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AICPA
AUDIT AND
ACCOUNTING
GUIDE

AUDITS OF PROPERTY AND LIABILITY INSURANCE COMPANIES

With Conforming Changes as of May 1, 1996

American Institute of
Certified Public Accountants

AICPA
AUDIT AND
ACCOUNTING
GUIDE

AUDITS OF PROPERTY AND LIABILITY INSURANCE COMPANIES

With Conforming Changes as of May 1, 1996

This edition of the AICPA Audit and Accounting Guide *Audits of Property and Liability Insurance Companies*, which was originally issued in 1990, has been modified by the AICPA staff to include certain changes necessary because of the issuance of authoritative pronouncements since the Guide was originally issued (see page iv). The changes made are identified in a schedule in appendix S of the Guide. The changes do *not* include all those that might be considered necessary if the Guide were subjected to a comprehensive review and revision.

American Institute of
Certified Public Accountants

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NOTICE TO READERS

This audit and accounting guide presents recommendations of the AICPA Insurance Companies Committee on the application of generally accepted auditing standards to audits of financial statements of property and liability insurance companies. This guide also presents the committee's recommendations on and descriptions of financial accounting and reporting principles and practices for property and liability insurance companies. The AICPA Accounting Standards Executive Committee and members of the AICPA Auditing Standards Board have found this guide to be consistent with existing standards and principles covered by Rules 202 and 203 of the AICPA Code of Professional Condut. AICPA members should be prepared to justify departures from this guide.

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This guide reflects relevant guidance contained in authoritative pronouncements through May 1, 1996:

FASB Statement No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*

FASB Interpretation No. 41, *Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements*

EITF Consensus No. 95-22, *Balance Sheet Classification of Revolving Credit Agreements That Include a Subjective Acceleration Clause and a Lock-Box Arrangement*

Practice Bulletin No. 14, *Accounting and Reporting by Limited Liability Companies and Limited Liability Partnerships*

SAS No. 79, *Amendment to Statement on Auditing Standards No. 58,* Reports on Audited Financial Statements

SOP No. 95-5, *Auditor's Reporting on Statutory Financial Statements of Insurance Enterprises*

SSAE No. 6, *Reporting on an Entity's Internal Control Over Financial Reporting: An Amendment to Statement on Standards for Attestation Engagements No. 2*

SSARS No. 7, *Omnibus Statement on Standards for Accounting and Review Services*

Preface

This audit and accounting guide, which supersedes the 1966 AICPA Industry Audit Guide, *Audits of Fire and Casualty Insurance Companies* and the statements of position (SOPs) that amend that guide (except for the SOP *Auditing Property and Liability Reinsurance* which has been incorporated into chapter 6 of this guide), has been prepared to assist the independent auditor in auditing and reporting on financial statements of property and liability insurance companies. This guide describes operating conditions and auditing procedures unique to the industry and illustrates the form and content of financial statements and disclosures for property and liability insurance companies, various pools, syndicates, and other organizations such as public entity risk pools. Chapter 1 discusses the nature, conduct, and regulation of the insurance industry. Among the other significant areas discussed in this guide are—

- Audit considerations, including a discussion of the assessment of control risk.
- The premium cycle, including a discussion of rating, transactions, accounting practices, and special risk considerations.
- The claims cycle, including a discussion of accounting practices and special risk considerations.
- The investment cycle, including a discussion of regulation, various investment alternatives, accounting practices, and special risk considerations.
- Reinsurance, including a discussion of the kinds of reinsurance, accounting practices, ceded reinsurance, and assumed reinsurance.
- Taxes, including both federal and state.
- Differences between statutory accounting practices and generally accepted accounting principles.

In addition, appendix B discusses control procedures and auditing objectives and procedures.

The specialized generally accepted accounting principles to be followed by property and liability insurance companies are included in the Financial Accounting Standards Board (FASB) *Current Text* at section In6. Discussions of accounting in this guide are generally intended to refer to authoritative literature. Discussions of statutory accounting practices are mentioned if they differ from generally accepted accounting principles. Some significant differences between generally accepted accounting principles and statutory accounting practices are discussed also in chapter 8.

Public entity risk pools are required to follow the accounting and financial reporting requirements of Governmental Accounting Standards Board (GASB) Statement No. 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues*. That Statement is based primarily on FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, and related pronouncements but includes certain accounting and financial reporting requirements that differ from FASB Statement No. 60. As discussed in chapter 1, many public entity risk pools are not subject to the same regulation as property and liability insurance companies.

Readers of this audit and accounting guide should be aware of certain accounting issues affecting the insurance industry that are being studied by

the accounting profession. The FASB and the AICPA Insurance Companies Committee and the AICPA Accounting Standards Executive Committee (AcSEC) are developing guidance to discuss those issues as well as present resolutions for them. Issues currently under consideration include:

- Present-value-based measurements in accounting (interest methods). (The FASB has issued a discussion memorandum.)

The National Association of Insurance Commissioners (NAIC) continually monitors statutory accounting practices for insurance companies. Through various committees, such as the NAIC Working Group on Emerging Issues, it makes recommendations to state insurance departments regarding changes in statutory accounting and reporting.

As issues are resolved, amendments to this guide may be issued by the AICPA, or pronouncements may be issued by the FASB or GASB.

Effective Date

The auditing provisions of this guide are effective for audits of financial statements of property and liability insurance companies for periods beginning on or after December 15, 1990.

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Glossary

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Chapter 1

Nature, Conduct, and Regulation of the Business

General Nature of the Business

1.01 The primary purpose of the property and liability insurance business is the spreading of risks. The term *risk* generally has two meanings in insurance. It can mean either a *peril insured against* (for example, fire is a risk to which most property is exposed) or a *person or property protected* (for example, a home or an automobile). For a payment known as a premium, insurance companies undertake to relieve the policyholder of all or part of a risk and to spread the total cost of similar risks among large groups of policyholders.

1.02 The functions of the property and liability insurance business include marketing, underwriting (that is, determining the acceptability of risks and the amounts of the premiums), billing and collecting premiums, investing and managing assets, investigating and settling claims made under policies, and paying expenses associated with these functions.

1.03 In conducting its business, an insurance company accumulates a significant amount of investable assets. In addition to funds raised as equity and funds retained as undistributed earnings, funds accumulate from premiums collected in advance; from sums held for the payment of claims in the process of investigation, adjustment, or litigation; and from sums held for payment of future claims settlement expenses. The accumulation of these funds, their investment, and the generation of investment income are major activities of insurance companies.

Kinds of Insurance

1.04 Kinds of insurance, generally referred to as lines of insurance, represent the perils that are insured by property and liability insurance companies. Some of the more important lines of insurance are—

- *Fire and allied lines*, which include coverage for fire, windstorm, hail, and water damage (but not floods).
- *Ocean marine*, which includes coverage for ships and their equipment, cargos, freight or money to be paid for use of the ships, and liability to third parties for damages.
- *Inland marine*, which covers property being transported other than transocean. (It also includes floaters, which are policies that cover movable property, such as a tourist's personal property.)
- *Workers' compensation*, which compensates employees for injuries or illness sustained in the course of their employment.
- *Automobile*, which covers personal injury or automobile damage sustained by the insured and liability to third parties for losses caused by the insured.
- *Multiple peril*, which is a package coverage including most property and liability coverage except workers' compensation, automobile insurance, and surety bonds.

- *Professional liability*, which covers physicians, surgeons, dentists, hospitals, engineers, architects, accountants, attorneys, and other professionals from liability arising from error or misconduct in providing or failing to provide professional service.
- *Miscellaneous liability*, which covers most other physical and property damages not included under workers' compensation, automobile liability, and multiple peril policies. (Damages include death, cost of care, and loss of services resulting from bodily injury, as well as loss of use of property.)
- *Fidelity bonds*, which cover employers against dishonest acts by employees. Blanket fidelity bonds cover groups of employees.
- *Surety bonds*, which provide for monetary compensation to third parties for failure by the insured to perform specifically covered acts within a stated period. (Most surety bonds are issued for persons doing contract construction, persons connected with court actions, and persons seeking licenses and permits. Surety bonds also include financial guarantees.)
- *Accident and health*, which covers loss by sickness or accidental bodily injury. (It also includes forms of insurance that provide lump-sum or periodic payments in the event of loss by sickness or accident, such as disability income insurance and accidental death and dismemberment insurance.)

1.05 In addition to these lines, insurance is provided by excess and surplus lines. *Excess liability* covers the insured against loss in excess of a stated amount, but only for losses as covered and defined in an underlying policy. The underlying amount is usually insured by another policy but can be retained by the insured. *Surplus lines* include coverage for risks that do not fit normal underwriting patterns, risks that are not commensurate with standard rates, or risks that will not be written by standard carriers because of general market conditions. These kinds of policies are generally written by carriers not licensed in the jurisdiction where the risk is located and generally are not subject to regulations governing premium rates or policy language.

1.06 The lines and premium volume that may be written by a company are generally restricted by state insurance regulations. States also monitor the amount of premium written as a ratio of the company's surplus.

1.07 Insurance written by property and liability insurance companies may be broadly classified as *personal lines*, which consist of insurance policies issued to individuals, and *commercial lines*, which consist of policies issued to business enterprises. Personal lines generally consist of large numbers of relatively standard policies with relatively small premiums per policy. Examples are homeowner's and individual automobile policies. Commercial lines involve policies with relatively large premiums that are often retroactively adjusted based on claims experience. The initial premium is often only an estimate because it may be related to payroll or other variables. Examples are workers' compensation and general liability. Many large insurance companies have separate accounting, underwriting, and claim-processing procedures for these two categories.

1.08 Insurance is generally available to the individual as a means of protection against loss. There are instances, however, in which a person cannot obtain insurance in the voluntary insurance market. States have established programs to provide insurance to those with high risks who otherwise would be excluded from obtaining coverage. Following are some of the more common programs that provide the necessary coverage:

- *Involuntary automobile insurance.* States have a variety of methods for apportioning involuntary automobile insurance. The most widely used approach is the Automobile Insurance Plan (formerly called the Assigned Risk Plan). Under this plan, all companies writing automobile insurance in a state are allocated a share of the involuntary business on an equitable basis. Each automobile insurer operating in the state accepts a share of the undesirable drivers, based on the percent of the state's total auto insurance that it writes. For example, a company that writes 5 percent of the voluntary business in a state may be assigned 5 percent of the involuntary applicants. It is then responsible for collecting the premiums and paying the claims on the policies issued to these applicants. Other states use a reinsurance plan, under which each insurer accepts all applicants but may place high-risk drivers in a reinsurance pool, with premiums paid to and losses absorbed by the pool. Still another approach is a joint underwriting association, in which one or more servicing companies are designated to handle high-risk drivers. All insurers in the state may be required to participate in the underwriting results.
- *FAIR plans.* FAIR (Fair Access to Insurance Requirements) plans are state-supervised programs established to provide coverage for property in high-risk areas. Companies that operate in the state are required to participate in the premiums, losses, expenses, and other operations of the FAIR plan.
- *Medical malpractice pools.* These pools were established when health-care professionals and institutions were experiencing difficulty in obtaining liability insurance in the voluntary insurance market. The pools were established by law and currently exist in the majority of states. All insurers writing related liability insurance in such states are considered mandatory participants in the pools as a condition for their continuing authority to transact business in such states.
- *Workers' compensation pools.* These pools are similar to FAIR plans. As with FAIR plans, companies operating in a given state are assessed a proportionate share, based on direct writings, of the underwriting results of the pool.

Organizations

1.09 The principal kinds of property and liability insurance organizations are—

a. *Stock companies*, which are corporations organized for profit with ownership and control of operations vested in the stockholders. Generally, the stockholders are not liable in case of bankruptcy or impairment of capital.

b. *Mutual companies*, which are organizations in which the ownership and control of operations are vested in the policyholders. On the expiration of their policies, policyholders lose their rights and interests in the company. Many states require the net assets of a mutual insurance company in liquidation to be distributed among the current policyholders of the company, and the prior policyholders have no claim against the assets. Most major mutual companies issue nonassessable policies as provided under state laws; if a mutual company is not qualified to issue such policies, however, each policyholder is liable for an assessment equal to at least one annual premium in the event of bankruptcy or impairment of minimum equity requirements.

c. *Reciprocal or interinsurance exchanges,* which are composed of a group of persons, firms, or corporations, commonly termed subscribers, who exchange contracts of insurance through the medium of an attorney-in-fact. Each subscriber executes an identical agreement empowering the attorney-in-fact to assume, on the subscriber's behalf, an underwriting liability on policies covering the risks of the other subscribers. The subscriber assumes no liability as an underwriter on policies covering his or her own risk; the subscriber's liability is several and not joint and is limited by the terms of the subscriber's agreement. Customarily, the attorney-in-fact is paid a percentage of premium income, from which he or she pays most operating expenses, but some exchanges pay his or her own operating expenses and compensate the attorney-in-fact at a lower percentage of premiums or by some other method.

d. *Public entity risk pools,* which are cooperative groups of governmental entities joining together to finance exposures, liabilities, or risks. Risk may include property and liability, workers' compensation, employee health care, and so forth. A pool may be a stand-alone entity or be included as part of a larger governmental entity that acts as the pool's sponsor. Stand-alone pools are sometimes organized or sponsored by municipal leagues, school associations, or other kinds of associations of governmental entities. A stand-alone pool is frequently operated by a board that has as its membership one member from each participating government. It typically has no publicly elected officials or power to tax. Public entity risk pools should be distinguished from private pools, which are organized under the Risk Retention Act of 1986. These private pools, or risk retention groups, can provide only liability coverage, whereas public entity risk pools organized under individual state statutes can provide several kinds of coverage. The four basic kinds of public entity risk pools are—
   - *Risk-sharing* pools, arrangements by which governments pool risks and funds and share in the cost of losses.
   - *Insurance-purchasing* pools, arrangements by which governments pool funds or resources to purchase commercial insurance products. These arrangements are also called *risk-purchasing groups.*
   - *Banking* pools, arrangements by which money is made available for pool members in the event of loss on a loan basis.
   - *Claims-servicing* or *account* pools, arrangements by which pools manage separate accounts for each pool member from which the losses of that member are paid.

