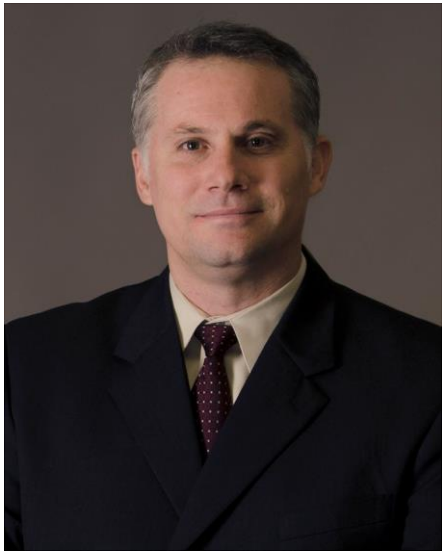
DIXON HUGHES GOODMAN LLP

Extended Warranty Providers
What You Need to Know

Introductions

DHG INSURANCE SERVICES GROUP

Michael Wright
Partner, Assurance



Chad Bullard
Director, Tax

Jordan Foley
Manager, Assurance

DHG Overview

2,000+ People, including 250 Partners / Principals

TOP 20 One of the top 20 largest accounting firms in the U.S.

60+ SEC / Public Audit Clients

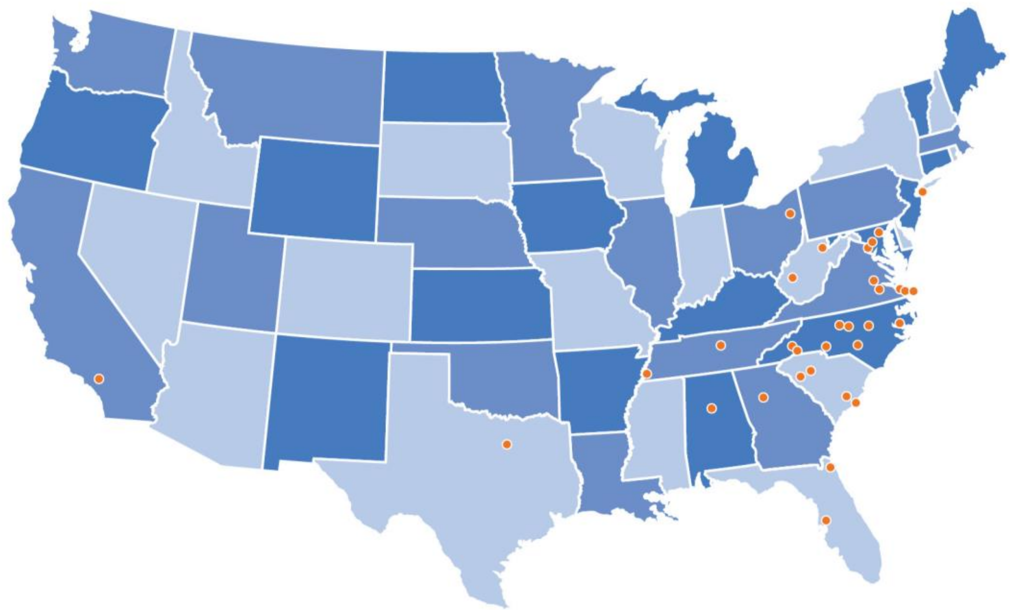
13 States with resources serving clients across the U.S. and internationally

Praxity MEMBER GLOBAL ALLIANCE OF INDEPENDENT FIRMS

Member of Praxity, an international alliance of independent accounting firms that offers multinational clients access to resources around the world

THERE WHEN IT COUNTS

- Experienced professionals who understand your industry
- Significant partner involvement
- Ongoing communication to avoid surprises
- Focused on business risks & their impact on your entity
- Accessible, responsive, hands-on style
- Customized service vs. one-size-fits-all approach
- Big Four alternative



DHG does business in all 50 states from offices in:

Alabama | California | Florida | Georgia | Maryland | New York | North Carolina
Ohio | South Carolina | Tennessee | Texas | Virginia | West Virginia

DHG Private Equity

NAVIGATING COMPLICATED MARKET TRANSACTIONS

Our professionals have solid industry knowledge plus a multi-disciplined approach to financial, accounting and operational solutions by offering coordinated comprehensive services and strategies.

Fund

- Fund Formation
- Tax Planning & Structuring
- Audit of Fund
- Valuation Services

Transaction Advisory

- Financial/Accounting Due Diligence
- Tax Due Diligence
- IT Due Diligence
- Operations & Human Resources Due Diligence

Portfolio Company

- Annual Audit
- Tax Planning & Compliance
- IT Audits & Assessments
- Valuation Services

Exit Strategy

- Sell-Side Due Diligence
- Initial Public Offering
- Tax Structuring
- Carve-Out Assistance

DHG Insurance

The Insurance practice is one of DHG's largest industry segments

30+ Years Serving the Insurance Industry

100+ Insurance Industry Clients Nationwide

150+ Collective Years of Leadership Team Experience

DHG has a strong insurance leadership team with decades of industry experience. We combine our industry and subject matter professionals with a wide range of services and accessibility to provide a client service approach that has a regional firm feel with a national firm reach.

