1991

Property and liability insurance industry developments - 1991; Audit risk alerts

American Institute of Certified Public Accountants. Auditing Standards Division

AUDIT RISK ALERTS

Property and Liability Insurance Industry Developments—1991

Update to AICPA Audit and Accounting Guide *Audits of Property and Liability Insurance Companies*

AICPA
American Institute of Certified Public Accountants

NOTICE TO READERS

This audit risk alert is intended to provide auditors of financial statements of property and liability insurance companies with an overview of recent economic, industry, regulatory, and professional developments that may affect the audits they perform. This document has been prepared by the AICPA staff. It has not been approved, disapproved, or otherwise acted upon by a senior technical committee of the AICPA.

Gerard L. Yarnall
Director, Audit and Accounting Guides

Ellise G. Konigsberg
Technical Manager, Accounting Standards Division

1211 Avenue of the Americas, New York, N.Y. 10036-8775
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Property and Liability Insurance Industry Developments—1991

Industry and Economic Developments

The property and liability insurance industry historically has operated in a cyclical environment. Periods during which the industry's overall capacity declines and premium rates and volume rise are followed by periods in which competition for premium volume and market share drive premium rates down. The overall industry pricing cycle is influenced by differing characteristics for certain types of business, such as commercial lines, workers' compensation, and personal lines, all of which should be evaluated separately.

- Commercial lines comprise many price-sensitive types of business, such as general liability, commercial multiperil, and commercial automobile. Competitive pricing conditions for these lines are cyclical and vary primarily with the availability of surplus capacity and the level of insurers' profitability. Currently, this segment of the industry is in the downward trough of the underwriting cycle that began in 1987. Overall growth in written premiums is sluggish, which affects the volume of earned premiums. Price competition currently is contributing to an increase in the combined ratio. Most industry analysts expect this downward cycle to continue into 1992.
- Workers' compensation rates are regulated by the states. For the past several years, approved rate increases have not kept pace with the escalation in loss costs (due, in part, to high medical cost inflation), and results have deteriorated. Many companies are reducing their exposure in unprofitable areas or are otherwise selectively writing this business, thus causing growth in the nonvoluntary market. Participation in involuntary pools further increases companies' exposure. Efforts to reform workers' compensation have been initiated in many states, but overall, this business is not expected to provide adequate returns over the next few years.
- Personal lines primarily comprise personal automobile and homeowners' business. Rates for personal auto insurance are heavily regulated by the states, some of which have initiated or implemented rate rollbacks and other reforms as a result of or to address consumer activism against rising rates. Adverse regulatory conditions have caused some insurers to withdraw from the

voluntary personal auto market, resulting in a shift in business to the involuntary market, low-cost insurers, and nonstandard writers.

Certain segments of the industry face uncertainties regarding exposure to environmental and other types of liability risks, such as environmental pollution and asbestos, because of evolving, and sometimes conflicting, legal theories and court decisions. The estimate of total loss exposures for some companies can be heavily influenced by the recoverability of ceded reinsurance.

In addition, property and liability insurers are likely to be affected by various regulatory actions under consideration by federal and state legislatures, and the Securities and Exchange Commission (SEC), with respect to financial reporting requirements.

Overall Risk Factors

Although conditions vary from company to company, the following are among the industry-specific conditions that may affect audit risk:

- Historically cyclical underwriting patterns
- Widespread rate and product competition in both domestic and international markets
- Extensive use of estimates, such as those for determining loss reserves
- Overall increases in claims costs resulting from increases in litigation, the amounts of jury awards or settlements, catastrophes and other large losses, and the rising costs of medical care
- The long-tail nature of the business, which is characterized by lags between the occurrence, reporting, and settlement of claims
- The retrospective nature of certain revenue and expense determinations, such as those in workers' compensation insurance
- Evolving changes in regulatory oversight and reporting requirements
- The need for liquidity and adequate funds to pay claims resulting from catastrophes or similar events
- The need to meet surplus requirements imposed by regulatory authorities
- Reliance on third parties, such as managing general agents, agents, brokers, insureds, reinsurers, loss adjusters, pools, syndicates, and underwriting intermediaries, for reporting information used by management and accounting systems
- Extensive and complex reinsurance arrangements

- Collectibility of balances due from policyholders, reinsurers, and agents
- Assessments by state guaranty funds and involuntary market mechanisms

Specific Conditions or Risk Factors

This section describes certain conditions that may indicate (but do not necessarily confirm) the existence of increased audit risk. The descriptions of these conditions are based partially on information contained in the *Troubled Insurance Company Handbook,* published by the National Association of Insurance Commissioners (NAIC), and on current events in the industry. This list is not all-inclusive.