   A pool can serve one or several of those functions. Pools that act *only* as banking or claims-servicing pools do not represent transfer of risk. Such pools are not insurers and should not report as insurer.

e. *Private pools.* Because of the unavailability and unaffordability of commercial liability insurance, Congress enacted the Risk Retention Act of 1986. This Act allows the organization of private pools for the purpose of obtaining general liability insurance coverage. Two basic types of private pools are allowed:
   - Risk retention groups, an insurance company formed by the members of the private pool primarily to provide commercial liability insurance to the members.

- Purchasing groups, where the members of the private pool purchase commercial liability insurance on a group basis.

Methods of Producing Business

1.10 The marketing department of an insurance company is responsible for sales promotion, supervision of the agency or sales force, and sales training. Property and liability insurance companies may produce business through a network of agents (agency companies) or through an employee sales force (direct writing companies), or they may acquire business through insurance brokers or through direct solicitation. A combination of methods may also be used. The distinctions among an agent, a broker, and a salesperson are based on their relationships with the insurance company.

1.11 *Agents.* Insurance agents act as independent contractors who represent one insurance company (exclusive agents) or more than one company (independent agents) with express authority to act for the company in dealing with insureds.

1.12 General agents have exclusive territories in which to produce business. They agree to promote the company's interest, pay their own expenses, maintain a satisfactory agency force, and secure subagents. They may perform a significant portion of the underwriting. They may also perform other services in connection with the issuance of policies and the adjustment of claims, including negotiating reinsurance on behalf of the insurer, which neither local agents nor brokers are authorized or expected to do.

1.13 Local and regional agents are authorized to underwrite and issue policies but are not usually given exclusive territories. They usually report either to company branch offices or directly to the company's home offices. Agents are generally compensated by commissions based on percentages of the premiums they produce. Because of their greater authority and duties, general agents usually receive higher percentages than local or regional agents.

1.14 Agents have the power to bind the company, which means that the insurance is effective immediately, regardless of whether money is received or a policy is issued. Generally, agents are considered to have vested rights in the renewal of policies sold for insurance companies. The company cannot, however, compel independent agents to renew policies, and the agents may place renewals with other companies.

1.15 *Brokers.* Insurance brokers represent only the insureds; they have no contractual relationships with insurance companies. As a result, brokers do not have the power to bind the company. Brokers solicit business and submit it for acceptance or rejection with one or more insurance companies. Brokers may submit business directly to a company or through general or local agents or through other brokers. Brokers are compensated by commissions paid by insurance companies, normally percentages of the premiums on policies placed with the companies.

1.16 *Direct writing.* Direct writing companies sell policies directly to the public, usually through salespeople, thus bypassing agents and brokers. Direct writing may be done from the company's home office or through branch sales offices. Underwriting and policy issuance may also be done from the home office or branches. The salespeople may be paid commissions, straight salaries, or both (that is, a commission incentive with a basic salary). Salespeople generally have the power to bind the company; however, the company retains the right to cancel the policy, generally for up to sixty days.

1.17 *Mass merchandising.* Mass merchandising is also used for producing business. This results in sales to many people simultaneously, with single programs to insure a number of people or businesses. Mass merchandising methods use direct billing techniques that may also permit individuals to pay premiums by salary deductions or on credit cards.

Major Transaction Cycles

Underwriting of Risks

1.18 Underwriting includes evaluating the acceptability of the risk, determining the premium, and evaluating the company's capacity to assume the entire risk.

1.19 *Evaluating risks.* Evaluating risks and their acceptance or rejection involves (*a*) a review of exposure and potential loss based on both the review of dailies (office copies of policies) and the endorsements to existing policies and (*b*) an investigation of risks in accordance with procedures established by company policy and state statutes. For example, applicants for automobile insurance may be checked by reference to reports on driving records issued by a state department of motor vehicles. Application for certain kinds of coverage may require an engineering survey, a fire hazard survey, or similar investigations. In addition, a company's underwriting policy may establish certain predetermined criteria for accepting risks. Such criteria often specify the lines of insurance that will be written as well as prohibited exposures, the amount of coverage to be permitted on various kinds of exposure, the areas of the country in which each line will be written, and similar restrictions.

1.20 *Setting premium rates.* Establishing prices for insurance coverage is known as the rate-making process, and the resultant rates that are applied to some measure of exposure (for example, payroll or number of cars) are referred to as *premiums*. Determining premiums is one of the most difficult tasks in the insurance business. The total amount of claims is not known at the time the insurance policies are issued and, for many liability policies, is not known until years later. Determining proper premium rates is further complicated by the fact that no two insurable risks are exactly alike. The intensity of competition among hundreds of property and liability insurance companies in the United States is also significant in setting premiums.

1.21 Premium rates may be established by one of three methods:

a. *Manual rating*, which results in standard rates for large groups of similar risks, used, for example, in many personal lines such as automobile insurance

b. *Judgment rating*, which depends on the skill and experience of the rate-maker, used generally for large or unusual risks such as ocean marine insurance

c. *Merit rating*, which begins with an assumed standard or "manual" rate that is adjusted based on an evaluation of the risk or the insured's experience in past or current periods, used in many commercial lines such as workers' compensation

1.22 The transaction cycle for premiums is described in detail in chapter 3.

1.23 *Reinsurance.* Insurance companies collect amounts from many risks subject to insurable hazards; it is expected that these amounts will be sufficient in the aggregate to pay all losses sustained by the risks in the group.

To do so, the number of risks insured must be large enough for the law of averages to operate. However, insurance companies are often offered, or may be compelled to accept, insurance of a class for which they do not have enough volume in the aggregate to permit the law of averages to operate. Further, companies often write policies on risks for amounts beyond their financial capacities to absorb; or a company may write a heavy concentration of policies in one geographic area that exposes the company to catastrophes beyond its financial capabilities. Ordinarily, all or part of such risks are passed on to other insurance or reinsurance companies.

1.24 Spreading of risks among insurance companies is called *reinsurance*. The company transferring the risk is called the *ceding company*, and the company to which the risk is transferred is called the *assuming company*, or the *reinsurer*. Although a ceding company may transfer its risk to another company through reinsurance, it does not discharge its primary liability to its policyholders. The ceding company remains liable for claims under the policy; however, through reinsurance, the ceding company reduces its maximum exposure in the event of loss by obtaining the right to reimbursement from the assuming company for the reinsured portion of the loss. The ceding company is also exposed to the possibility that the reinsurer will not be able to reimburse the ceding company.

1.25 The term *portfolio reinsurance* is applied to the sale of all or a block of a company's insurance in force to another company. This kind of reinsurance is frequently used when a company wishes to withdraw from a particular line, territory, or agency. In portfolio reinsurance, the assuming company generally undertakes responsibility for servicing the policies—collecting the premiums, settling the claims, and so on—and the policyholder subsequently deals directly with the assuming company.

1.26 *Fronting.* Fronting is an arrangement between two or more insurers whereby the fronting company issues a policy and then cedes all or substantially all the risk through a reinsurance agreement to the other insurer(s) (the fronted company) in return for a ceding commission. As with other reinsurance contracts, the fronting company remains primarily liable on the insurance contract with the insureds. Fronting arrangements usually are initiated by fronted companies that are not authorized to write insurance in particular states.

1.27 The principal kinds of reinsurance agreements and the mechanics of reinsurance are discussed in detail in chapter 6.

1.28 *Pooling.* The term *pooling* is often used to describe the practice of sharing among groups of associated insurance companies all or portions of the insurance business of the groups. Each premium written by the associated companies is customarily ceded to one company; then, after allowing for any business reinsured outside the group, the premiums are in turn ceded back in agreed-upon ratios. Claims, claim adjustment expenses, commissions, and other underwriting and operating expenses are similarly apportioned. Each member of the group shares pro rata in the total business of the group, and all achieve similar underwriting results. Another kind of pooling involving sharing of risks among governmental entities is discussed in paragraph 1.09.

1.29 *Underwriting pools, associations, and syndicates.* Underwriting pools, associations, or syndicates are formed by several independent companies or groups of companies in joint ventures to underwrite specialized kinds of insurance or to write in specialized areas. These groups are often operated as

separate organizations having distinctive names and their own staffs of employees. The pools, associations, or syndicates may issue individual or syndicate policies on behalf of the member companies, which share in all such policies in accordance with an agreement, or policies may be issued directly by the member companies and then reinsured among the members in accordance with the agreement. The agreement stipulates the group's manner of operation and the sharing of premiums, claims, and expenses. Such groups customarily handle all functions in connection with the specialized business that would otherwise have to be handled by specific departments in each of the member companies. This kind of arrangement usually is more economical in handling the business for the members.

1.30 *Captives.* Noninsurance businesses try to use various methods to minimize their cost of insurance. Other than retaining the risk (that is, self-insurance), perhaps the most conventional method is the use of captive insurers. Captive insurers are wholly owned subsidiaries created to provide insurance to the parent companies. Captives were originally formed because no tax deductions are allowed if risks are not transferred, whereas premiums paid to insurers are tax deductible. Many captives are chartered in locales in which the business climate is receptive to their formation. However, in 1977 the IRS ruled that premiums paid to an offshore captive would not be allowed as a deductible expense unless a significant volume of insurance was placed with the captive firm by companies outside the consolidated group. The Tax Reform Act of 1986 subjects any U.S. person who owns stock in a 25 percent or more U.S.-owned foreign insurance company to current taxation based on its pro rata share of income arising from insuring risks of U.S. shareholders and related parties.

Processing and Payment of Claims

1.31 An insurance company's claim department accepts, investigates, adjusts, and settles claims. The first step in the claims process is for the insured to notify the company that a loss has occurred. The insured reports the loss to the agent, who will either help the insured to prepare or will prepare a loss report, which will be forwarded to the insurance company. The second step is investigation and adjustment, which is designed to determine whether a loss occurred and whether the loss is covered by the policy. Companies generally use claims adjusters, who may be employees of the insurance companies or of the agents, to investigate claims. Insurance companies may also use outside organizations to adjust claims.

1.32 *Adjustment bureaus.* Insurance companies establish adjustment bureaus to investigate and settle some or all of the claims of the member companies. Subject to certain limitations, an adjustment bureau adjusts claims and negotiates the settlement of claims for each company, with each company retaining the final power of approval or disapproval. Expenses of the adjustment bureau are shared by all members on an equitable basis generally determined by the number or dollar volume of claims referred to it for adjustment.

1.33 *Independent adjusters.* Insurance companies engage independent adjusters, who charge stipulated fees for their services to investigate and adjust certain claims. The adjustment process also includes estimating the loss. The adjuster will help determine the amounts of losses and the reserves required.

1.34 The third step of the claims process is claim settlement, either payment or denial of a claim. After settlement (through negotiation or court

action) with a claimant, a check or draft is issued for the amount of the adjusted claim. Upon receipt of payment, the claimant generally signs a release indicating that final settlement has been received.

1.35 The transaction cycle for claims is discussed in more detail in chapter 4.

Investments

1.36 Property and liability insurance companies function as conduits of funds. They collect funds, known as premiums, from those desiring protection from financial loss and disburse funds to those who incur such losses. Between receipt of premiums and payment of losses, which can be long periods for third-party claims, the companies invest these funds.

1.37 Because insurance companies must be able to meet the claims of their policyholders, their investments should be both financially sound and sufficiently liquid. To ensure that companies will be able to meet their obligations, statutory restrictions have been placed on their investment activities. Although statutes and regulations vary from state to state, most states specify maximum percentages of a company's assets and/or surplus that may be placed in various kinds of investments. In addition, regulatory authorities may require that some investments be deposited with the state insurance departments as a condition for writing business in those states. Investment standards and restrictions for public entity risk pools differ significantly from standards for insurance companies. In some jurisdictions, public entity risk pools must follow regulations governing the investment of public funds. Invested assets consist primarily of bonds and marketable equity securities, but investments are also commonly made in mortgage loans and income-producing real estate. In addition, the insurance industry has been increasingly utilizing options, financial futures, and similar investments in its investment activities.