Circular 230 Disclosure

To ensure compliance with requirements imposed by the IRS, we inform you that any tax advice contained in this communication is not intended or written to be used, and cannot be used, for the purpose of avoiding penalties under the Internal Revenue Code.

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An Overview of
Extended Warranty Providers

Poll #1

WHAT DO YOU KNOW ABOUT EXTENDED WARRANTY PROVIDERS?

A. I don’t know anything about extended warranty providers

B. I’m somewhat familiar

C. I’m extremely familiar

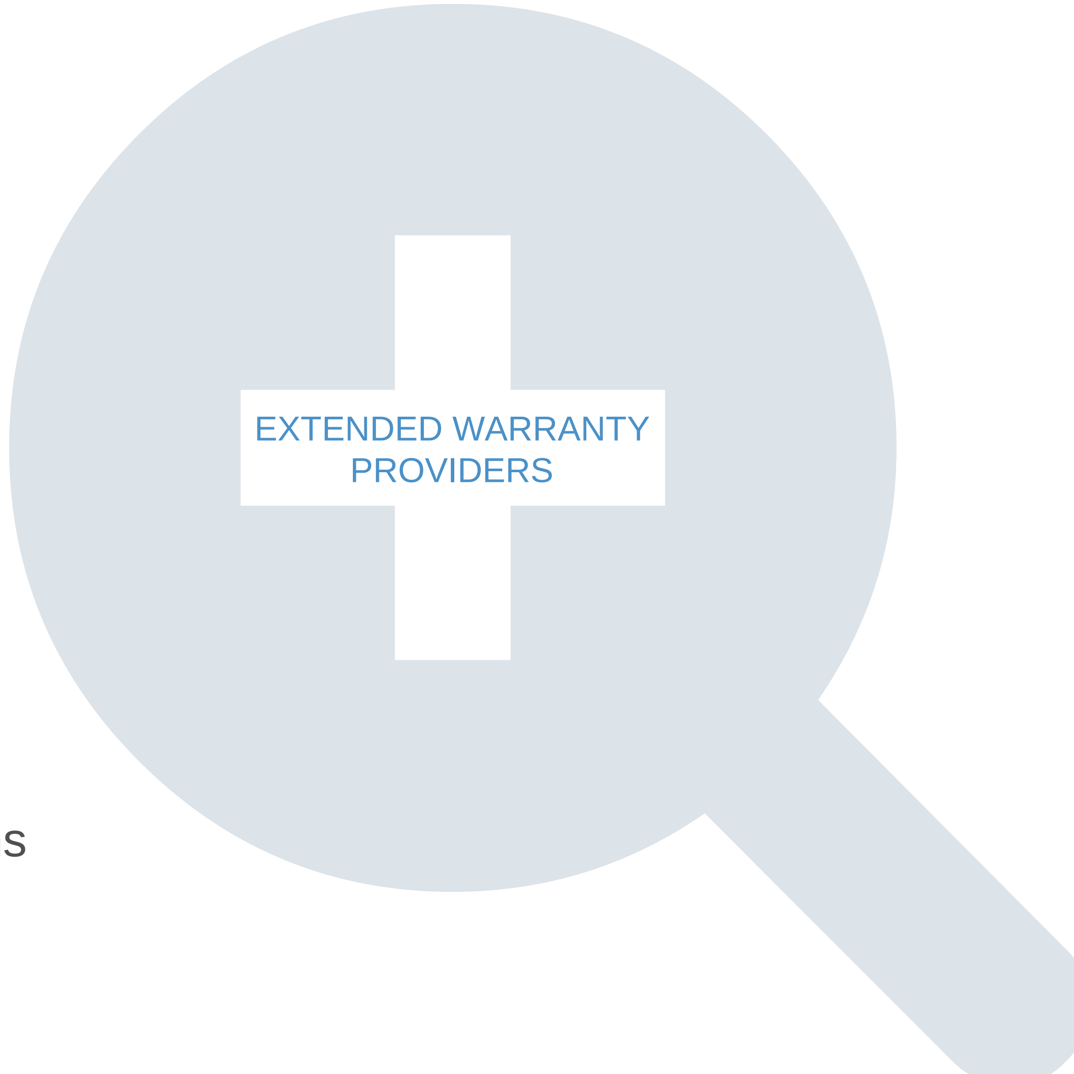
Objectives For Today

1. Understand how different programs/contracts are structured