Rapid Growth in Premium Volume. Particularly during periods in which the industry's overall premium growth rate is slow, rapid growth in premium volume may indicate that a company is engaged in "cash flow underwriting"—that is, keeping its premium rates low to maintain or increase market share. The possible effects of excessive or uncontrolled growth in premium volume may include the following:

- The company's surplus may not be sufficient to support the increased level of exposure.
- The company may not have adequate resources or expertise to properly administer the new business.
- The company may have inappropriate pricing or underwriting practices that could result in inadequate loss reserves or premium deficiencies.
- The company may enter into non-transfer-of-risk reinsurance arrangements to avoid the statutory surplus strain associated with writing new business.

New Lines of Business. Rapid expansion into new lines of business or new geographic areas may indicate increased risk if a company does not have sufficient experience or qualified personnel to underwrite and manage the new business. In addition, a new company or a company entering a new line of business may not have developed sufficient relevant data for establishing premium rates or estimating loss reserves.

Pricing or Underwriting Practices. Lack of adherence to sound pricing and underwriting policies may indicate increased audit risk. Sound pricing decisions require appropriate information and reasonable estimates of expected losses and expenses. The determination of premium rates based solely on the rates charged by competitors may not adequately consider differences in the nature of the risk being insured. A lack of established policies may lead to the acceptance of unanticipated risks or the inappropriate pricing of those risks, which could result in concerns about the recoverability of deferred acquisition costs and possible premium deficiencies.

Reserving. Loss and loss-adjustment-expense reserves generally are the most significant and the most subjective amounts in a property and liability insurer's balance sheet. Inappropriate reserving may result from a lack of expertise on the part of a company's loss-reserving personnel, a lack of understanding of the factors affecting the frequency or severity of losses, or poor judgment. It is difficult to estimate reserves because claims may not be reported—much less settled—until a future date, and because the ultimate amount of losses and related expenses may be affected by factors such as future inflation, negotiation, or court decisions. These difficulties in estimation become greater for long-tail lines of business, and in recent years, the "tail" for the industry in general has lengthened.

Appropriate loss reserving is based on the analysis of historical and current loss-development data. It also requires the use of loss-reserve projection methods that are appropriate in light of possible changes in circumstances, and that properly consider developing trends in experience. Inadequate, incomplete, or inconsistent data can lead to inappropriate loss-reserve estimates.

Claims Management. Inadequate claims-management procedures or failure to observe established procedures can result in excessive or improper claims-settlement payments. Inadequate claims management also may result in unsound reserving if claims-settlement practices are not considered in estimating loss reserves.

Management and Controls. Insurance companies may delegate major operational authority to outside parties, such as investment managers for investment decisions, managing general agents or third-party administrators for underwriting or claims functions, or claims-settlement companies for claims management. In some instances, outside parties have pursued objectives that conflict with those of the insurance companies to which they provide services. If significant operational authority is delegated to outside parties, the companies need to establish sound procedures to supervise, control, and monitor their performance.

Involuntary Pools. Property and liability insurers have significant exposure to adverse loss development from previously reported results on various involuntary pools such as that experienced by the 1991 National Workers' Compensation Pool. An individual insurer's exposure to fund such deficits should be evaluated and the sufficiency of accruals made for statutory purposes and for purposes of generally accepted accounting principles (GAAP) should be considered. For certain state pools, insolvencies of major carriers that participated may cause additional assessments to other carriers.

Surplus Enhancement. At times, some insurers have engaged in a variety of surplus-enhancement transactions. Surplus-relief insurance transactions, in particular, have come under increased scrutiny by regulators, legislators, and the press.

Auditors should carefully evaluate transactions (1) that result in a material adjustment of statutory income or surplus or (2) for which the effect on the statutory-basis financial statements is substantially different from the effect on statements prepared in conformity with GAAP, especially when a company's surplus is at or near statutory minimum levels. In evaluating such transactions or the related adjustments to the statutory surplus, consideration should be given to the company's correspondence with state insurance departments and documentation of compliance with applicable insurance laws or regulations.