1.38 Most insurance companies have separate investment departments responsible for managing the companies' investable funds. Insurers should plan investments so that the maturities of their investment portfolios match their claims payment patterns. This is generally referred to as *asset and liability management*—that is, funds are invested so that the income from these investments plus maturities will meet the ongoing cash flow needs of the company. This matching approach requires a correct mix of long-and short-term investments.

1.39 The transaction cycle for investments is discussed in more detail in chapter 5.

Accounting Practices

1.40 Although the increased use of systems application software interfaced with general ledger packages has encouraged the use of full accrual accounting records by many insurers, many companies still maintain their general ledger on a modified cash basis and then prepare financial statements for regulatory filings on an accrual basis. The accounting practices used to prepare such statutory financial statements differ in some respects from generally accepted accounting principles (GAAP), as discussed in chapter 8. The adjustments necessary to convert the accounts to the accrual basis are usually recorded in working papers that are part of the company's official accounting records, rather than in the general ledger. Modified cash-basis accounting is employed by property and liability insurance companies because

it is readily usable for preparing certain exhibits of income and expense items, on both a cash basis and an accrual basis, that are required to be included in the annual statements filed with the state insurance departments, which regulate the activities of property and liability insurance companies.

1.41 Because the cash-basis of accounting is used for recording purposes and the accrual-basis of accounting is used for reporting purposes, assets are generally categorized as—

- *Ledger assets,* which are assets companies have recorded on their general ledgers. These are generally items resulting from cash expenditures (for example, investments) or items that arise from insurance transactions, or premiums receivable and reinsurance recoverables.
- *Nonledger assets,* which are assets not recorded on a company's general ledger but are available from supplemental ledger records or other sources—for example, excess of market value over book value of common and nonredeemable preferred stock and accrued investment income.
- *Nonadmitted assets,* which are assets that are considered to be of no value by state insurance departments in determining the solvency of an insurance company. Such items include excess of book value over market value of common and nonredeemable preferred stock, furniture and fixtures, equipment, supplies, and uncollected premiums or agents' balances over ninety days past due. Assets required to be classified as nonadmitted vary from state to state. Although equipment is generally a nonadmitted asset, electronic data processing equipment is considered an admitted asset primarily because of the high cost of such equipment. Nonadmitted assets are excluded from the statutory balance sheet by a direct charge to statutory surplus.

1.42 Insurance companies also have ledger liabilities and nonledger liabilities. For most property and liability insurance companies, ledger liabilities consist of liabilities arising directly from cash transactions, such as payroll deductions, whereas nonledger liabilities consist of liabilities that do not arise as a direct result of cash transactions, such as loss reserves, unearned premiums, contingent commissions, and taxes.

Statutory Accounting Practices

1.43 State insurance departments require insurance entities to maintain records in accordance with statutory accounting practices (SAP). Statutory accounting employs those accounting principles and practices prescribed or permitted by an insurer's domiciliary insurance department and in some instances, by the insurance departments of other states in which the insurer is licensed to write business, that is, authorized to do business.

1.44 The term "statutory accounting practices" is something of a misnomer, because it does not necessarily refer to principles enacted by statute. SAP may be prescribed in numerous ways. The National Association of Insurance Commissioners' (NAIC) *Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies* prescribes statutory accounting practices. In addition, individual states may adopt laws, regulations, and administrative rulings governing the operations and reporting requirements of insurance companies licensed to write business in those states. NAIC's *Annual Statement Instructions, Examiners Handbook, Valuations of Securities Manual,* committee minutes, model rules, regulations, and guidelines provide other sources of SAP. Some states may issue circular letters describing their positions

on various areas of accounting. In areas in which specific accounting practices are not prescribed, widely recognized practices may be permitted in a given state or specific accounting applications may be approved by the state insurance department, either orally or in writing. Auditors are able to review state examiners' reports to obtain evidence of accounting practices that have either been explicitly or implicitly accepted on examination. SAP generally differs from state to state. For example, an insurance entity may request from the insurance department of its state of domicile special accounting consideration for unusual or significant transactions that materially affect statutory surplus. This practice, in addition to some variations in state statutes, precludes uniformity and absolute definitions of statutory accounting practices.

1.45 Each state insurance department requires all insurance entities licensed to write business in that state to file an *Annual Statement*, also referred to as the convention blank, statutory blank, or simply the blank, with the state insurance commissioner for each individual insurance entity by March 1 of the following year. All states require that the *Annual Statement* for the calendar year be comparative, presenting the amounts as of December 31 of the current year and the amounts as of the immediately preceding December 31. The *Annual Statement* includes numerous supplementary financial data, such as Analysis of Operations by Lines of Business and detailed schedules of investments. The NAIC's *Instructions to the Annual Statement* require that insurance entities file with their *Annual Statement* (1) an opinion by a qualified actuary concerning the adequacy of reserves and other actuarial items and that such reserves conform with statutory requirements and (2) a narrative document captioned "Management Discussion and Analysis" discussing material changes in significant annual statement line items and material future operating events, similar to the disclosures currently required by the SEC for public companies. The Management Discussion and Analysis is due April 1 of the following year.

1.46 The NAIC requires insurance entities in all states to file, by June 1, an Audited Financial Report with the insurance commissioners of their state of domicile and all other states in which they are licensed. The financial statements included in the Audited Financial Report should be prepared in a form and using language and groupings substantially the same as the relevant sections of the *Annual Statement* of the insurer. The annual Audited Financial Report is to include a reconciliation of differences, if any, between the audited statutory financial statements contained in that report and the *Annual Statement* filed with the state commissioner and a written description of the nature of the differences.

1.47 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. Some states also require the filing of an "Evaluation of Accounting Procedures and System of Internal Control" letter.

1.48 Many public entity risk pools are not required to prepare reports on a SAP basis. Enabling legislation generally sets forth each pool's reporting requirements and may require pools to report to the state insurance commissioner or state agency. Separate rules may apply to reporting, capitalization requirements, and so forth.

1.49 Insurance companies are examined regularly by state or zone (a group of states) insurance examiners, usually triennially. The Annual Statements filed with the regulatory authorities are used to monitor the financial condition of insurance companies in the period between examinations and to provide the financial data to help regulate the industry.

1.50 In addition to the audits of financial statements, insurance examiners review compliance with laws or regulations concerning policy forms, premium rates, kinds of investments, composition of the board of directors, members' attendance at board meetings, reinsurance contracts, intercompany transactions, and fair treatment of policyholders. Insurance examiners use the *Examiners Handbook*, a publication of the NAIC that outlines the procedures for conducting an examination as a guide in performing examinations and in preparing reports. Many of the steps followed in the examination are similar to those followed by independent auditors.

Generally Accepted Accounting Principles

1.51 In 1966, the AICPA issued the Industry Audit Guide, *Audits of Fire and Casualty Insurance Companies*, which included guidance on prescribed financial reporting principles and practices. In response to variations in accounting practices, and in an effort to clarify and expand the accounting discussion in the guide, in 1978 the AICPA issued Statement of Position (SOP) No. 78-6, *Accounting for Property and Liability Insurance Companies*. Then, in 1982, the Financial Accounting Standards Board issued FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, which sets forth specialized industry accounting principles for insurance companies. Other FASB pronouncements which significantly affect insurance companies include FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Investments*, and EITF Abstract No. 93-6, *Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises*.

1.52 FASB Statement No. 60 classifies insurance contracts as short-duration or long-duration contracts. The classification depends on whether a contract is expected to provide coverage for an extended period. The factors that should be considered in determining whether a particular contract can be expected to remain in force for an extended period are—

a. A *short-duration contract*, which provides insurance protection for a fixed period of short duration and enables the insurer to cancel the contract or to adjust the provisions of the contract at the end of any contract period, such as adjusting the amount of premiums charged or coverage provided.

b. A *long-duration contract*, which generally is not subject to unilateral changes in its provisions, such as a noncancelable or guaranteed renewable contract, and which requires the performance of various functions and services (including insurance protection) for an extended period.

Determining whether a contract is short-duration or long-duration requires both judgment and an analysis of the contract terms. Most property and liability insurance contracts currently issued are classified as short-duration contracts.

1.53 Under FASB Statement No. 60, premiums from short-duration contracts ordinarily are recognized as revenue over the contract period in proportion to the amount of insurance provided, and liabilities from unpaid claims and for claim adjustment expenses are accrued when insured events occur dur-

ing the contract period. Certain costs, called *acquisition costs*, vary with and are primarily related to the acquisition of insurance contracts. These costs are capitalized and charged to expense in proportion to premium revenue recognized (that is, also over the contract period). (Particular sections of this audit guide discuss the requirements of FASB Statement No. 60, but the reader should refer to the statement itself for specific guidance.)

1.54 GASB Statement No. 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues*, sets forth the accounting and financial reporting requirements for public entity risk pools. That Statement is based primarily on FASB Statement No. 60 but includes certain accounting and financial reporting requirements that differ from FASB Statement No. 60. In addition to the requirements of GASB Statement No. 10, there are other pronouncements of the GASB that affect accounting and financial reporting by public entity risk pools. For example, GASB Statement No. 3, *Deposits With Financial Institutions, Investments (Including Repurchase Agreements), and Reverse Repurchase Agreements*, requires pools to make certain disclosures about the credit and market risks of their investments. GASB Statement No. 9, *Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Fund Accounting*, requires pools to present a statement of cash flows using cash flows categories that differ from those required by FASB Statement No. 95, *Statement of Cash Flows*. This guide does not attempt to highlight the areas in which different accounting or reporting is required for public entity risk pools.

Regulation

State Insurance Regulation

1.55 The insurance industry is deemed to be a business vested with the public interest and is regulated by the states. Statutes in each state provide for the organization and maintenance of an insurance department responsible for supervising insurance companies and enforcing compliance with the law. Property and liability insurance companies are subject to formal regulation by the insurance department of the state in which they are domiciled and are also subject to the insurance regulations of the states in which they are licensed to do business. Although statutes vary from state to state, they have as their common principal objective the development and enforcement of measures designed to promote solvency, propriety of premium rates, fair dealings with policyholders, and uniform financial reporting.

1.56 State statutes (*a*) restrict investments of insurance companies to certain kinds of assets, (*b*) prescribe methods of valuation of securities and other assets, (*c*) require maintenance of minimum reserves, risk-based capital, and surplus, and (*d*) define those assets not permitted to be reported as admitted assets in annual statements filed with insurance departments.

1.57 The states regulate insurance premium rates to ensure that they are adequate, reasonable, and not discriminatory. In a 1944 decision, the Supreme Court held that insurance is interstate commerce and as such is subject to regulation by the federal government. However, in 1945 Congress passed the McCarran-Ferguson Act, which exempts the insurance business from antitrust laws. Although Congress insisted that the federal government has the right to regulate the insurance industry, it stated in the McCarran-Ferguson Act that the federal government would not regulate insurance as long as state legislation provided for the supervision of insurance companies, including rate making. The following practices are protected by the McCarran-Ferguson Act:

- Pooling of statistical data for rate making
- Standard policy forms and standardized coverage
- Joint underwriting and joint reinsurance (such as insurance pools for exceptional hazards)
- Tying of various lines of insurance, that is, making the purchase of lines of insurance that are unprofitable to the insurance company conditional on the purchase of profitable lines

1.58 All states have passed legislation requiring insurance commissioners to review, with or without prior approval, most rates charged by insurance companies. A company must file most rates with the insurance department of each state in which it is authorized to do business. A number of states also require formal or tacit approval of rates by respective state insurance departments.

1.59 To promote fair dealing with policyholders, state statutes provide for certain standard provisions to be incorporated in policies and for the insurance departments to review and approve the forms of policies. Insurance agents, brokers, and salespeople must qualify for and obtain licenses granted by the insurance department of a state before they may conduct business in the state.

1.60 To promote uniform financial reporting, as previously discussed, the statutes provide for annual or more frequent filings with the insurance departments in prescribed form.

1.61 In a majority of states, insurance companies may not be organized without the authorization of the insurance department and, in states in which such authorization is not required, approval by the insurance department is necessary for the completion of organization.

1.62 An insurance department generally consists of an insurance commissioner or superintendent in charge, one or more deputies, and staffs of examiners, attorneys, and clerical assistants. Many larger insurance departments also employ actuaries to review rate filings and to assist in the monitoring of financial solvency, principally relating to loss reserves. A commissioner usually is granted discretionary powers and can issue rules and regulations necessary to ensure compliance with state statutes.