2. Discuss the types of entity structures used and the associated cash flows

3. Identify key federal and state tax benefits and considerations

4. Identify common audit and due diligence considerations



Types of Extended Warranty Providers

Extended Warranty Providers

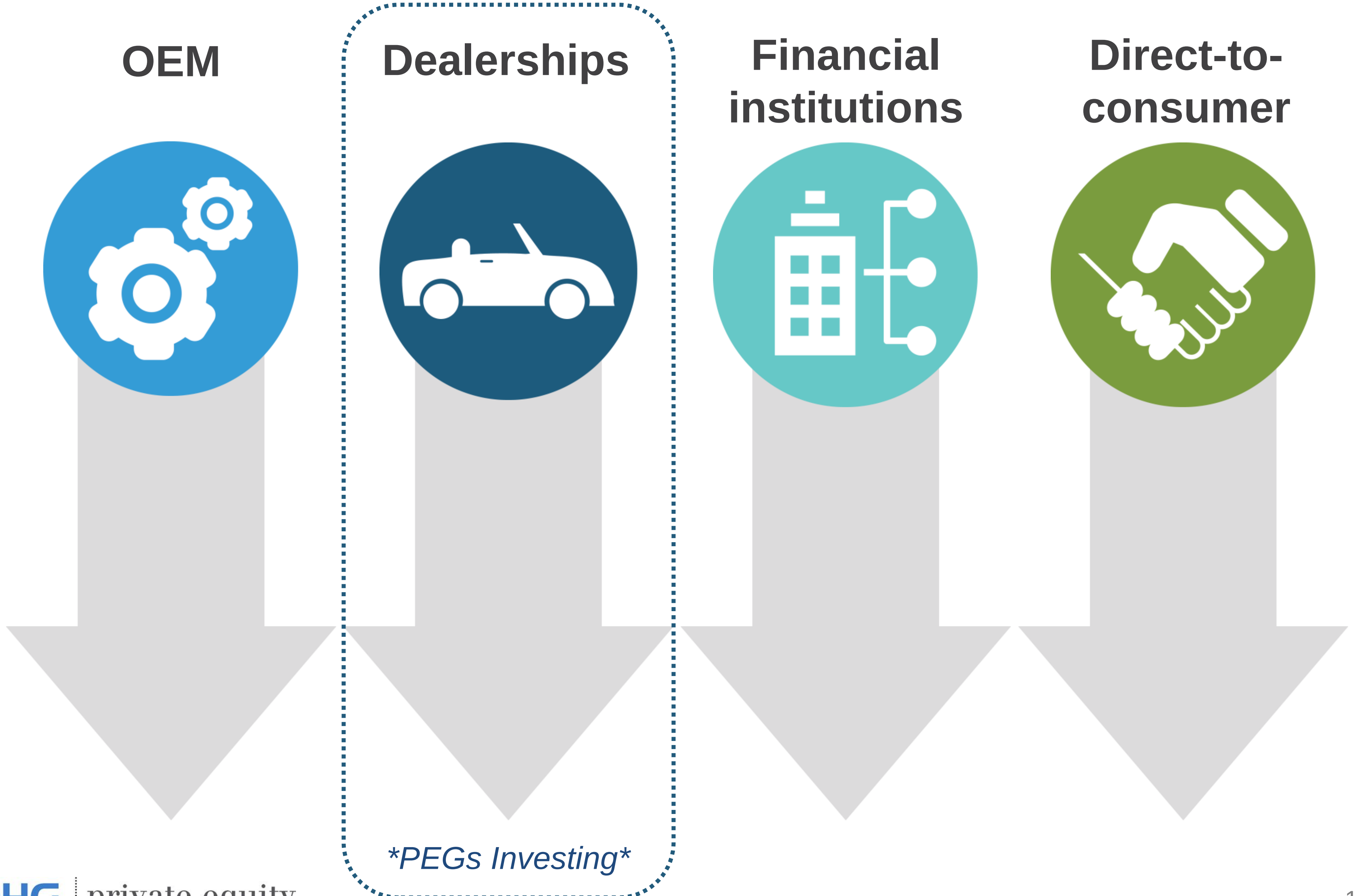
Contract Obligor

- **Administrator Obligor (AO)**
- **Dealer Obligor (DO)**
- **Dealer Owned Warranty Company (DOWC)**

PEGs Investing

- **Original Equipment Manufacturers (OEMs)**

Types of Distribution Channels



Primary Types of Products

Vehicle Service Contracts (VSC)	Guaranteed Asset Protection (GAP)
Key Considerations:	Key Considerations:
The Contract	The Contract
The Coverage	The Coverage