''Rental'' of Securities. Several recent articles in the press have centered on instances in which insurance companies have "rented" mortgage-backed securities issued by the Government National Mortgage Association (GNMA) to bolster their balance sheets or to use as collateral for bank loans. Government regulators and investigators have uncovered several scams in which the rented securities turned out to be fraudulent or otherwise defective. The GNMA recently issued a warning to participants in the market for its securities about perfecting security interests in ownerships of GNMA securities. Further information on the warning was printed in the October 1991 issue of the *CPA Letter*.

Environmental Cleanup. Some estimates of the cost of cleaning up hazardous waste sites currently on the so-called Superfund list are in the hundreds of billions of dollars. It is conceivable, but by no means certain, that some portion of these costs will ultimately be borne by the insurance industry under pre-1986 liability coverages because insurance companies that wrote general liability or commercial multiperil policies prior to 1986 used policy forms that did not contain the "absolute" pollution exclusion currently in standard use within the industry.

Some insureds are arguing that coverage should be afforded under these contracts for their potential liability for the cleanup of inactive hazardous waste sites or other similar environmental liabilities. Most insurers are vigorously resisting such arguments with mixed success in court. Although some major U.S. corporations and specialized industries have begun to litigate pollution liability coverage issues, these cases may represent only the tip of the iceberg. Potential for additional litigation exists in the form of non-Superfund claims that will be reported to insurers in the future.

Although the largest environmental liabilities are likely to arise from chemical producers, petroleum processors, and other heavy industries, any company writing liability coverage has some environmental liability exposure for service stations, dry cleaners, hardware stores, paint stores, gardening supply stores, small metal plating operations, and other similar businesses. Even homeowners' policies are potentially exposed to the cleanup costs for leaks from underground heating oil storage tanks.

Structured Settlements. Property and liability insurance companies frequently settle certain claims by purchasing structured settlements from life insurance companies. The ability of the issuing life insurance company to make good on its obligation should be evaluated using the same criteria that are used to evaluate an assuming reinsurer and should include an analysis of concentrations of structured settlements placed with one or more insurers. In the event that an issuing life insurance company becomes insolvent, in most instances the property and liability company would remain liable to pay the claim to the insured.

Reinsurance

Reinsurance arrangements can be complex, and reinsurance contracts can be complicated documents. Adequate control over a company's reinsurance program requires that management have knowledge and understanding of the reinsurance business and the financial effects of reinsurance. Guidance is provided in the AICPA Audit and Accounting Guide *Audits of Property and Liability Insurance Companies* and the Statement of Position (SOP) entitled *Auditing Property and Liability Reinsurance* that was issued in October 1982. The following points provide a summary of additional audit risk considerations related to reinsurance.

Ceded Reinsurance. The lack of an adequate reinsurance program may expose an insurance company to risks that can jeopardize its financial stability, particularly if its risks are concentrated by type or geographic area. In contrast, excessive reinsurance coverage can significantly reduce the margins available to cover fixed and overhead expenses. The unusually large catastrophe losses incurred by the industry in recent years resulted in higher renewal rates for reinsurance. Significant changes in a company's reinsurance program or retention limits ordinarily should be considered in evaluating estimates of loss reserves and reinsurance recoverables.

Uncollectible Reinsurance. The collectibility of amounts due under ceded reinsurance arrangements continues to be of concern to the insurance industry. Collectibility problems may arise if the assuming company becomes financially unsound or if there is a dispute concerning coverage. The AICPA Audit and Accounting Guide *Audits of Property and Liability Insurance Companies* discusses the controls that ceding companies should implement to evaluate the financial stability of assuming companies. Collectibility concerns can also arise when assuming companies challenge or repudiate reinsurance claims based on disagreements over interpretations of contract terms or allegations that a ceding company has not fulfilled its obligations under a contract. Ceding companies are subject to reductions in reported statutory surplus for balances due from authorized reinsurers on paid losses that are overdue by more than ninety days.

Assumed Reinsurance. Assumed reinsurance may be difficult to underwrite because the coverage is often unique. Accordingly, some companies, particularly those that assume reinsurance only occasionally, may not have sufficient experience to manage such business or may not have adequate procedures to evaluate underwriting standards, or to monitor the business. In addition, assuming companies may experience significant delays in receiving information from ceding companies, intermediaries, retrocessionaires, or other parties to the contracts, which may result in delays in notification of amounts of written premiums or losses incurred under contracts, or a lack of supporting information needed for financial reporting and administration of the business.