National Association of Insurance Commissioners

1.63 To create greater uniformity both in the laws and their administration and to recommend desirable legislation in state legislatures, the state commissioners of insurance organized an association that is known today as the National Association of Insurance Commissioners. The work of the NAIC over the years has helped to eliminate many conflicts of state law and to promote more uniform and efficient regulation of insurance companies. The NAIC meets at least four times a year in general sessions. The organization has appointed committees to consider various proposals presented that cover all phases of the insurance business. The decisions of the NAIC are not binding on any of the commissioners, but state legislatures and insurance departments generally adopt, with some exceptions, NAIC "model statutes" or regulations. In order to provide guidance to the states regarding the minimum standards and an incentive to put them in place, the NAIC adopted an accreditation program. Under this plan, each state's insurance department will be reviewed by an independent review team whose job it is to assess that department's compliance with the NAIC Financial Regulation Standards. Departments meeting the NAIC Standards will be publicly acknowledged, while departments

not in compliance will be given guidance by the NAIC to bring the department into compliance. Furthermore, for exams covering years beginning in January 1994, accredited states will not accept reports of zone examinations from unaccredited states except under limited circumstances, providing further impetus for states to adopt the minimum standards. It is likely that states will pass similar provisions to act as incentives for state insurance departments to become accredited. For example, a state may decide not to license a company domiciled in a non-accredited state.

Federal Regulation—Securities and Exchange Commission

1.64 Because property and liability insurance companies are subject to state insurance department supervision and regulations, the Securities Exchange Act of 1934 contains certain provisions exempting stock property and liability insurance companies from registration with the Securities and Exchange Commission (SEC). However, a large number of companies have registered under the 1934 Act, either in connection with the listing of their shares on a national securities exchange or because they have formed holding companies that do not qualify for exemption under the 1934 Act. Property and liability insurance companies registered under the 1934 Act must comply with the SEC's periodic reporting requirement and are subject to the proxy solicitation and insider-trading rules. Insurance companies making public offerings are required to file under the Securities Act of 1933 and must thereafter comply with the annual and periodic reporting requirements of the 1934 Act. However, these companies are not under the proxy solicitation or insider-trading rules of the Act as long as they meet the attendant provisions for exemption. Insurance companies that are SEC registrants should follow Article 7 of SEC Regulation S-X, SEC Industry Guide 6, and applicable Staff Accounting Bulletins, which prescribe the form and content of financial statements.

Industry Associations

1.65 The property and liability insurance industry has many industry associations to help with the multitude of technical problems that arise in the course of business. These organizations also monitor regulatory developments and provide public relations for the industry. (See appendix G for a list.)

Chapter 2

Audit Considerations

Preliminary Audit Considerations

Overall Risk Factors

2.01 An initial step in any audit is to obtain knowledge of the entity's business and the industry in which it operates. Chapter 1 discusses the nature of the property and liability insurance business and many characteristics of operations in the industry. The Bibliography at the end of this guide provides sources for additional information on the industry. In planning an audit, the auditor should be aware of the various economic, financial, and organizational conditions that create business risks faced by companies in the industry. SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*, provides guidance on the independent auditor's responsibility for the detection of errors and irregularities in audits of financial statements in accordance with generally accepted auditing standards. This knowledge helps the auditor judge the audit risks that may be involved in the engagement. Although conditions will vary from company to company, the independent auditor may consider the conditions discussed in the Audit Risk Alert, *Insurance Industry Developments*, for the current year.

2.02 The profitability of an insurance company on a statutory basis is generally gauged by its combined ratio and its operating ratio. The combined ratio is the sum of its loss ratio (total incurred losses and loss adjustment expenses expressed as a percent of earned premiums), its expense ratio (total underwriting expenses incurred to written premiums), and its dividend ratio (policyholder dividends expressed as a percent of earned premiums). The operating ratio is the combined ratio less the ratio of investment income to earned premiums. Industry ratios from prior years are shown in the following table:

Industry Ratios*
(After Dividends)

Year	*Combined ratio*	*Operating ratio*
1980		
1981		
1982		
1983		
1984		
1985		
1986		
1987		
1988		
1989		
1990		
1991		
1992		

Table not reproduced in Web version

* Source: *Best's Aggregates and Averages*, 1993 Edition.

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2.03 The auditor should consider using the combined and operating ratios—both for the industry and for the insurance company whose financial statements are being audited—in evaluating the audit risk at the financial statement level. For example, these ratios may provide information about the company's profitability relative to the industry and about the economic conditions prevalent in the industry as a whole.

NAIC Insurance Regulatory Information System

2.04 Many insurance laws and regulations address insurance companies' financial solvency, and insurance departments consequently monitor reports, operating procedures, investment practices, and other activities of insurance companies. One of the main purposes of the monitoring system is to detect, at an early stage, companies that are insolvent or may become insolvent.

2.05 To assist state insurance departments in monitoring the financial condition of property and liability insurance companies, the NAIC Insurance Regulatory Information System (IRIS) was developed by a committee of state insurance department regulators. It is intended to assist state insurance departments in identifying insurance companies requiring close surveillance. The system is based on eleven tests for property and liability insurance companies. The tests are based on studies of financially troubled companies compared to financially sound companies. Usual ranges have been established under each of the tests for a property and liability company, but the ranges may be adjusted to reflect changing economic conditions. The results of the tests of all companies are compared, and those companies with three or more results outside of the usual range are given a priority classification indicating that a close review of the company should be undertaken. In addition, a regulatory team annually reviews the results and recommends regulatory attention if needed. One or more results outside the usual range does not necessarily indicate that a company is in unstable financial condition, but the company may need to explain the circumstances causing the unusual results. Annually, the NAIC publishes a booklet entitled *Using the NAIC Insurance Regulatory Information System*, which explains the IRIS ratios in detail. (Each of the individual ratios and the acceptable results is briefly described in appendix E.) IRIS test results may be useful in analytical procedures performed in the planning stage of an audit.

2.06 The NAIC has also established risk-based capital standards for the property and liability insurance industry. Risk-based capital provides an elastic means of setting the capital standards for insurance companies to support their overall business operations in light of their size and risk profile. A company's risk-based capital is calculated by applying factors to various asset, premium, and reserve items, where the factor is higher for those items with greater underlying risk and lower for less risky items. Risk-based capital standards will be used by regulators to set in motion appropriate regulatory actions relating to insurers which show signs of weak or deteriorating conditions. They also provide an additional standard for minimum, below which companies would be placed in conservatorship.

NAIC Profitability Reports

2.07 The annual statement and supplemental exhibits are the sources of data for the NAIC Profitability Reports. The Overall Profitability Report develops six rates of return: two on sales (earned premium), two on net worth, and two on assets. The Overall Profitability Report by Company was developed

by the NAIC in 1971. The stated purpose of the report is to establish uniform standards for measuring the profitability of property-liability insurance companies (individually and for companies collectively) on a basis that will facilitate comparisons with other businesses and industries. Certain assumptions are made, and the data reported in insurers' annual statements are adjusted by formulas adopted by the NAIC to estimate a "going-concern" basis. Annually, the NAIC publishes a booklet entitled *Using the NAIC Profitability Results*. This booklet explains in detail the rate-of-return calculations for the Overall Profitability Report by company. In addition to the NAIC, several states have developed their own systems of early-warning tests.

2.08 Other industry sources useful in the preliminary assessment of audit risks include annual and quarterly statements filed with regulatory authorities, regulatory examination reports, IRS examination reports, and communications with regulatory authorities.

Specific Audit Risk Factors

2.09 Experience has demonstrated that audit risk may be greater in certain operating areas than in others. The most significant transaction cycles of property and liability insurance companies are the premium cycle, the claims cycle, and the investment cycle. Risk factors specific to these cycles, as well as other audit risk factors, are described in appendix A to this guide. Although the summary of the risk potential in these operating areas is not all-inclusive, the summary does present major areas of recommended concentration in determining the nature and extent of audit procedures described in other chapters of this guide. The auditor's preliminary conclusions regarding the degree of audit risk may be modified by the results of audit work performed. The procedures described throughout this guide for each major operating cycle focus on the preceding overall risks as well as on other kinds of audit risks, and the auditor should refer to those chapters for additional guidance.

Internal Control Structure*

2.10 SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*, describes the elements of an internal control structure and explains how an independent auditor should consider the internal control structure in planning and performing an audit. An entity's internal control structure consists of three elements: control environment, accounting system, and control procedures.

2.11 To plan the audit, the independent auditor should obtain a sufficient understanding of each of the three elements by performing procedures to understand the design of policies and procedures relevant to audit planning and evaluate whether they have been placed in operation.

2.12 After obtaining an understanding of the elements of the internal control structure, the independent auditor assesses control risk for the assertions embodied in the account balance, transaction class, and disclosure components of the financial statements. The independent auditor uses the knowledge provided by the understanding of the internal control structure and

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* SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55*, revises the definition and description of internal control and makes conforming changes to relevant terminology. SAS No. 78 was issued in December 1995 and is effective for audits of financial statements for periods beginning on or after January 1, 1997. This Guide will be amended to conform to SAS No. 78 nearer to the pronouncement's effective date.

the assessed level of control risk in determining the nature, timing, and extent of substantive tests for financial statement assertions. Appendix A of the Audit Guide, *Consideration of Internal Control in a Financial Statement Audit*, describes the relationship of the auditor's consideration of internal control to other audit judgments and procedures.

Electronic Data Processing

2.13 Because of large volumes of premium transactions and the need to maintain accountability for individual policies, most property and liability insurance companies use electronic data processing (EDP) systems to maintain statistical and accounting records. Typically, policy and agent master files are maintained on computerized systems, and companies may use telecommunications, including direct access capability by agents and insureds, integrated premium and claims data bases, and processing systems that lack traditional audit trails. Some companies have made significant investments in computer hardware and software and require large staffs of programmers, systems analysts, and technicians to maintain day-to-day operations. Dependence on EDP systems and controls may affect control risk, particularly for larger multiple-line insurance companies.

2.14 The methods an entity uses to process significant accounting applications may influence its control procedures. The auditor's assessment of control risk should encompass the EDP aspects of accounting systems. Insurance companies have been leading users of advanced EDP methods. Consequently, the control issues involving EDP have received considerable attention within the industry. The auditor should consider performing tests of controls over the general EDP controls relevant to major classes of transactions within those cycles. Such general controls may include—

- *Organization and operations controls.*
  - EDP department and user department functions should be segregated.
  - Guidelines for the general authorization of executing transactions should be provided. For example, the EDP department should be prohibited from initiating or authorizing transactions.
  - Functions within the EDP department should be segregated.
- *Systems development and documentation controls.*
  - The procedures for system design, including the acquisition of software packages, should require active participation by representatives of the users and, as appropriate, the accounting department and internal auditors.
  - Each system should have written specifications that are reviewed and approved by an appropriate level of management and applicable user departments.
  - System testing should be a joint effort of users and EDP personnel and should include both the manual and computerized phases of the system.
  - Final approval should be obtained prior to placing a new system into operation.
  - All master file and transaction file conversion should be controlled to prevent unauthorized changes and to provide accurate and complete results.
  - After a new system has been placed in operation, all program changes should be approved before implementation to determine whether they have been authorized, tested, and documented.

  - Management should require documentation and establish formal procedures to define the system at appropriate levels of detail.
- *Hardware and systems software controls.*
  - The control features inherent in the computer hardware, operating system, and other supporting software should be used to the maximum possible extent to provide control over operations and to detect and report hardware malfunctions.
  - Systems software should be subjected to the same control procedures as those applied to installation of and changes to application programs.
- *Access controls.*
  - Access to program documentation should be limited to those persons who require it in the performance of their duties.
  - Access to data files and programs should be limited to those individuals authorized to process or maintain particular systems.
  - Access to computer hardware should be limited to authorized individuals.
- *Data and procedural controls.*
  - A control function should be responsible for receiving all data to be processed, for ensuring that all data are recorded, for following up on errors detected during processing to ensure that the transactions are corrected and resubmitted by the proper party, and for verifying the proper distribution of output.
  - A written manual of systems and procedures should be prepared for all computer operations and should provide for management's general or specific authorization to process transactions.
  - Internal auditors or some other independent group within an organization should review and evaluate proposed systems at critical stages of development.
  - On a continuing basis, internal auditors or some other independent group within an organization should review and test computer processing activities.

2.15 The sophistication of insurance EDP systems is often an element of competition regarding a company's ability to service accounts. The EDP operations are characterized by one or several large installations, extensive use of telecommunications equipment, including some direct-access capability by independent agents and insureds, large premium and claims data bases, some of which are integrated, and operating systems and applications that lack visible audit trails.