Common Add-On Products

Lifetime Powertrain Warranty

Etch/Theft Protection

LoJack

Prepaid Maintenance Programs

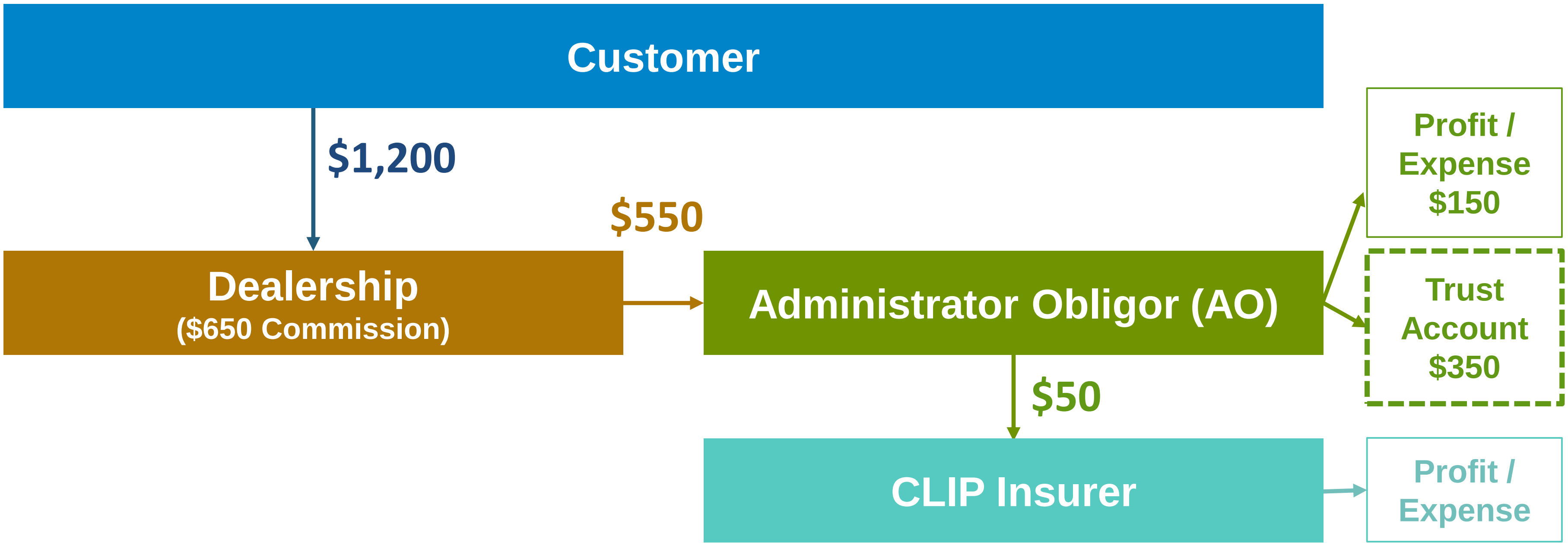
Key Replacement

Roadside Assistance Programs

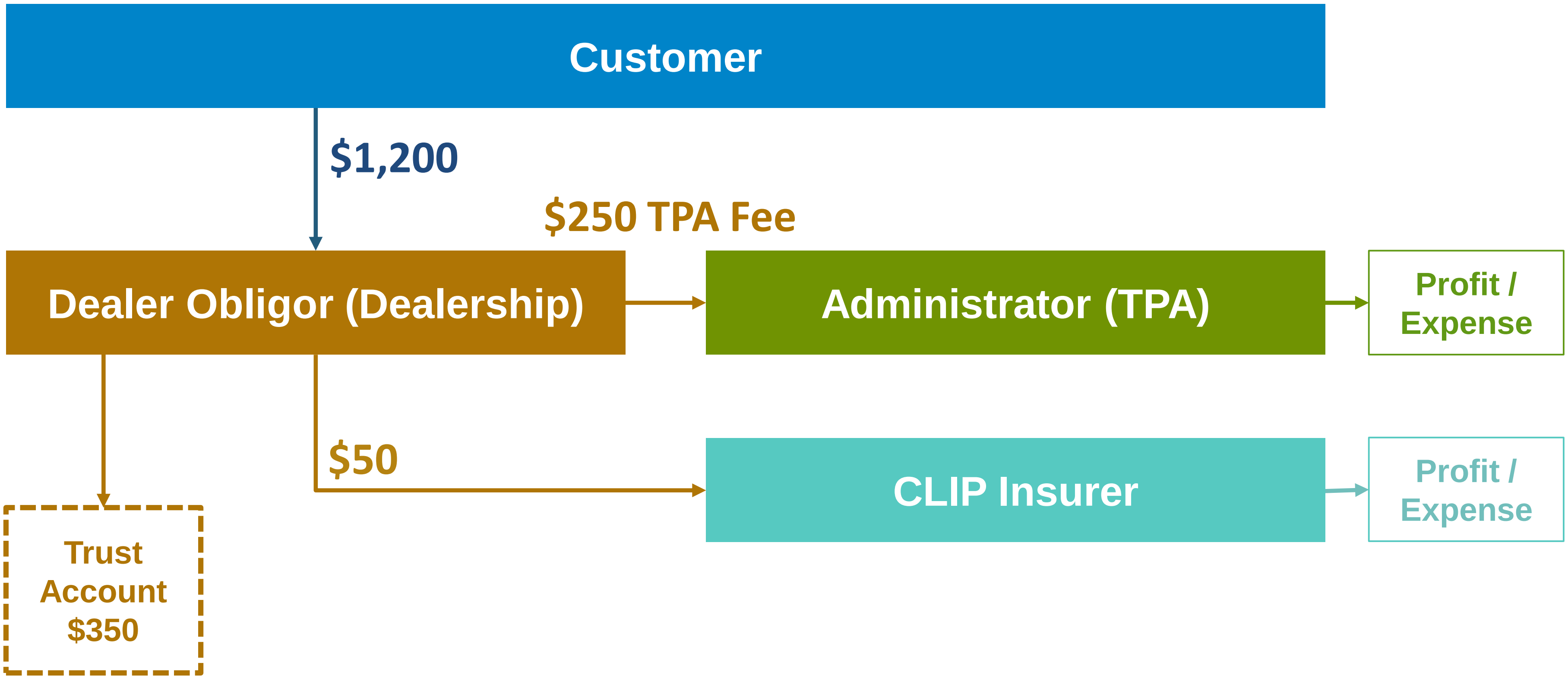
Tire & Wheel Protection

Other

Administrator Obligor Program



Dealer Obligor Program

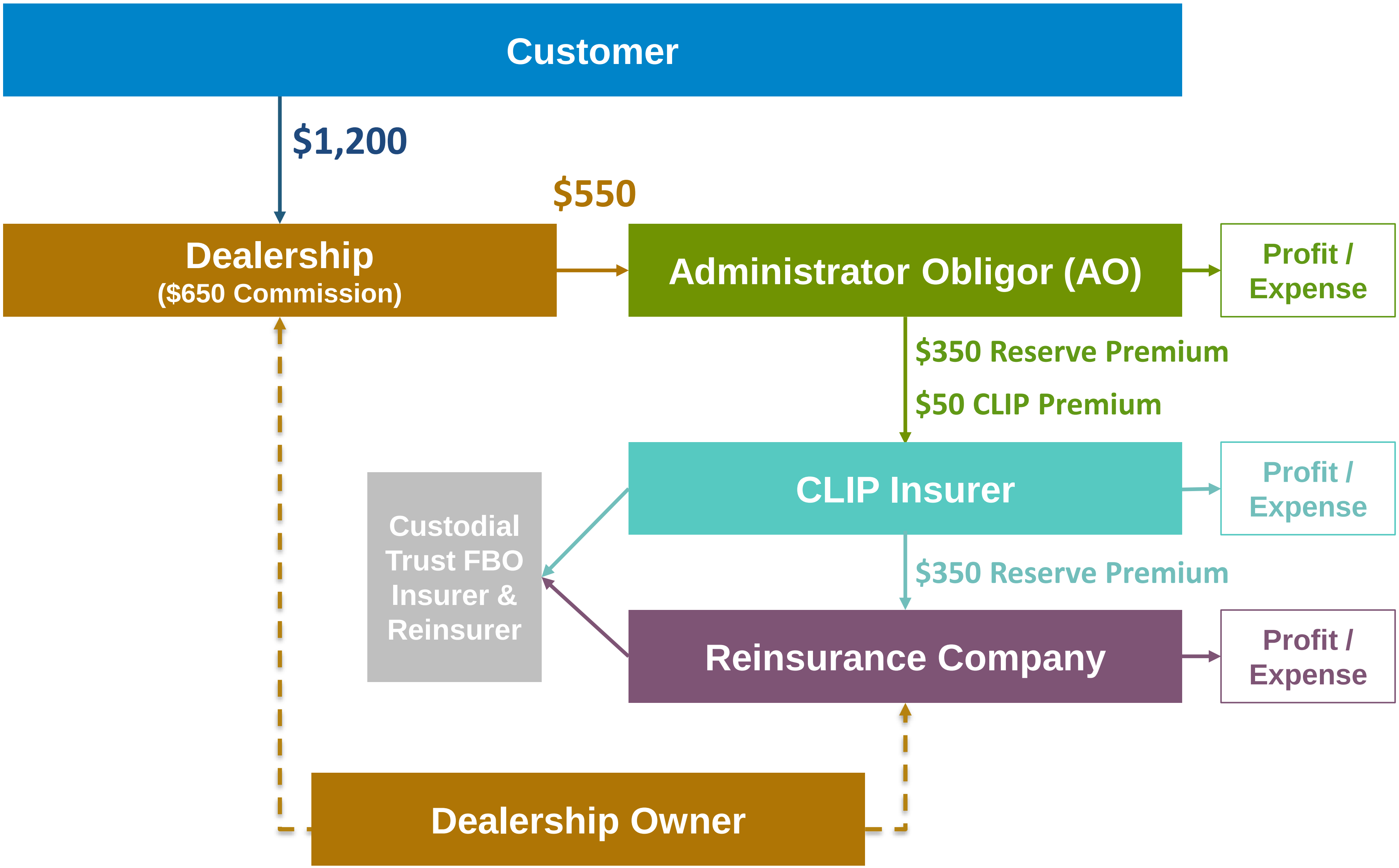


CLIPs

Contractual Liability Insurance Policy:

- Insurance that covers liability of the insured assumed in a contract.
- Most commonly associated with service contracts but can be used in a variety of areas.
- CLIPs can be used for a variety of reasons, but the two primary reasons are driven by regulatory requirements and economics.
- Policy issued to the VSC Company that guarantees the performance obligation of the VSC Company.