Fronting. Fronting is an arrangement between two or more insurers whereby the fronting company issues a policy and then cedes substantially all the risk to other insurers through a reinsurance agreement in return for a commission. Fronting might occur, for example, in a jurisdiction in which the fronted company is not authorized to write business. Fronting arrangements may result in the fronting company's having large potential liabilities to pay claims if the fronted company becomes unable to meet its obligations. The fronting company may have little information about or control over the nature and extent of the risk being written under its policies on behalf of the fronted company. Consequently, the results of the fronting company may depend on the underwriting standards and the integrity and financial stability of the fronted company.

At its July 31, 1991, meeting, Financial Accounting Standards Board (FASB) members stated their belief that fronting arrangements are a form of reinsurance, to which the disclosure requirements of FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, apply.

Auditors should make inquiries of management about whether the accounting treatment of reinsurance or other transactions is being challenged by regulators. Disallowance of reinsurance credits by regulators for statutory-basis financial statements may impair an insurer's ability to write new business or meet minimum surplus requirements. In such cases, the circumstances should be adequately disclosed, including, for SEC registrants, appropriate commentary in the Management's Discussion and Analysis (MD&A) section of reports filed with the SEC. In financial statements prepared under GAAP, such treaties generally would be accounted for as financing arrangements.

The FASB is currently addressing certain reinsurance issues, including disclosure, gross versus net presentation, and gain recognition. Deliberations on the project began in early September.

Investments

Many property and liability companies have invested (although generally to a lesser extent than life insurance companies) in speculative or high-yield investments, such as junk bonds and certain types of real estate, that usually involve higher risk. The turmoil in the junk bond markets and the rapid softening of commercial real estate markets in various regions of the country have raised concerns about the quality of insurance companies' investment portfolios. Although most of the media attention has been directed at investments held by the life insurance industry, investments of property and liability insurance companies are not immune to the effects of the economic decline.

Mortgage Loans and Real Estate. Economic recession, lack of available lending and refinancing sources, and overdevelopment have continued to depress property values in many areas of the country. Default rates and nonperforming loans continue to be significant problems for many insurers. Declining property values have highlighted the need to review investment portfolios to determine the appropriateness of accounting policies and the extent of exposure to continuing weakness in the real estate sector. Among the factors that may require additional audit attention are the following:

- Restructurings or refinancings of loans and the related accounting treatment

- Concentrations of loans to particular borrowers, loans for certain types of properties or properties in geographic regions that are experiencing economic difficulty or may be reasonably expected to experience such problems in the future
- Valuation practices for property acquired in foreclosure, including the company's policies for obtaining appraisals of such properties
- The consistency and reasonableness of the company's policies for ceasing accrual of interest on loans when interest or principal payments are past due
- The company's policies for determining (1) allowances for losses and valuation allowances on mortgage loans and investments in real estate and (2) changes in such allowances in the past year
- Identification of situations qualifying as in-substance foreclosures and recognition of related losses

In addition to appropriate financial statement disclosure and the adequacy of reserves for mortgage loans, the SEC staff is expected to focus on the adequacy of discussion in the MD&A section in registrants' reports regarding the risks and the related impact of material holdings of mortgage loans and investments in real estate on financial condition, results of operations, and liquidity.

Debt Securities. The continuing volatility of the junk bond market continues to present concerns for insurers holding investments in highly leveraged companies. A principal concern has been the credit risk inherent in such higher risk investments. The current recessionary economic environment may add to concerns that issuers of such debt securities may default. In addition, the lack of an active market and buyers for such securities has raised concerns about the liquidity of investments in junk bonds.

The lack of a ready market for investments in privately placed debt securities may cause concerns about the liquidity of such investments and may make it difficult to determine their market value.

Investors in mortgage-backed securities may face increased market risk in an unsettled economic environment because the market values of such investments fluctuate with the levels of mortgage prepayments and refinancings. In addition, mortgage-backed securities that are not guaranteed by financially stable guarantors may present credit risk to investors.

Auditors should consider whether declines in the market value of debt securities are other than temporary. An auditing interpretation of section 332, "Long-Term Investments," of Statement on Auditing Standards No. 1, *Codification of Auditing Standards and Procedures*

(AU sec. 9332.01-14), discusses factors that auditors should consider in evaluating the reasons for market declines when market value is below cost, as well as the types of evidential matter that auditors should obtain in evaluating whether amounts at which debt securities are carried in the financial statements are appropriate. The Auditing Standards Board is currently amending the guidance in this interpretation. Further information is expected to be included in the December 1991 issue of the *CPA Letter*.