Consideration of the Work of Internal Auditors

2.16 In audits of property and liability insurance companies, auditors may consider using the work of internal auditors in the following areas:

- Testing EDP general and application controls
- Testing premiums and claims processing
- Testing the integrity of the data bases underlying the loss-reserving systems

If the independent auditor will be considering or using the work of, or receiving direct assistance from, the entity's internal auditors, he or she should follow the provisions of SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements.*

Auditor's Consideration of State Regulatory Examinations

2.17 SAS No. 57, *Auditing Accounting Estimates*, states that the auditor should consider evaluating "information contained in regulatory or examination reports, supervisory correspondence, and similar materials from applicable regulatory agencies." SAS No. 54, *Illegal Acts by Clients*, notes that "the auditor may encounter specific information that may raise a question concerning possible illegal acts, such as . . . violations of laws or regulations cited in reports of examinations by regulatory agencies that have been available to the auditor." Accordingly, it is appropriate that the auditor review examination reports and related communications between regulators and the insurance enterprises to obtain competent evidential matter.

2.18 The auditor should review reports of examinations and communications between regulators and the insurance enterprise and make inquiries of the regulators. The auditor should—

- Request that management provide access to all reports of examinations and related correspondence including correspondence relating to financial conditions.
- Read reports of examinations and related correspondence between regulators and the insurance enterprise during the period under audit through the date of the auditor's report.
- Inquire of management and communicate with the regulators, with the prior approval of the insurance enterprise, when the regulators' examination of the enterprise is in process or a report on an examination has not been received by the insurance enterprise regarding conclusions reached during the examination.

2.19 A refusal by management to allow the auditor to review communications from, or to communicate with, the regulator would ordinarily be a limitation on the scope of the audit sufficient to preclude an unqualified opinion. (See SAS No. 58, *Reports on Audited Financial Statements.*) A refusal by the regulator to communicate with the auditor may be a limitation on the scope of the audit sufficient to preclude an unqualified opinion, depending on the auditor's assessment of other relevant facts and circumstances.

Auditor's Consideration of Permitted Statutory Accounting Practices

2.20 Prescribed statutory accounting practices currently include state laws, regulations, and general administrative rules applicable to all insurance enterprises domiciled in a particular state; the NAIC Annual Statement Instructions; the NAIC *Accounting Practices and Procedures Manuals*; the *Securities Valuation Manual* (published by the NAIC Securities Valuation Office); NAIC official proceedings; and the NAIC *Examiners' Handbook.*

2.21 Permitted accounting practices include practices not prescribed in paragraph 2.20 but allowed by the domiciliary state insurance department. Insurance enterprises may request permission from the domiciliary state insurance department to use a specific accounting practice in the preparation of their statutory financial statements (*a*) when the enterprise wishes to depart from the prescribed statutory accounting practices, or (*b*) when prescribed statutory accounting practices do not address the accounting for the transaction(s). Accordingly, permitted accounting practices differ from state to state, may differ from company to company within a state, and may change in the future.

2.22 Auditors should exercise care in concluding that an accounting treatment is *permitted*, and should consider the adequacy of disclosures in the financial statements regarding such matters.* For each examination, auditors should obtain sufficient competent evidential matter to corroborate management's assertion that permitted statutory accounting practices that are material to an insurance enterprise's financial statements are permitted by the domiciliary state insurance department.

2.23 Sufficient competent evidential matter consists of any one or combination of—

- Written acknowledgment sent directly from the regulator to the auditor. (This type of corroboration includes letters similar to attorneys' letters and responses to confirmations.)
- Written acknowledgment prepared by the regulator, but not sent directly to the auditor, such as a letter to the client.
- Direct oral communications between the regulator and the auditor, supported by written memorandum. (If the auditor, rather than the regulator, prepares the memorandum, the auditor should send such memorandum to the regulator to make sure it accurately reflects the communication.)

Auditors should use judgment to determine the type of corroboration that is necessary in the circumstances.

2.24 If the auditor is unable to obtain sufficient competent evidential matter to corroborate management's assertion regarding a permitted statutory accounting practice that is material to the financial statements, the auditor should qualify or disclaim an opinion on the statutory financial statements because of the limitation on the scope of the audit. (See SAS No. 58, paragraphs 40-44.)

The Auditor's Consideration of Regulatory Risk-Based Capital for Property and Liability Insurance Enterprises[1]

Introduction and Scope

2.25 Property and liability insurance enterprises operate in a highly regulated environment. The regulation of property and liability insurance en-

* SOP 94-5, *Disclosures of Certain Matters in the Financial Statements of Insurance Enterprises*, requires insurance enterprises to disclose information about permitted statutory accounting practices in their financial statements prepared in conformity with generally accepted accounting principles.

[1] SOP 93-8, *The Auditor's Consideration of Regulatory Risk-Based Capital for Life Insurance Enterprises*, has been conformed to apply to property and liability insurance enterprises.

terprises is directed primarily toward safeguarding policyholders' interests and maintaining public confidence in the safety and soundness of the property and liability insurance system. One of the primary tools used by state insurance departments for ensuring that those objectives are being achieved is risk-based capital (RBC).

2.26 This section of the Guide addresses the auditors' responsibility that arises from the RBC requirements imposed on property and liability insurance enterprises. These RBC requirements affect audits of property and liability insurance enterprises in the following three primary areas:

a. Audit planning

b. Going-concern considerations

c. Other reporting considerations

Overview of Risk-Based Capital

2.27 Regulation of property and liability insurance enterprises has historically focused on their capital. NAIC requires property and liability insurance enterprises to disclose RBC in their statutory filings. The RBC calculation serves as a benchmark for the regulation of property and liability insurance enterprises' solvency by state insurance regulators. RBC requirements set forth dynamic surplus formulas similar to target surplus formulas used by commercial rating agencies. The formulas specify various weighting factors that are applied to financial balances or various levels of activity based on the perceived degree of risk. Such formulas focus on four general types of risk:

a. The risk related to the insurer's assets (asset risk)[2]

b. The credit risk related to the collectibility of insurance recoverables and miscellaneous receivables (credit risk)

c. The risk of adverse insurance experience with respect to the insurer's liabilities and obligations including excessive premium growth (underwriting risk)

d. All other business risks (management, regulatory action, and contingencies)

The amount determined under such formulas is called the authorized control level RBC (ACLC).

2.28 RBC requirements establish a framework for linking various levels of regulatory corrective action to the relationship of a property and liability insurance enterprise's total adjusted capital (TAC) (equal to the sum of statutory capital and surplus and such other items, if any, as the NAIC's RBC instructions[3] may provide) to the calculated ACLC. The levels of regulatory action, the trigger point, and the corrective actions are summarized as follows:

Risk-Based Capital Levels and Corrective Actions

Level	*Trigger*	*Corrective Action*
Company Action Level RBC (CALC)	TAC is less than or equal to 2 x ACLC, or TAC is less than or equal to 2.5 x ACLC with negative trend	The property and liability insurance enterprise must submit a comprehensive plan to the insurance commissioner.

[2] This risk also includes risk of default.

[3] The NAIC's RBC instructions may be amended by the NAIC from time to time in accordance with procedures adopted by the NAIC.

Level	*Trigger*	*Corrective Action*
Regulatory Action Level RBC (RALC)	TAC is less than or equal to 1.5 x ACLC, or unsatisfactory RBC Plan	In addition to the action above, the insurance commissioner is required to perform an examination or analysis deemed necessary and issue a *corrective order* specifying corrective actions required.
Authorized Control Level RBC (ACLC)	TAC is less than or equal to 1 x ACLC	In addition to the actions described above, the insurance commissioner is permitted but not required to place the life insurance enterprise under regulatory control.
Mandatory Control Level RBC (MCLC)	TAC is less than or equal to .7 x ACLC	The insurance commissioner is required to place the property and liability insurance enterprise under regulatory control.

2.29 Under the RBC requirements, the comprehensive financial plan should—

a. Identify the conditions in the insurer that contribute to the failure to meet the capital requirements.

b. Contain proposals of corrective actions that the insurer intends to take and that would be expected to result in compliance with capital requirements.

c. Provide projections of the insurer's financial results in the current year and at least the four succeeding years, both in the absence of proposed corrective actions and giving effect to the proposed corrective actions.

d. Identify the key assumptions impacting the insurer's projections and the sensitivity of the projections to the assumptions.

e. Identify the quality of, and problems associated with the insurer's business, including but not limited to its assets, anticipated business growth and associated surplus strain, extraordinary exposure to risk, mix of business, and use of reinsurance in each case, if any.

Audit Planning

2.30 The objective of an audit of a property and liability insurance enterprise's financial statements is to express an opinion on whether they present

fairly, in all material respects, the enterprise's financial position, results of operations, and cash flows in conformity with GAAP. To accomplish that objective, the auditor assesses the risk that the financial statements contain material misstatements and plans and performs audit procedures to provide reasonable assurance that the financial statements are free of material misstatements. Because of the importance of RBC to property and liability insurance enterprises, RBC should be considered in assessing risk and planning the audit. The auditor should ordinarily obtain and review the client's RBC reports and should understand the RBC requirements for preparing such reports and the actual regulations associated with RBC.

Going-Concern Considerations

2.31 SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, requires auditors to evaluate, as part of every audit, whether there is substantial doubt about the ability of the entity to continue as a going concern for a reasonable period of time, not to exceed one year beyond the financial statement date. A significant consideration in the auditor's evaluation of a property and liability insurance enterprise's ability to continue as a going concern is whether the enterprise complies with regulatory RBC requirements.[4]

2.32 In view of the serious ramifications of noncompliance with regulatory RBC requirements for property and liability insurance enterprises (see paragraph 2.28), such failure is a condition that indicates that there could be substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. Accordingly, the auditor should obtain information about management's plans that are intended to mitigate the adverse effects of the noncompliance with regulatory RBC capital requirements or events that gave rise to the condition and assess the likelihood that such plans can be implemented. In evaluating management's plans, the auditor should consider—

a. The property and liability insurance enterprise's existing regulatory capital position.

b. Whether a comprehensive financial plan has been filed and, if so, whether it has been accepted by the regulators.

2.33 The auditor should consider the amount of any RBC capital deficiency. In general, the lower the ratio of total adjusted capital to authorized control level RBC, the greater the doubt about the enterprise's ability to continue as a going concern for a reasonable period. The auditor should, however, also assess the likelihood that the property and liability insurance enterprise's regulatory capital position will improve or deteriorate in the next twelve months.

2.34 The auditor should also consider the nature or source (asset quality, underwriting, collectibility, or other) of the deficiency. Curing deficiencies from certain sources may be more within the control of the management of the property and liability insurance enterprise than curing deficiencies from other sources.

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[4] Auditors should evaluate a property and liability insurance enterprise's ability to continue as a going concern even if the enterprise meets the minimum RBC standards. There are other conditions and events that may indicate that there could be substantial doubt about a property and liability insurance enterprise's ability to continue as a going concern, such as recurring operating losses, indications of strained liquidity, concerns expressed by regulators, and indications of strained relationships with regulators. However, this SOP discusses only failure to meet RBC standards.

2.35 Furthermore, the auditor should ascertain whether a comprehensive financial plan has been filed and accepted by the commissioner. If the commissioner has accepted the comprehensive financial plan, the auditor should identify those elements of the comprehensive financial plan that are particularly significant to overcoming the adverse effects of the failure to comply with regulatory RBC requirements and should identify and perform auditing procedures to obtain evidential matter about the significant elements. For example, the auditor should consider the adequacy of support regarding an enterprise's ability to obtain additional capital or a planned disposal of assets. When prospective financial information is particularly significant to management's plans, the auditor should request that management provide the information and should consider the adequacy of support for significant assumptions that underlie it. Further, the auditor should identify those elements of the comprehensive financial plan and conditions placed on the property and liability insurance enterprise by the commissioner that are most difficult to achieve and consider the likelihood that the property and liability insurance enterprise will not be able to implement the elements successfully.

2.36 If the commissioner has rejected the comprehensive financial plan, the auditor should consider the commissioner's reasons for rejecting it, any revisions proposed by the commissioner to render the comprehensive financial plan satisfactory, management's intentions for revising the comprehensive financial plan, and possible regulatory sanctions. If the commissioner has not yet notified the insurer whether the comprehensive financial plan has been accepted,[5] the auditor should review related communication between the commissioner and the property and liability insurance enterprise and make inquiries of both management and regulatory officials to determine the current status of the comprehensive financial plan. If the property and liability insurance enterprise has not filed a financial plan with the commissioner,[6] the auditor should make inquiries of management officials about their comprehensive financial plan and their plans for filing.

2.37 After the auditor has evaluated management's plans, the auditor should conclude whether substantial doubt about the property and liability insurance enterprise's ability to continue as a going concern for a reasonable period of time remains or is alleviated. This is often a complex judgment requiring considerable professional experience.

Substantial Doubt Remains

2.38 If the auditor concludes that substantial doubt about the property and liability insurance enterprise's ability to continue as a going concern for a reasonable period of time remains, the auditor should (*a*) consider the possible effects on the financial statements and the adequacy of the related disclosures[7] and (*b*) modify his or her report.

Independent Auditor's Reports

2.39 The auditor's report should either (*a*) include an explanatory paragraph (following the opinion paragraph) to reflect the auditor's conclusion about

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[5] The RBC Requirements require the commissioner to notify the insurer whether the comprehensive financial plan is accepted or is unsatisfactory within sixty days of submission of the plan.

