
  - SAP has non-admitted asset concept where GAAP doesn't.
  - Nonadmitted assets. GAAP does not distinguish between admitted and nonadmitted. SAP certain assets are non-liquid and considered nonadmitted. These are not included in surplus.
  - Separately listing different nonadmitted assets such as agent's balances, furniture, office equipment, etc.

- Deferred Acquisition Cost
  - SAP recognizes acquisition cost immediately. GAAP defers recognition to match earning of premium.
  - SAP incurs policy acquisition costs immediately. GAAP creates a DPAC asset that's amortized to match the earning of premium.
  - GAAP has deferred acquisition cost where SAP doesn't.

- Valuation of Invested Assets
  - SAP values bond based on bond class. GAAP values bonds based on intended use.
  - SAP records bonds based on whether they're investment grade or not. GAAP records bonds based on their use (available for sale, held to maturity, held for trading).
  - The treatment of carrying value of investment asset, like Bond. GAAP – depends on whether its holding for trade or to maturity, it can go with the fair value or, amortized value respectively. SAP- based on the rating
  - GAAP recognizes the value of bonds based on their intended purpose. SAP recognizes the value of bonds based on their class.

- Deferred Taxable Asset
  - Both do allow, BUT SAP has strict rules about the assessment.
  - Under SAP, DTAs must undergo a strict admissibility test. No such test is required under GAAP.

- Goodwill
  - the calculation of goodwill for SAP is purchase price minus statutory surplus and it is amortized to unrealized gains for no more than 10 years. For GAAP goodwill is the purchase price minus (fair value of assets – fair value of liabilities) and is evaluated for impairment.
- Reinsurance
  - Prospective reinsurance: SAP has reserves net of ceded reserves; GAAP does not allow offsetting of reserves so has an asset to account for the recoverable.
  - Retroactive reinsurance: SAP treats ceded reserves as a contra-liability; GAAP treats is as another asset.

Part d: 1.00 point

- DAC
  - does support philosophical standards because GAAP is focused on profitability over time which DAC more accurately reflects by matching revenues with expenses over the policy period. Since those costs are not available to meet obligations in event of liquidation, SAP does not recognize them which is in line with standards.
  - Treatment of acquisition cost supports philosophical difference. SAP assumes these costs are not recoverable in the event of liquidation. GAAP defers their recognition to provide more accurate view of profitability, supporting the going-concern view.
  - Since the acquisition cost have been paid out, it can't be used to pay claims. It match the philosophy of SAP. SAP is conservative to protect policyholders. Under GAAP acquisition cost is deffered for accurate measure of income. It matches the philosophy of GAAP.
  - The GAAP and SAP treatment of acquisition costs align well with their goals. By recognizing costs along with earning of premium, GAAP is providing a going concern view. By recognizing all of the costs at once, SAP is recognizing that the funds are not available for use, which is in line with its conservative standards.
  - GAAP is intended to show financial results that closely match the timing of when liabilities incurre and revenue recognized. Deferring the acquisition cost to match when premium is earned accomplishes this objective. SAP does not view the expense costs as something that is recoverable, as such it does not allow for costs to be deferred. This fits the conservative objective of SAP.
  - Deferred Acquisition Costs – Treatment aligns with the matching principle under GAAP and the conservatism principle under SAP (i.e. acquisition costs incurred cannot be used to satisfy policyholder obligations.

- Non-admitted assets
  - By not recognizing assets as admitted vs. non-admitted, GAAP looks at overall value to show profitability. SAP recognizes assets as non-admitted if they would

not be available to meet obligations in event of liquidation. Thus, this supports the philosophical standards.
    - Supports philosophical difference. SAP does not include nonadmitted asset in surplus calc because these assets have low liquidity, and may not be liquidated in the event of insolvency. GAAP includes them because nonadmitted assets are still assets + of value to company.
    - The GAAP and SAP treatment of nonadmitted assets also reflect their respective goals. GAAP recognizes all assets, which provides an accurate view of their equity. SAP only recognizes the more liquid assets, which would be available if they were to become insolvent.
    - GAAP shows result on ongoing basis so there is less focus on liquidity scenarios. As such it does not need to categorize assets as non admitted. SAP is focused in "liquidation view" so its objective is to be more conservative in its view that non admitted assets, like furniture are not easily convertible to cash.
    - Treatment aligns with the purpose of GAAP (i.e. presenting the total worth of the company) and the conservatism principle under SAP (nonadmitted assets are assets that cannot be readily used to satisfy policyholder obligations).
- Other acceptable answers
    - Draw from acceptable answer to part C, above
    - Correctly explain how the SAP and GAAP treatment aligns with (or does not align with) the focus of the accounting methods

EXAMINER'S REPORT

Candidates were expected to understand the intended users of US Statutory and GAAP financial statements as well as the users' needs and interests. Candidates were also expected to describe accounting differences between US statutory and GAAP standards and the reasons underlying these differences.

Part a

Candidates were expected to identify the intended users of US statutory and GAAP financial statements.

Part b

Candidates were expected to describe why the accounting framework aligns with the user's interests.

Common errors included

- Only described GAAP or SAP, not both.
- Provide an answer with more detail about the accounting framework without discussing the user's interests.

Part c

Candidates were expected to describe four differences between US GAAP and SAP accounting in their treatment of Balance Sheet assets.

A common error included describing differences in the treatment of liabilities instead of assets.

Part d

Candidates were expected to describe the underlying reason for the differences in account treatment provided in part c.

- Common errors was to describe an accounting difference again rather than discuss the reason for the difference.
- Only explained SAP and not GAAP, or vice versa.
- Confusion among prospective, retroactive and uncollectible reinsurance.

FALL 2018 EXAM 6US, QUESTION 20	
TOTAL POINT VALUE: 1.5	**LEARNING OBJECTIVE: C3**
SAMPLE ANSWERS	
Part a: 0.75 point	

Sample 1
IFRS ASSETS = Free surplus + Tech Provision + SCR
11,500 = 900 + Tech Provision + 8,621
Tech Provision = 1,979

Sample 2
SCR is corresponding to 99.5% one-year VaR
SCR = 8,621
Technical provision = 11,500-900-8,621 = 1,979

Sample 3
Free Surplus = Assets – Liab – Risk Margin – SCR
SCR = Company's 99.5% VaR

900 = 11,500 – 1,200 – Margin – 8,621

Margin = 779

Technical Provision = liabilities + margin = 1,200 + 779 = 1,979

Part b: 0.75 point

Sample 1
- Assessment of own solvency need
- Whether it complies with the technical provision
- The extent to which its risk profile deviates from the underlying assumptions of the technical provision