Consideration should be given to whether insurers currently have the ability to hold debt securities to maturity and intend to hold them for the foreseeable future. Evaluation of an insurer's ability to hold securities to maturity should include consideration of statutory limits on the amount of high-yield securities and other securities that may be held as assets.

During 1991, the SEC made inquiries of insurers regarding investments in high-yield and noninvestment-grade securities. Such inquiries concerned—

- Whether persuasive evidence exists indicating that a decline in the market value of debt securities that has existed for a period of time is other than temporary.
- The insurers' procedures for determining market values of securities and establishing losses on their investment portfolios.
- The insurers' portfolios, including investment ratings, sources of market value data, terms of payment, maturities, performance, downgrades by the NAIC, and specific information on certain high-yield securities when their carrying value exceeded market value and on certain significant investments.

The SEC staff also indicated that it intends to review statements of cash flows of registrants to identify companies in the financial services industries (including insurance companies) conducting significant trading in their investment portfolios, and to consider whether discussions of realized gains in the portfolio are accompanied by appropriately balanced discussions of potential unrealized losses remaining in the portfolio.

The NAIC, in an effort to regulate high-yield investments more stringently, has changed its yes/no bond rating to a new six-category system. The rating system for preferred stocks also has been revised effective for the 1992 annual statement to make the valuation procedures more consistent with those used for bonds.

Various state insurance departments have adopted new investment limitations on the amount of high-yield securities insurers may hold in their portfolios. Such limitations may prohibit insurers from reporting as admitted assets the total value of securities in a specific category, such as noninvestment-grade bonds or investments of a single issuer that exceed a fixed percentage of total admitted assets. Other states have proposed investment limitation guidelines or have proposed more restrictive revisions to existing guidelines. In addition, the NAIC has adopted a model law that limits insurers' holdings of medium and lower grade bonds and other investments.

Equity Securities. Investments in equity securities also have been receiving increased attention from the SEC staff. As with debt securities, the SEC staff has challenged whether impairment of value exists for certain equity securities when their market value has been below their cost. SEC Staff Accounting Bulletin (SAB) Topic 5M, *Noncurrent Marketable Securities,* describes the SEC staff's position.

Other Investment Transactions. Auditors should make inquiries of management about whether significant or unusual investment transactions have occurred and should evaluate the appropriateness of the accounting treatment. Investment transactions that may require particular audit consideration include dividend capture or dividend rolls, delayed delivery sales, covered call options, asset transfers with put options, stocks owned with call options, wash sales, investment swaps, and sale and leaseback transactions. Particular attention should be given to transfers of assets to or from affiliates or special-purposes entities. In addition, the SEC staff has been inquiring about investment activities that may indicate that wash sales have taken place fifteen days before and after year ends.

Declines in the value of property-related and high-yield investments have induced some insurers to sell portfolio securities in an effort to record capital gains. In addition, some insurers have purchased securities similar to those sold in order to keep portfolio structure unchanged. Auditors should consider the guidance in SOP 90-3, *Definition of the Term* Substantially the Same *for Holders of Debt Instruments,* as they evaluate the appropriateness of the accounting treatment given to such transactions.

Regulatory and Legislative Developments

California Proposition 103 and Other Rate-Regulation Efforts

Beginning in the mid-1980s, regulatory and legislative resources have focused extensively on the cost of private-passenger automobile insurance and workers' compensation insurance. Increasing pressure from consumer groups, such as the voter revolt in California that instigated the passage of Proposition 103 in November 1988, has prompted state legislatures to adopt or consider legislation to limit or roll back certain premium rates.

As of the end of the third quarter of 1991, few refunds have been made to policyholders under Proposition 103, and there remains a significant state of uncertainty as to the status of future refunds. As events unfold, the financial statement accounting and disclosure impact will need to be addressed and evaluated.

Legislatures in several other states have adopted or are considering legislation that would limit or roll back certain premium rates. Many of these laws and proposals include some commercial lines of business as well as private-passenger automobile lines. For instance, in New Jersey, insurance companies are required to fund a portion of the $3 billion deficit developed by the former state-run Joint Underwriting Association, without recoupment of the deficit costs from policyholders.