Affiliated Reinsurance with CLIP



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An Overview of
Revenue Recognition &
Why Correct Earnings Matter

Poll #2

HAVE YOU INVESTED IN OR ARE YOU CURRENTLY EXPLORING AN INVESTMENT IN AN EXTENDED WARRANTY PROVIDER?

A. Yes

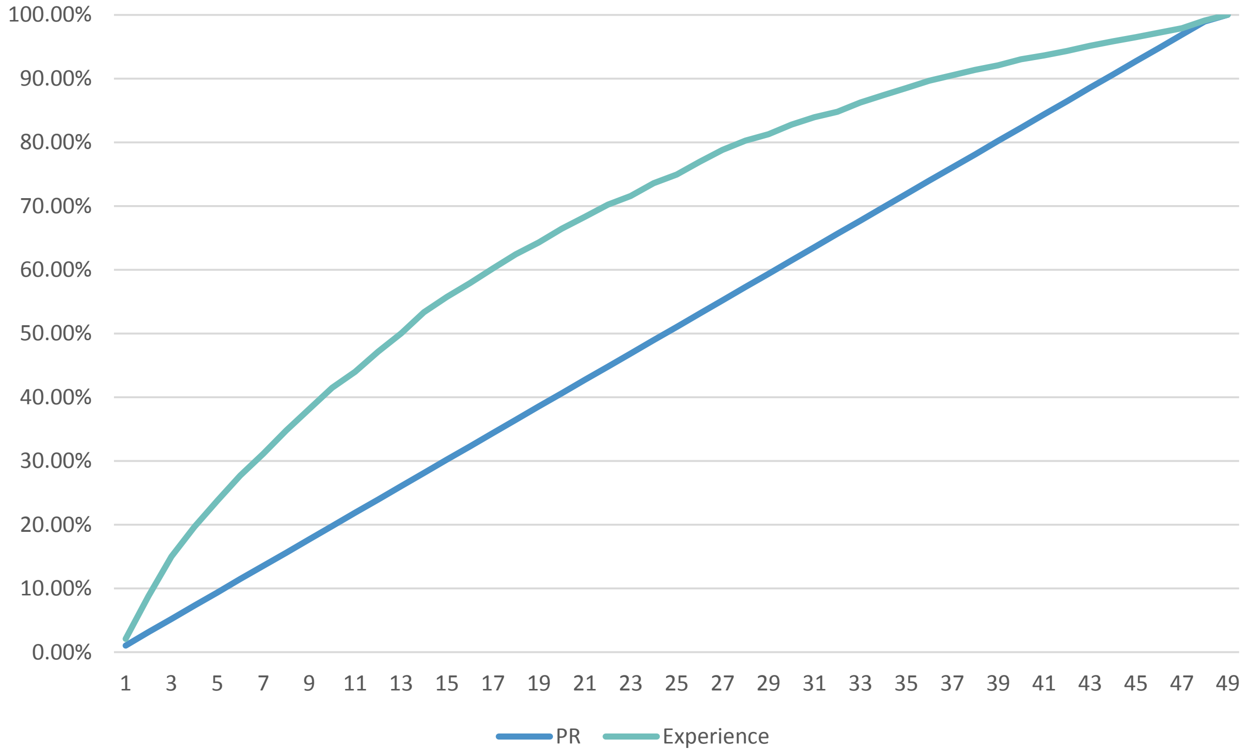
B. No

Revenue Recognition

- ASC 605-20-25- “Separately Priced Extended Warranty and Product Maintenance Contracts”
- Similar to short-duration insurance contracts
- Should be pro rata, unless evidence suggests cost are incurred in a different pattern (“Loss Emergence”)
- Also allows for deferral of certain costs, amortized on same pattern

Earnings Patterns or Curves

- Calculated actuarially and generally expressed as a cumulative earned percentage by term month
- Curves will vary based on term, coverage, initial mileage, make, etc.