[6] The RBC Requirements require that a comprehensive financial plan be filed with the commissioner within forty-five days of the failure to meet RBC standards.

[7] Auditors of publicly held property and liability insurance enterprises should consider SEC Financial Reporting Release No. 16, *Rescission of Interpretation Relating to Certification of Financial Statements*, which states, "...filings containing accountants' reports that are qualified as a result of questions about the entity's continued existence must contain appropriate and prominent disclosure of the registrant's financial difficulties and viable plans to overcome these difficulties."

the existence of substantial doubt that the entity can continue as a going concern for a reasonable period of time (see paragraph 2.41) or (*b*) disclaim an opinion (see paragraph 2.42).

2.40 The illustrative auditors' reports in this SOP are presented to assist auditors in drafting their reports under various RBC circumstances. Each illustration intentionally describes the same general fact situation to avoid suggesting that particular facts always lead to a particular form of opinion. The appropriate form of opinion depends on the auditor's judgment as to the severity and most probable outcome of the matter described.

2.41 The following is an illustration of an auditor's report (unqualified opinion) on the financial statements of a property and liability insurance enterprise with an explanatory paragraph added because of the existence of substantial doubt about the enterprise's ability to continue as a going concern.

Independent Auditor's Report[8]

To the Board of Directors and Shareholders
ABC Property and Liability Company

We have audited the accompanying balance sheets of ABC Property and Liability Company as of December 31, 19X2 and 19X1, and the related statements of income, changes in stockholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of ABC Property and Liability Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

The accompanying financial statements have been prepared assuming that ABC Property and Liability Company will continue as a going concern. As discussed in Note XX to the financial statements, [*State of Domicile's Insurance Regulatory Body*] imposes risk-based capital requirements on property and liability insurance enterprises, including the Company. At December 31, 19X2, the Company's total adjusted capital is at the company action level based on the risk-based capital calculation required by [*State of Domicile's Insurance Regulatory Body*]. The Company has filed a comprehensive financial plan with the commissioner outlining the Company's plans for attaining the required levels of regulatory capital by December 31, 19XX. To date, the Company has

[8] The circumstances described in the fourth paragraph of this illustrative report represent assumptions made for purposes of illustration only. They are not intended to provide criteria or other guidelines to be used by independent auditors in deciding whether an explanatory paragraph should be added to their reports.

not received notification from the commissioner regarding acceptance or rejection of its comprehensive financial plan. Failure to meet the capital requirements and interim capital targets included in the Company's plan would expose the Company to regulatory sanctions that may include restrictions on operations and growth, mandatory asset dispositions, and placing the Company under regulatory control. These matters raise substantial doubt about the ability of ABC Property and Liability Company to continue as a going concern. The ability of the Company to continue as a going concern is dependent on many factors, one of which is regulatory action, including ultimate acceptance of the Company's comprehensive financial plan. Management's plans in regard to these matters are described in Note XX. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

[*Signature*]

[*Date*]

2.42 SAS No. 59 states that inclusion of an explanatory paragraph (following the opinion paragraph) in the auditor's report as described above serves adequately to inform users of the financial statements of the auditor's substantial doubt. Nonetheless, SAS No. 59 does not preclude the auditor from declining to express an opinion in cases involving uncertainties. If the auditor disclaims an opinion, the uncertainties and their possible effects should be disclosed in an appropriate manner and the auditor's report should state all of the substantive reasons for the disclaimer of opinion. The following is an illustration of an auditor's report containing a disclaimer of opinion as the result of uncertainties relating to an auditor's substantial doubt about a property and liability insurance enterprise's ability to continue as a going concern for a reasonable period of time.

Independent Auditor's Report[9]

To the Board of Directors and Shareholders
XYZ Property and Liability Company

We have audited the accompanying balance sheets of XYZ Property and Liability Company as of December 31, 19X2 and 19X1, and the related statements of income, changes in stockholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to report on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our report.

The accompanying financial statements have been prepared assuming that XYZ Property and Liability Company will continue as a going concern. As discussed in Note XX to the financial statements, [*State of Domicile's Insurance Regulatory Body*] imposes risk-based capital requirements on property and lia-

[9] The circumstances described in the third paragraph of this illustrative report represent assumptions made for purposes of illustration only. They are not intended to provide criteria or other guidelines to be used by independent auditors in deciding whether to disclaim an opinion on financial statements.

bility insurance enterprises, including the Company. At December 31, 19X2, the Company's total adjusted capital is at the company action level based on the risk-based capital calculation required by [*State of Domicile's Insurance Regulatory Body*]. The Company has filed a comprehensive financial plan with the commissioner outlining its plans for attaining the required levels of regulatory capital by December 31, 19XX. To date, the Company has not received notification from the commissioner regarding acceptance or rejection of its comprehensive financial plan. Failure to meet the capital requirements and interim capital targets included in the Company's plan would expose the Company to regulatory sanctions that may include restrictions on operations and growth, mandatory asset dispositions, and placing the Company under regulatory control. These matters raise substantial doubt about the ability of XYZ Property and Liability Company to continue as a going concern. The ability of the Company to continue as a going concern is dependent on many factors, one of which is regulatory action, including ultimate acceptance of the Company's comprehensive financial plan. Management's plans in regard to these matters are described in Note XX. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

Because of the significance of the uncertainty discussed above, we are unable to express, and we do not express, an opinion on the financial statements for the year ended December 31, 19X2.

In our opinion, the 19X1 financial statements referred to above present fairly, in all material respects, the financial position of XYZ Property and Liability Company as of December 31, 19X1, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

Substantial Doubt Alleviated

2.43 If the auditor concludes that substantial doubt about the property and liability insurance enterprise's ability to continue as a going concern for a reasonable period of time is alleviated, the auditor should consider the adequacy of disclosure in the financial statements of the principal conditions or events that initially raised the substantial doubt. The auditor should follow the guidance in SAS No. 59, paragraphs 10 and 11. Furthermore, the auditor may wish to add an emphasis of matter paragraph to the auditor's report (see paragraphs 2.47 and 2.48, below).

Other Reporting Considerations

Uncertainties

2.44 A matter involving an uncertainty is one that is expected to be resolved at a future date, at which time conclusive evidential matter concerning its outcome would be expected to become available. Uncertainties include, but are not limited to, contingencies covered by FASB Statement No. 5, *Accounting for Contingencies,* and matters related to estimates covered by SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties.*

2.45 Conclusive evidential matter concerning the ultimate outcome of uncertainties cannot be expected to exist at the time of the audit because the outcome and related evidential matter are prospective. In these circumstances, management is responsible for estimating the effect of future events on the fi-

nancial statements, or determining that a reasonable estimate cannot be made and making the required disclosures, all in accordance with generally accepted accounting principles, based on management's analysis of existing conditions. An audit includes an assessment of whether the evidential matter is sufficient to support management's analysis. Absence of the existence of information related to the outcome of an uncertainty does not necessarily lead to a conclusion that the evidential matter supporting management's assertion is not sufficient. Rather, the auditor's judgment regarding the sufficiency of the evidential matter is based on the evidential matter that is, or should be, available. If, after considering the existing conditions and available evidence, the auditor concludes that sufficient evidential matter supports management's assertions about the nature of a matter involving an uncertainty and its presentation or disclosure in the financial statements, an unqualified opinion ordinarily is appropriate.

2.46 If the auditor is unable to obtain sufficient evidential matter to support management's assertions about the nature of a matter involving an uncertainty and its presentation or disclosure in the financial statements, the auditor should consider the need to express a qualified opinion or to disclaim an opinion because of a scope limitation is appropriate if sufficient evidential matter related to an uncertainty does or did exist but was not available to the auditor for reasons such as management's record retention policies or a restriction imposed by management.

Emphasis of a Matter

2.47 In some circumstances, the auditor may wish to emphasize a matter regarding the financial statements, but nevertheless intends to express an unqualified opinion. An example of such a circumstance is the failure to comply with regulatory RBC requirements. Prior to considering whether an emphasis of a matter paragraph should be added to the auditor's report for a failure to comply with regulatory RBC requirements, however, the auditor should have concluded that the matter being emphasized does not create substantial doubt about the property and liability insurance enterprise's ability to continue as a going concern (see paragraphs 2.31 through 2.43, above) and does not reflect a material uncertainty (see paragraphs 2.44 through 2.46, above).

2.48 Emphasis of a matter should be presented in a separate paragraph of the auditor's report. Phrases such as "with the foregoing explanation" should not be used in the opinion paragraph in situations of this type. The following is an illustration of an unqualified opinion with an emphasis of a matter paragraph regarding the possible effects of a property and liability insurance enterprise's failure to comply with regulatory RBC requirements on its financial statements.

Independent Auditor's Report[10]

To the Board of Directors and Shareholders
DEF Property and Liability Company

We have audited the accompanying balance sheets of DEF Property and Liability Company as of December 31, 19X2 and 19X1, and the related statements of income, changes in stockholders' equity, and cash flows for the years

[10] The circumstances described in the third paragraph of this illustrative report represent assumptions made for purposes of illustration only. They are not intended to provide criteria or other guidelines to be used by independent auditors in deciding whether an emphasis paragraph should be added to their reports.

then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note XX to the financial statements, [*State of Domicile's Insurance Regulatory Body*] imposes risk-based capital requirements on property and liability insurance enterprises, including the Company. At December 31, 19X2, the Company's total adjusted capital is at the company action level based on the risk-based capital calculation required by [*State of Domicile's Insurance Regulatory Body*].

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of DEF Property and Liability Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

Chapter 3

The Premium Cycle

3.01 Insurance companies record premiums in premiums written accounts. As policy periods expire, the premiums written are earned and are recognized as revenue. The pro rata portion of premiums written allocable to unexpired policy periods represents unearned premiums, which are reflected as a liability in the balance sheet. Premiums written are also used as a basis for paying commissions to agents, calculating premium taxes, and guaranty fund assessments. The following are definitions of several kinds of written premiums.

Direct premiums. Premium income less return premiums arising from policies issued by the company collecting the premiums and acting as the primary insurance carrier.

Assumed reinsurance premiums. Premium income less return premiums arising from policies issued or other contracts entered into to reinsure other insurance companies that provide the related primary coverage.

Ceded reinsurance premiums. Outgoing premiums less return premiums arising from reinsurance purchased from other insurance companies.

Return premiums. Premium refunds due to insureds, arising from endorsements (changes in coverage, term, and so on), cancellations, or audits.

Rating

3.02 Rates used by an insurance company are based on the company's experience by line of insurance or the industry loss experience compiled by advisory rating organizations, which are subject to supervision and regulation by state insurance departments. The principal rating organizations are the National Council on Compensation Insurance (NCCI) for workers' compensation insurance, the Surety Association of America for fidelity and surety insurance, and the Insurance Services Office (ISO) for all other property and liability lines of insurance.

3.03 States have established mechanisms to provide insurance to those with high risks who would otherwise be excluded from obtaining coverage. For property in high-risk areas, FAIR plans, which are federally approved and state supervised, provide insurance to owners. Companies that operate in a state are assessed for any underwriting loss experienced by the FAIR plan in the state.

3.04 As discussed in chapter 1, states have several methods of apportioning involuntary automobile insurance. These methods include automobile insurance plans, joint underwriting associations, and reinsurance pools or associations.

The Transaction Cycle

3.05 The premium cycle normally includes the following functions, which generate most premium-related transactions:

- Evaluating and accepting risks
- Issuing policies
- Billing and collecting premiums
- Paying commissions and other costs of acquiring business

- Adjusting premiums
- Home office and branch office recordkeeping

Evaluating and Accepting Risks

3.06 The evaluation and risk-accepting function has three general objectives: to evaluate the acceptability of the risk, to determine the premium, and to evaluate the company's capacity to retain the entire risk.

3.07 To initiate new business, an agent or broker submits to the company an application for a policy, often with a deposit from the customer for a portion of the estimated premium. Pending issuance of the policy, the agent or broker provides the insured with a binder, which is a temporary contract that may be oral or written. The period covered by the binder is usually short, often limited to thirty days or less. A written binder is evidence of an understanding by both parties of what the insurance covers, the amount of insurance, the premium charged, and the company writing the insurance. The cash is recorded in a clearing (suspense) account and deposited, and the application is forwarded to the company's underwriting department for evaluation. The risks are evaluated in accordance with company procedures; these may include a review of exposure and potential loss based on the applications, changes, or endorsements to existing policies submitted by the agent or broker. For example, applications for automobile insurance may be checked by requesting motor vehicle reports issued by a state department of motor vehicles. Applications for certain property coverages may require engineering surveys or fire hazard surveys. (Refer to appendix A for a summary of audit risk factors.)

3.08 If an application is denied, the deposit premium is returned to the applicant with an explanation. When the refund is sent, the suspense account is cleared.