In response to adverse regulatory changes in some states, several companies have attempted to reduce their exposure by withdrawing entirely from these markets, prompting state legislatures to consider proposals that would inhibit a company from withdrawing from a line of business and to restrict its ability to terminate agents or reduce their commissions.

Most states have laws that require employees to be covered by workers' compensation insurance. Since the early 1980s, rapidly increasing medical care costs and the trend toward increased litigation, coupled with political pressures on rate levels, have resulted in unprofitable results from insurers in the workers' compensation line. As companies have become less willing to write this business, the involuntary market has swelled, and insurers' results have further deteriorated due to increasing residual market assessments. Many states have adopted or are considering legislation to bring the costs and premiums more in balance. However, even if such reforms are implemented, it may take several years for insurers to recover from years of unprofitability.

These regulatory developments require companies to monitor the possible effects of such actions on existing or new business and to evaluate the possible need for financial statement recognition or disclosures of those effects. These regulatory developments also may increase the possibility of premium deficiencies. In addition, companies need to review all profit-related calculations, such as deferred acquisition costs and balances due from reinsurers and agents, for the impact of these regulatory developments.

SEC Developments

In addition to the items discussed in the section "Specific Conditions or Risk Factors," the SEC staff has indicated its intention to focus on the discussions of liquidity in the MD&A section in reports that registrants file with the SEC.

Statutory Reporting Developments

Effective for 1991, the NAIC incorporated several new regulatory requirements in its "Annual Statement Blank" or the instructions thereto. The new requirements include the following:

- All insurers meeting certain criteria are required to file audited financial statements prepared in conformity with statutory accounting practices prescribed or permitted by the state of domicile. These audited statutory-basis financial statements are to be filed as a supplement to the annual statement on or before June 1 for the year ended December 31 immediately preceding. The notes to the audited financial statements shall include those disclosures appropriate to the financial statements being presented and include any applicable notes required by GAAP.
- Insurers are required to have their auditors prepare and file an "Accountants' Letter of Qualification" and a "Report on Significant Deficiencies in Internal Controls" in accordance with the NAIC instructions.
- A narrative document, captioned "Management's Discussion and Analysis," discussing material changes in significant annual statement line items and material future operating events, similar to the disclosure currently required by the SEC for public companies, will be required of all insurers.

Statements of Actuarial Opinion

The 1991 "Property & Casualty Annual Statement Instructions" significantly expand the required contents of the accompanying statements of actuarial opinion. The new requirements include the following:

- The actuarial opinion must separately address direct, assumed, and net reserves.
- If the company's reserves result in "exceptional values" on the NAIC Insurance Regulatory Information System (IRIS) tests, those results must be explained by the actuary.
- Actuarial methods and assumptions must be explained.
- Reliance on others for the accuracy of underlying data should be disclosed.
- The actuarial opinion must comment on how any of the following impact loss reserves: discounting, salvage and subrogation, financial reinsurance, reinsurance collectibility, or loss portfolio transfers.

- Working papers that support the actuarial opinion must be maintained at the company for seven years.

Many companies may not have historically maintained development data both gross and net of ceded reinsurance and may need to substantially modify their data-processing systems to obtain the necessary information.

Other Developments

Individual state insurance departments have proposed or enacted regulations addressing accounting for surplus notes, reinsurance, and other transactions. In certain instances these regulations represent a change from previously permitted accounting practices.

The regulations, combined with more restrictive interpretations being applied by state insurance departments during regulatory examinations, increase the need for insurers to seek specific written approval for unusual transactions. Auditors should assess the potential impact of adjustments to the statutory-basis financial statements resulting from insurance department examinations in progress.

Audit and Accounting Developments

Auditing Insurance Entities' Loss Reserves

An exposure draft of a proposed SOP, *Auditing Insurance Entities' Loss Reserves*, was issued by the AICPA on September 16, 1991. The proposed SOP will supplement the AICPA Audit and Accounting Guide *Audits of Property and Liability Insurance Companies*. It is designed to assist auditors in developing an effective audit approach when auditing loss reserves of insurance entities. In addition to providing guidance on the determination and audit of loss reserves, the proposed SOP requires that a "loss reserve specialist" be involved in the determination of loss reserves, and that an outside loss-reserve specialist be used in the audit of loss reserves.