Loss Ratios

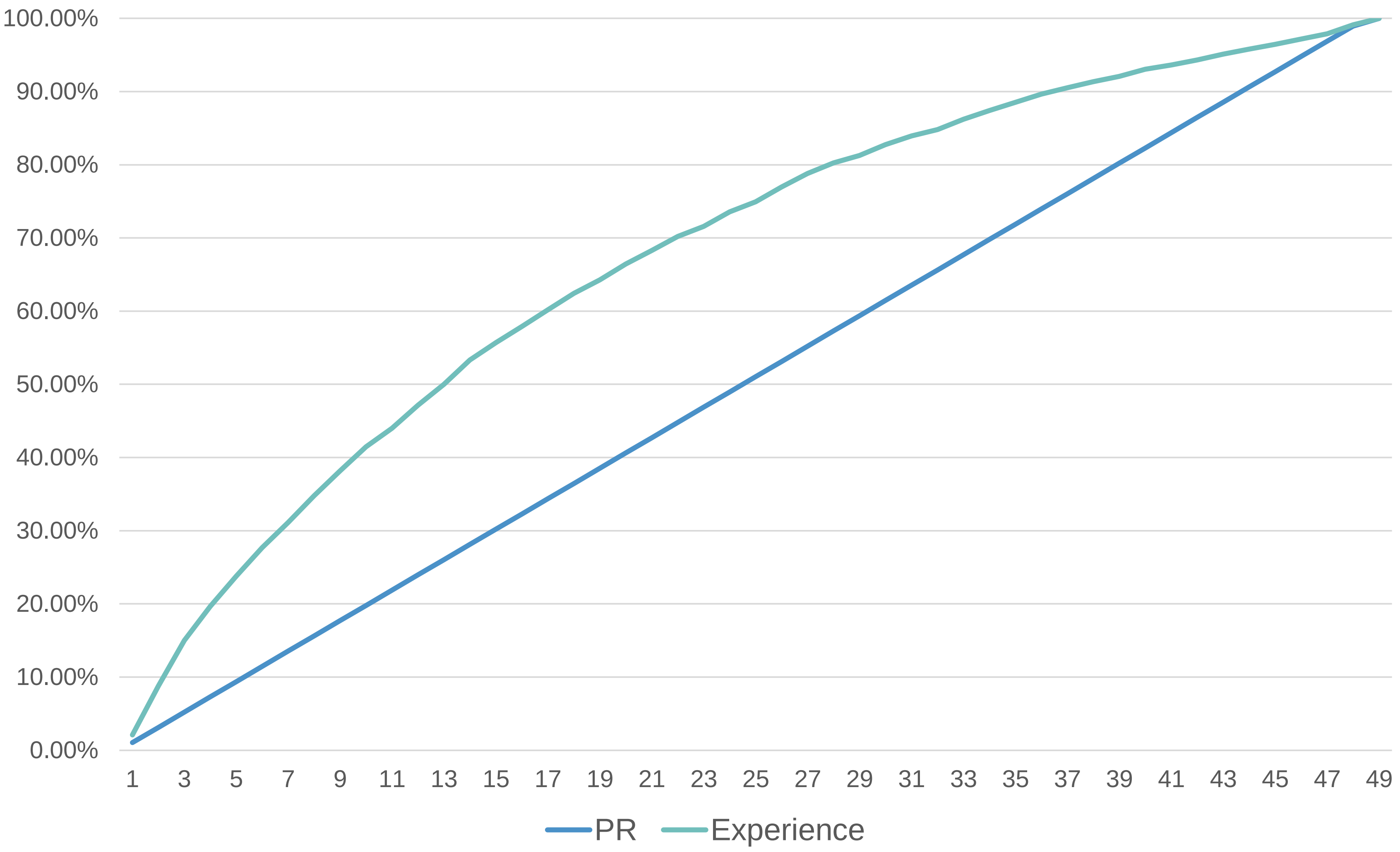
- A measure by which to express losses as a percent of premiums
- Calculated as total incurred losses over premiums earned
- Incurred losses = paid losses + any loss reserves
- Can be used to estimate future losses

An Example of Why Correct Earnings Matter

Assumptions:

- Total premiums written = $10 million
- Total ultimate losses = $8 million
- Ultimate loss ratio = 80%
- Currently half way through term (24/48 mo.)
- $5.9 million incurred through 24 mo.

Earnings Patterns



Loss Ratios

Pro Rata

- Prem. Earned $5 million
- Losses incurred $5.9 million
- Loss ratio 118%

Loss Emergence

- Prem. Earned $7.4 million
- Losses incurred $5.9 million
- Loss ratio 80%

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An Overview of
Audit & Financial
Due Diligence Considerations

Key Audit & FDD Issues/Considerations

1. Databases
2. Revenue Recognition
3. Working Capital
4. Other

Audit & FDD Considerations

Databases (Internally Developed)

- Lack of proper controls
- Incorrect data input, mappings or logic
- Earnings / expense deferrals may not be accurate
- Calculated amounts may be priced incorrectly

Revenue Recognition

- Mismatch in earnings pattern to loss emergence
- Incorrect earnings start date
- Incorrect obligor classifications
- GAAP revenue may be misstated (QofE adj.)
- GAAP unearned premium may also be misstated (working capital adj.)