3.09 If the underwriter determines that the applicant falls within the company's underwriting guidelines and is an acceptable risk, an underwriting report is prepared, and the risk is coded so that the company can prepare reports concerning premiums, such as—

- Premiums by state, by line of business, and by underwriting year, which are required to be included in the company's annual statement.
- Premiums written by territory and by class of risk, required by the company or rating bureaus to aid in ratemaking.
- Premiums by producer, required to prepare agents' production reports and to compute any contingent commissions due at the end of a year.

Proper coding of premiums is important for the above reports and because it affects areas such as loss ratios by line of business, future underwriting and pricing, treaty reinsurance, premium tax assessments, and contingent commission arrangements.

3.10 Accounting entries are made for accepted applications by crediting premiums written, clearing the premium cash-suspense account for the deposits, and recording the balances due as premiums receivable. The combination of the rating codes entered on the underwriting report becomes the basis for the premium rates charged. A portion of the premiums is deferred because the billed premiums are for coverage to be provided by the insurance company over the term of the policy. At the end of each reporting period, unearned premiums are calculated, and the change in unearned premiums is recorded as a charge or credit to premium income.

3.11 Premiums are generally established by one of three methods: class or manual rating, individual or judgment rating, or merit rating, which are defined as follows:

- *Class or manual rating* is used primarily to establish rates for various coverages for individuals, families, and small businesses. Based on statistical data, these large groups of similar risks can be classified by a few important and easily identifiable characteristics. These classifications result in standard rates.
- *Individual or judgment rating* is used when the rates for large or unusual risks are established almost entirely by the skill and experience of the rate maker, such as ocean marine risks.
- *Merit rating* is generally used for larger risks of commercial lines and is divided into three types. *Schedule rating* starts with an assumed standard, frequently the manual rate, and adjusts such standard rate according to an evaluation of greater or lesser exposure to risk. Schedule rating is often used in fire insurance or commercial properties. *Experience rating* departs from manual rates based on the insureds' past experiences under the coverage. Premiums are adjusted prospectively based on average past experience. Experience rating is widely used in workers' compensation insurance. *Retrospective experience rating* differs from experience rating in that it adjusts the premium during the period of coverage based on actual experience during that same period. Policies that are retrospectively rated often specify minimum and maximum premiums and, in effect, may leave some risks uninsured. (Paragraph 3.22 discusses retrospective premium adjustments.)

3.12 A renewal of a policy is a new contract but, unless otherwise stated, the terms are those of the original policy. The risk insured under the original policy expires when the policy expires, and each renewal must be considered as an application for a new risk. When a policy is renewed, the premium is determined in the same manner as for a new business.

3.13 Finally, after a risk has been accepted and the premium has been calculated, a determination must be made as to whether the entire risk should be retained or whether all or part of it should be reinsured. Reinsurance is discussed in detail in chapter 6.

Issuing Policies

3.14 Applications and endorsements that have been accepted are submitted, along with an underwriting report, to a coding unit for verification of items on the underwriting report. Verified applications are then coded for data entry into the statistical system. Coded applications are batched, and input control totals are established before delivery to data entry. Alternatively, many companies have the capability to submit applications on-line. After coded applications and endorsements have been entered into the system, batch control totals generated by the computer are compared to the input control totals. Processing the information generates a premium register and documents known as *declaration sets*, which include the billing statement and insurance I.D. card, as well as information such as terms of the policy, lines of coverage, premiums, and agent information. The policy, including any endorsements, is prepared, assigned a sequential policy number, and sent directly to the insured or to the agent or broker for distribution.

Billing and Collecting Premiums

3.15 The two basic methods for billing premiums are agency billing and direct billing. Some companies use only one of these methods; others use both. Under direct billing, the company bills insureds directly for premiums due and, on collection, remits commissions to the agents. The following are several variations of agency billing, also called *account current*:

- *Account current "item basis."* For individual policies, the agent collects the premiums directly from the insureds, subtracts his or her commissions, and remits the net premiums due the company. If the agent cannot collect a premium during the credit period allowed by the company, he or she may request cancellation of the policy.
- *Account current "rendering basis."* The agent submits to the insurance company a statement of all the policies issued or due during the current month, and the net amount of the statement is subsequently to be paid in accordance with the agency agreement. The statement, which includes all known current activity, such as endorsements, cancellations, or audits, is compared to the company's accounts receivable and adjusted as necessary.
- *Account current "billing basis."* The company sends the agent a statement that contains a listing of all the policies written or due, minus the policies canceled during the month. The net amount of the statement is to be paid in accordance with the agency agreements.

3.16 The credit terms to agents are usually outlined in the agency agreement. The agent's account current is usually payable within a specified period after the last day of the month of the account.

3.17 Uncollected premiums from an agent represent premiums due the company from the agent based on his or her contract with the company to write insurance, to collect the necessary premiums, and to remit the collected premiums net of commissions. Uncollected premiums from an agent are generally reflected as "Agents' Balances" or "Uncollected Premiums," which are netted against the commissions payable on the uncollected premiums. Companies should also consider FASB Technical Bulletin No. 88-2, *Definition of a Right of Setoff*, concerning the netting of agents' balances. FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts*, supersedes FASB Technical Bulletin No. 88-2 and is effective for financial statements issued for periods beginning after December 15, 1993. Interpretation No. 39 defines *right of setoff* and specifies what conditions must be met to have that right. The guidance in Technical Bulletin No. 88-2 is incorporated substantially unchanged in paragraphs 5 through 7 of Interpretation No. 39.

3.18 Uncollected premiums from policyholders represent premiums due the company that may have been directly solicited from policyholders either by an agent or by the company. The company sends bills directly to the policyholders, and the policyholders remit the premiums directly to the company. Customers typically have the option of remitting premiums on an installment basis. Policies and billing, therefore, may be on a monthly, quarterly, or annual cycle. If an agent had solicited the business, the company, after receiving payments from the policyholders, either sends the agent a check or otherwise credits the agent's account for his or her commission. Under direct billing, the entire amount of uncollected premiums is generally recorded as "Agents' Balances or Uncollected Premiums," and the commissions on the uncollected premiums are not netted but are recorded as a liability.

3.19 The premium collection department is responsible for accounting for customer remittance advices and the agent's account current. Adequate control over these documents and the related cash must be maintained to ensure that all payments received are processed. Customer and agent remittances should be batched and input control totals established before data entry. These input control totals should be compared to output control totals generated in the EDP department. As a result of processing, the agency cash-receipts register, difference ledger, and agent's aged trial balance are generated. The related files are then updated.

3.20 The agency cash-receipts register is reconciled with the cash-receipts record. The premium register includes information by line of business, such as current premiums, commissions, year-to-date premiums, current expired, premiums in force, and earned and unearned premiums. The difference ledger results from a comparison of accounts current submitted by the agent with transactions recorded on the company's records. Old outstanding differences and large discrepancies are reviewed and investigated. Differences may occur because the agent and the company use different cutoff dates or because of errors or omissions by the agent or the company. An agent's aged trial balance includes information such as the current month's premiums, net premiums, prior balance, cash received, net balance, installment fees, and balance due. The total premium column equals total written premiums shown on the premium register. In addition, the agent's trial balance is reviewed to determine any uncollectible accounts.

Paying Commissions and Other Costs of Acquiring Business

3.21 Agents, both independent and exclusive, and brokers are compensated for their services by commissions. Some commissions are paid on the basis of a standard percentage of premiums or on an agreed scale, known as level commissions. Retroactive commissions are used in areas such as workers' compensation, in which the final premium may be experience rated and the commissions would therefore require adjustment. Contingent commissions result from agreements with agents and brokers whereby the amounts of commissions are contingent on favorable loss experience of the business placed with the company. Establishing accounting provisions for contingent commissions is difficult because they are based on estimates of the ultimate loss experience, and in many cases the commission period does not coincide with the company's fiscal year. FASB Statement No. 60, paragraph 44, discusses accounting for contingent commission arrangements.

Adjusting Premiums

3.22 Adjustments to premiums written and to unearned premiums can result from—

- *Cancellation*, a complete termination of an existing policy before expiration. Cancellation results in a return premium to the insured.
- *Endorsements*, changes in existing policies that may result in additional premiums or return premiums, such as increases or decreases in coverage limits, additions or deletions of property or risks covered, or changes in location or status of insureds.
- *Audit premiums*, premiums determined from data developed by periodic audits of insureds' records or from periodic reports submitted by insureds. An audit may result in an additional premium or a return

premium. An example of a policy subject to audit premiums is a workers' compensation policy for which the premium is based on the payroll of the employer.

- *Retrospective premium adjustments*, modifications of the premiums after expiration of the policies. An adjustment is based on the experience of an individual risk during the term of the policy and is generally subject to maximum and minimum premium limits specified in the policy.
- *Policyholder dividends*, dividends paid to policyholders either in cash or as credits against each policyholder's next renewal premium.

Home Office and Branch Office Recordkeeping

3.23 Record-processing functions performed through branch locations vary among property and liability insurance companies. Further, those functions may vary depending on whether the company is direct billing or agency billing. The use of EDP has decentralized activities through computer input-output devices for remote locations in branch and field offices. For remote entry and access, the branch office, in effect, functions as an extension of the home office's centralized data processing.

3.24 For branch operations in which processing, accounting, and recordkeeping activities are decentralized, several alternative approaches exist. The more efficient and effective methods minimize duplication and result in compatibility between the branch and home office procedures.

3.25 Companies may follow these procedures for controlling policies and applications for policies at their branch offices:

- Applications are forwarded to the home office daily, with or without control listings.
- Applications are accompanied by control listings that have been balanced to entries made in branch records.
- Applications are retained at the branch offices, and only monthly summary journal entries are transmitted to the home office for entry in the general ledger.
- Policy numbers are assigned at branch offices or the home office, and overall numerical control of policies is maintained at the home office.

3.26 Companies may follow these procedures to control cash receipts at their branch offices:

- Branch offices prepare journal entries and forward them with the cash to the home office for deposits.
- Branch offices deposit cash in their branch accounts and transmit copies of the deposit slips and statements of cash applications to the home office.
- Branch offices deposit locally, and forward only the bank receipts to the home office. Branch offices forward monthly journal entries that summarize the monthly deposits to the home office.

3.27 Home office record-maintenance methods may include—

- Duplication of branch records.
- Maintenance of detailed entries of policies for statistical purposes but only a control account for uncollected premiums.
- Use of summary controls received monthly from the branches for both premiums and cash.

Premiums Transaction Flow

3.28 The following summarizes the premiums transaction flow of an insurance company:

a. An agent or broker submits a binder or application for a policy to the insurance company, often with a deposit premium.

b. Underwriting evaluates the risk, often using predetermined acceptance criteria and other factors such as a knowledge of the agent or broker.

c. If the risk is accepted, the amount of premium is determined, and the policy is issued. Premiums are generally established by class rating, individual rating, or merit rating. If the application is denied, the deposit premium is returned to the applicant with an explanation.

d. A decision to reinsure part or all of the risk is made. If reinsurance is chosen, the reinsurance company is notified, and the amount of ceded premium is determined.

e. Premiums are billed either by agency billing using an account current with the agent or by direct billing. Written premiums are recorded as an unearned premium reserve and are recognized as revenue over the period of risk in proportion to the amount of insurance protection provided.

f. Commissions and other costs of acquiring business are paid. Certain costs, known as *deferred acquisition costs*, typically are capitalized and amortized over the term of the policy.

g. Premiums may be adjusted over the life of the policy or at the expiration of the policy. Adjustments may result from audits, endorsements, or retrospective rating.

Accounting Principles

3.29 The specialized industry accounting principles for insurance enterprises are specified in FASB Statement No. 60. The following is a brief discussion of the principles and policies relating to the premium cycle. Readers should refer to the FASB Statement for specific guidance. Most property and liability insurance contracts are classified as short-duration contracts, and this guide generally focuses on such contracts.

Revenue Recognition

3.30 Premiums from a short-duration contract ordinarily should be recognized as revenue over the period of the contract in proportion to the amount of insurance protection provided. This generally results in premiums being recognized as revenue evenly over the contract period. Under a few kinds of contracts, the period of risk differs significantly from the contract period. An example is insurance policies for recreational vehicles issued for an annual period, covering claims that are incurred primarily in the summer months. Under other kinds of contracts, the amount of coverage declines over the contract period on a scheduled basis. In those cases, the premium is recognized as revenue over the period of risk in proportion to the amount of insurance protection provided. Unearned premiums, that portion of the premium applicable to the unexpired period of the policy, are included as an unearned premium reserve within the company's balance sheet.