Guidance for Assessing Risk Transfer in Property and Liability Reinsurance Contracts

An exposure draft of a proposed SOP, *Guidance for Assessing Risk Transfer in Property and Liability Reinsurance Contracts*, was issued by the AICPA on September 10, 1991. The proposed SOP discusses the nature of risk transfer in property and liability reinsurance contracts and the accounting principles to be applied. The proposed SOP provides guidance in determining whether indemnification against loss or liability has in substance been achieved by a reinsurance contract.

Accounting for Foreign Property and Liability Reinsurance

An exposure draft of a proposed SOP, *Accounting for Foreign Property and Liability Reinsurance*, was issued by the AICPA on August 22, 1991. The proposed SOP provides guidance on how U.S. companies should account for property and liability reinsurance assumed from foreign insurance companies.

Accounting for Foreclosed Assets

In August 1991, the Accounting Standards Executive Committee approved a proposed SOP, *Accounting for Foreclosed Assets*, for final issuance. The SOP includes a presumption that foreclosed assets are held for sale and requires foreclosed assets to be classified in the balance sheet as assets held for sale and reported at the lower of (1) fair value minus the estimated costs to sell or (2) cost. In addition, the net amount of revenues and expenses related to foreclosed assets would be charged or credited to income as a net gain or loss on holding foreclosed assets. Capital additions, improvements, or any related capitalized interest would be added to the cost basis of the asset. No depreciation, depletion, or amortization expense related to foreclosed assets would be recognized. The SOP would be applied to all foreclosed assets in annual financial statements for periods ending on or after June 15, 1992. The proposed SOP has been sent to the FASB for clearance prior to final issuance.

Audits of Property and Liability Insurance Companies

Audits of Property and Liability Insurance Companies is an Audit and Accounting Guide that the AICPA issued in the third quarter of 1990. The guide supersedes the 1966 AICPA Industry Audit Guide *Audits of Fire and Casualty Insurance Companies*, and the statements of position that amend that guide, except for the 1982 SOP, *Auditing Property and Liability Reinsurance*. The guide was prepared to assist independent auditors in auditing and reporting on financial statements of property and liability insurance companies. It describes operating conditions and auditing procedures unique to the industry and illustrates the form and content of financial statements and disclosures. The guide is effective for audits of financial statements of property and liability insurance companies for periods beginning on or after December 15, 1990.

Insurance Agents and Brokers

An exposure draft of a proposed AICPA Industry Accounting Guide *Insurance Agents and Brokers* was issued on August 11, 1991. The proposed guide describes existing accounting and reporting practices of insurance agents and brokers and recommends certain changes in those practices to eliminate alternatives.

Auditor's Responsibility Concerning Actuarial Opinions

In February 1991, the staff of the AICPA published a Notice to Practitioners, *Auditor's Responsibility Concerning Statement of Actuarial Opinion Required by Insurance Regulators*, in the *CPA Letter*. The Notice describes the auditor's responsibility in situations in which an actuary assumes responsibility for the examination of the underlying data on which actuarial items are based in his or her actuarial opinion, and in situations in which an actuary does not assume that responsibility. The AICPA continues to work with the NAIC and other organizations concerning actuarial opinions.

Market Value Disclosures

In December 1990, the FASB issued an exposure draft of a proposed Statement, *Disclosures about Market Value of Financial Instruments*. The proposed Statement would require disclosure of information about the market value of financial instruments, both assets and liabilities on and off balance sheet, for which it is practicable to estimate market value. Descriptive information pertinent to estimating the value of financial instruments for which it is not practicable to estimate market value would also be required to be disclosed. Certain financial instruments (for example, lease contracts, deferred-compensation arrangements, and insurance contracts) are excluded from the scope of the proposed Statement. The FASB is expected to issue a final Statement in late 1991. However, the statement will not be effective for 1991 year-end reporting.

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This Audit Risk Alert supersedes *Property and Liability Industry Developments—1990*.

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Auditors should also be aware of the economic, regulatory and professional developments that may affect the audits they perform as described in *Audit Risk Alert—1991* (No. 022087). *Audit Risk Alert—1991* was printed in the November 1991 issue of the *CPA Letter*. Additional copies can be obtained from the AICPA Order Department.

Copies of AICPA publications may be obtained by calling the AICPA Order Department at (800) 334-6961 (outside New York) or (800) 248-0445 (New York only). Copies of FASB publications may be obtained directly from the FASB by calling the FASB Order Department at (203) 847-0700, ext. 10.