Working Capital

- Treatment of unearned revenue in working capital
  - Ensure consistency
  - Inclusion generally favorable to seller
  - Exclusion generally favorable to buyer
- Unearned revenue current vs. non-current liability
- Cash requirements for liabilities acquired

Other

- DAC and prepaid insurance premiums
- Claims liabilities
- Revenue on a ‘written’ vs. earned basis
- Private company expenses
- Employee compensation
- Profit sharing and “Retro’ liabilities
- Seasonality and product trends

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An Overview of
Tax Treatment & Benefits
for the ESC Provider

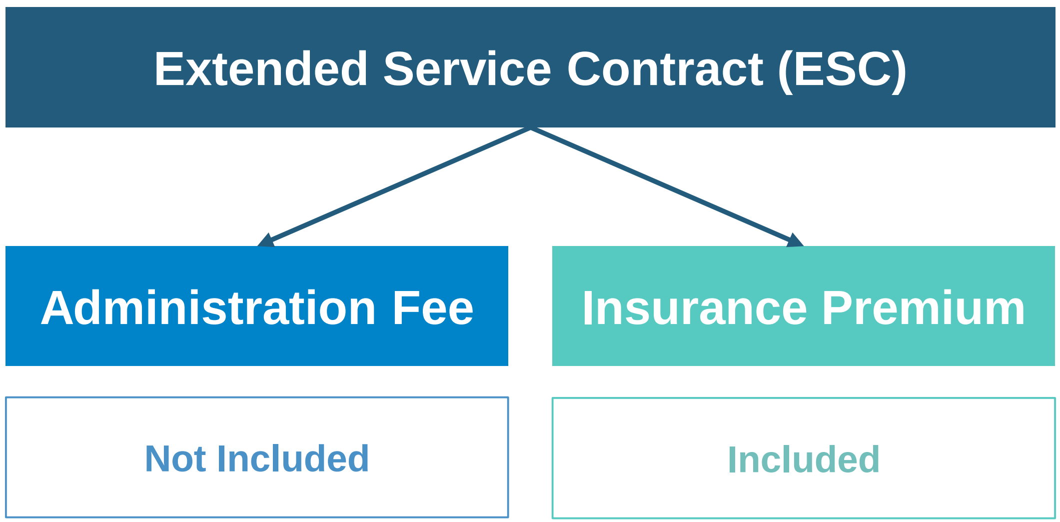
Poll #3

TRUE OR FALSE?

Companies issuing extended service contracts (“ESCs”) qualify as insurance companies for federal tax purposes.

Qualifying as Insurance for Tax

THE 50% INSURANCE TEST



Private Letter Rulings (PLRs)

Multiple PLRs have been issued concluding that companies issuing ESCs qualify as insurance companies for federal tax purposes:

PLR 200042018

PLR 200028018

PLR 200340011

PLR 201419007

A sample of such PLRs

Federal Vs. State Taxes

WAYS TO ACHIEVE DESIRABLE TAX TREATMENT

Extended Service Contract Providers

Federal Taxes	State Taxes
Might qualify as an insurance company	Might be subject to state income taxes

Federal Tax Benefits

WHY IS INSURANCE TAX TREATMENT DESIRABLE?

- A mismatch of revenue and expense in favor of the taxpayer
- Loss reserves for known incurred and IBNR can be established and deducted subject to a small discounting percentage

Extended Service Contract

Acquisition Costs	Insurance Premium Revenue	Loss Reserves
Expenses are deducted as incurred	80% of revenue is deferred & recognized over the policy life	Tax reserves are generally 90% to 95% of GAAP reserves

- *ESCs can have a coverage period of 3-7 years*
- *Some ESCs aren't effective for years after which the policy is sold*

Federal Tax Provisions

- Warranty companies file GAAP financials and most likely are not filing statutory statements

- Regulation 1.6012-2_ states that insurance companies are required to file with its tax return a copy of the annual statement (or proforma annual statement)

State Tax Provisions & Benefits

STATE TAX SAVINGS:

- ESCs are generally subject to state income tax *in lieu of* premium tax

Extended Service Contract (ESC)

State Income Tax	Premium Tax
Taxed on Profit	Taxed on Written Premium
Lower Tax Cost	Higher Tax Cost
May Not Pay State Income Tax For Many Years	

State Sales & Use Tax Considerations

STATES DIFFER IN THEIR TREATMENT OF ESCs:

- ESCs will generally fall into 1 of 2 categories

Extended Service Contract (ESC)

Sales Tax	**Use Tax**
Exempt any subsequent services of the contract	Exempt the sale of the contract

State Sales & Use Tax Considerations

TAX COMPLIANCE:

1. The non-filing of returns and remitting of the respective taxes is quite common

2. States are becoming aware of such underreporting and are initiating sales and use tax audits with success

3. If ESC companies have not yet been contacted by a state, they can mitigate exposure through voluntary disclosure agreements