3.31 As discussed in FASB Statement No. 60, some premiums are subject to subsequent adjustment (for example, retrospectively rated or other experience-rated insurance contracts). In these cases, the premium is determined after the period of the contract and is based on claim experience, or reporting-form contracts, for which the premium is adjusted after the period of the contract based on the value of insured property. If, as is usually the case, the ultimate premium is reasonably estimable, the estimated ultimate premium should be recognized as revenue over the period of the contract. It should be revised to reflect current experience. However, if the ultimate premium cannot be reasonably estimated, the cost-recovery method or the deposit method may be used until the ultimate premium becomes reasonably estimable. Under the cost-recovery method, premiums are recognized as revenue in amounts equal to estimated claims as insured events occur until the ultimate premium is reasonably estimable, and recognition of income is postponed until then. Under the deposit method, premiums are not recognized as revenue and claims are not charged to expense until the ultimate premium is reasonably estimable, and income recognition is postponed until that time.

Policy Acquisition Costs

3.32 Acquisition costs are those costs that vary with and are primarily related to the acquisition of new and renewal insurance contracts. Examples of such costs are commissions and other costs, such as salaries of certain employees involved in the underwriting and policy-issue functions, as well as premium taxes and inspection fees that are primarily related to insurance contracts issued or renewed during the period in which the costs are incurred. Acquisition costs should be capitalized and amortized by a method similar to that used for amortizing unearned premiums. The computation should be made by reasonable grouping of the company's business in a manner consistent with the company's manner of acquiring, servicing, and measuring the profitability of its insurance products. If deferred acquisition costs are based on the relationship of costs incurred to written premiums, called the *equity-in-unearned-premium* method, such relationship should be consistently applied throughout the term of the policies unless adjustments for deficiencies are required.

Premium Deficiencies

3.33 A premium deficiency relating to short-duration insurance contracts indicates a probable loss. A premium deficiency should be recognized if the sum of expected claim costs and claim adjustment expenses, expected dividends to policyholders, unamortized acquisition costs, and maintenance costs exceeds related unearned premiums. To determine if a premium deficiency exists, insurance contracts should be grouped consistently with the company's manner of acquiring, servicing, and measuring the profitability of its insurance contracts. A premium deficiency is recognized by first charging unamortized acquisition costs to expense to the extent required to eliminate the deficiency. Disclosure is required about whether the insurance company considers anticipated investment income in determining whether a premium deficiency relating to short-duration contracts exists. If the premium deficiency is greater than unamortized acquisition costs, a liability for the excess deficiency should be accrued.

Special Risk Considerations

3.34 To plan and carry out tests of transactions in the premium cycle, it is helpful for the auditor to understand the specific conditions that may increase the risks of errors or irregularities in the transactions and related account bal-

ances. These conditions may be peculiar to an individual company's business practices, markets, products, or risk philosophies. This section provides examples of conditions that may indicate special risks in the premium cycle and that might be considered by the auditor in the audit. The factors considered in assessing risk should be evaluated in combination in making an overall judgment; the presence of some factors in isolation would not necessarily indicate increased risk.

3.35 The following are examples of conditions that may indicate special risks in the premium cycle:

- Rapid growth in premium volume
- New lines of business
- Changes in pricing or underwriting practices
- Premium deficiencies

3.36 In evaluating the use of anticipated investment income in calculating a premium deficiency, the auditor should consider reviewing the company's cash flow assumptions and calculations based on anticipated claim payment patterns.

3.37 The auditor must also recognize that many areas of the premium cycle, such as policy acquisition costs, loss ratios, and premium deficiencies, may be evaluated through the use of a loss reserve specialist. In these cases, the auditor should refer to chapter 4 of this guide.

Chapter 4
The Loss Reserving and Claims Cycle

Accounting Practices

4.01 The specialized industry accounting principles for insurance enterprises are described in FASB Statement No. 60, FASB Statement No. 97, FASB Statement No. 113, and SOP 92-5, *Accounting for Foreign Property and Liability Reinsurance.*

4.02 Under GAAP, liabilities for the cost of unpaid claims, including estimates of the cost of claims incurred but not reported, are accrued when insured events occur. The liability for unpaid claims should be based on the estimated ultimate cost of settling the claims (that is, the total payments expected to be made) and should include the effects of inflation and other social and economic factors. Estimated recoveries on unpaid claims, such as salvage and subrogation are deducted from the liability for unpaid claims. A liability for those adjustment expenses expected to be incurred in the settlement of unpaid claims should be accrued when the related liability for unpaid claims is accrued. Changes in estimates of the liabilities resulting from their periodic review and differences between estimates and ultimate payments are reflected in the income of the period in which the estimates are changed or the claim is settled. If the liabilities for unpaid claims and claim-adjustment expenses are discounted (that is, the liabilities are not recorded at their ultimate cost because the time value of the money is taken into consideration), the amount of the liabilities presented at present value in the financial statements and the range of interest rates used to discount those liabilities are required to be disclosed. For public companies, the SEC staff issued Staff Accounting Bulletin No. 62, *Discounting by Property/Casualty Insurance Companies*, which discusses the appropriate accounting and financial reporting when a company adopts or changes its policy with respect to discounting certain unpaid claims liabilities related to short-duration insurance contracts. The SEC issued Financial Reporting Release No. 20, *Rules and Guide for Disclosures Concerning Reserves for Unpaid Claims and Claim Adjustment Expenses of Property-Casualty Underwriters*, which requires additional disclosures concerning the underwriting and claims reserving experience of property-casualty underwriters. The SEC staff also issued Staff Accounting Bulletin No. 87, *Contingency Disclosures on Property/Casualty Insurance Reserves for Unpaid Claim Costs*, which provides guidance concerning those uncertainties surrounding property and casualty loss reserves that may require FASB Statement No. 5, contingency disclosures and Staff Accounting Bulletin No. 92, *Accounting and Disclosures Relating to Loss Contingencies*, which provides the SEC staff's interpretation of current accounting literature relating to the following:

- Offsetting of probable recoveries against probable contingent liabilities
- Recognition of liabilities for costs apportioned to other potential responsible parties
- Uncertainties in estimation of the extent of environmental or product liability

- The appropriate discount rate for environmental or product liability, if discounting is appropriate
- Accounting for exit costs
- Financial statement disclosures and disclosure of certain information outside the basic financial statements

Statutory Accounting Practices

4.03 Statutory accounting practices (SAP), which vary by state, are similar to GAAP for transactions in the claims cycle—estimated liabilities for unpaid claims, including IBNR and claim-adjustment expenses, are accrued when the insured events occur; however, there are certain differences. Under SAP, reinsurance recoverable on unpaid losses is deducted from the liability for unpaid claims. For certain lines of insurance, such as auto liability, general liability, medical malpractice, and workers' compensation, a minimum statutory reserve may be required. The formula for determining this reserve is described in the footnotes to Schedule P in the NAIC Annual Statement. If it is determined that an additional statutory reserve is needed, this amount is reported as a separate liability and a reduction from surplus.

4.04 Discounting of loss reserves varies by state. SAP generally permits discounting settled lifetime workers' compensation claims and accident and health long-term disability claims at discount rates of 4 percent or less. In some states, medical malpractice liability claims may also be discounted. For statutory reporting purposes, reinsurance recoverable balances are segregated between those recoverable from companies authorized by the state to transact reinsurance and those recoverable from other companies, called unauthorized reinsurers. Insurance companies are required to provide a reserve by a charge to surplus for reinsurance that is recoverable from unauthorized companies. The reserve is provided to the extent that funds held or retained for account of such companies are exceeded or not secured by trust accounts or by letters of credit. (Differences between SAP and GAAP are discussed in more detail in chapter 8.)

Types of Business and Their Effect on the Estimation Process

4.05 The reporting and payment characteristics of a company's losses will differ depending on the types of policies written. Insurance policies may be categorized in several different ways:

- By policy duration (short-duration or long-duration)
- By type of coverage provided (occurrence basis or claims-made basis)
- By kind of insurance underwritten—in this chapter, the terms *line of business* and *type of risk* are used interchangeably to mean kind of insurance underwritten (for example, property, liability, workers' compensation, and reinsurance)*

Policy Duration

4.06 Insurance policies are considered to be either short-duration or long-duration. Policies are considered short-duration when the contract provides for insurance coverage for a fixed period of short duration and enables

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* The terms *line of business* and *type of risk* are used interchangeably to mean kind of insurance underwritten.

the insurer to cancel the contract or adjust the provisions of the contract at the end of the contract period. Policies are considered long-duration when the contract provides for insurance coverage for an extended period and is not generally subject to unilateral changes in its provisions. Because most policies written by property and liability insurance companies are short-duration policies, only short-duration contracts are considered in this chapter.

Type of Coverage

4.07 Insurance policies may be issued on either an occurrence basis or a claims-made basis. Occurrence-basis policies provide coverage for insured events occurring during the contract period, regardless of the length of time that passes before the insurance company is notified of the claim. Under occurrence-basis policies, claims may be filed months or years after the policy contract has expired, making it difficult to estimate the eventual number of claims that will be reported. Theoretically, a pure claims-made policy only covers claims reported to the insurer during the contract period; however, in practice, claims-made policies generally cover claims reported to either the insurer or the insured during the contract period. As a result, claims may be reported to the insurer after the contract expires. Even if claims have been reported to the insurer during the contract period, it may take several months for the insurer to investigate and establish a case reserve for reported claims. In practice, most claims-made insurance policies contain "extended reporting" clauses or endorsements that provide for coverage, in specified circumstances, of claims occurring during the contract period but reported after the expiration of the policy. In many states, a claims-made insurance policy is required to (*a*) contain an extended-reporting clause, (*b*) provide for the purchase, at the policyholder's option, of "tail coverage," that is, coverage for events occurring during the policy term but reported after the initial policy expires, or (*c*) provide for automatic tail coverage upon the death, disability, or retirement of the insured. Thus, in practice, claims-made policies can resemble occurrence-basis policies. If a claims-made insurance policy provides for coverage of claims incurred during the policy period but reported to the insurer after the end of the policy period, loss reserve requirements for such claims should be considered.

Kind of Insurance Underwritten, Line of Business, or Type of Risk

4.08 The kind of insurance underwritten by property and liability insurance companies may be broadly categorized into five classes of coverage: property, liability, workers' compensation, surety, and fidelity. Additionally, policies may be written as primary coverage or reinsurance assumed.

4.09 Claims can be further classified as primary or reinsurance. Primary coverage involves policies written directly by the company. Reinsurance assumed involves the indemnification of liabilities of one insurance company by another (see chapter 6). Excess claims are those in which another insurer or the insured pays a significant portion of the claim amount (called a retention) before the excess coverage responds. Retentions can be thousands of dollars or millions of dollars, depending on the situation.

4.10 Property claims generally are reported and settled quickly, often within several months. Some exceptions to this general rule are coverages known as business interruption insurance and ocean marine insurance. Property claims usually are first-party claims, that is, they are direct obligations of

the insurer to pay the insured, with the claimant being the policyholder. In addition, the occurrence and the extent of property losses are relatively easily determinable because the claims relate to tangible property. The processing of property claims is often streamlined through bulk reserving or small-claim procedures in which many small claims are summarized and aggregated.

4.11 Liability claims are reported more slowly than property claims, and settlement is often delayed, especially if litigation is involved. Liability claims are third-party claims in which the insurer has agreed to pay, defend, or settle claims made by third parties against the insured. A single insured event may result in several claimants. In processing a liability claim, many companies keep a single file for each insured event, with separate identification of each claimant.

4.12 Workers' compensation claims are reported quickly, and some claims are settled slowly. The amount of most claim payments is set by law and may change during the life of a claim. A claim settlement is characterized by numerous payments to the claimants or survivors for medical expenses and loss of earnings, possibly over extended periods of time.

4.13 Surety or fidelity claims are reported and settled very slowly because the loss may be discovered months or years after it has occurred. Determining the extent of the loss, which is done by the claimant, also often takes a long time. Financial guarantee insurance has become a significant insured risk to some companies. Financial guarantees include the guaranteeing of interest and principal payments on corporate and municipal debt, the guaranteeing of limited partnership obligations, and a number of other products in which the insurance company takes on an obligation to pay or perform at some later date. The ultimate exposure to a large loss can be high with financial guarantees.

4.14 Some lines of insurance are commonly referred to as "long-tail" lines because of the extended time required before claims are ultimately settled. Examples of long-tail lines are automobile bodily injury liability, workers' compensation, professional liability, and other lines such as products and umbrella. Lines of insurance in which claims are settled relatively quickly are called "short-tail" lines. It is generally more difficult to estimate loss reserves for long-tail lines because of the long period that elapses between the occurrence of a claim and its final disposition, and the difficulty of estimating the settlement value of the claim.

The Transaction Cycle

4.15 Although specific procedures vary from company to company, there is a common pattern to the flow of transactions through the claims cycle, which consists of the following major functions: claim acceptance and processing, claim adjustment and estimation, claim settlement, and loss reserve evaluation.

Claim Acceptance and Processing

4.16 Notice of a loss or accident is received at the home or branch office directly from the insured or through agents. A file number for the claim, which forms the basis for all future references, is assigned to the case, usually in numerical sequence, and a loss file and abstract are prepared. Policy applications or other records of insurance coverage are examined to determine whether the loss is covered by the insurance policy and whether the policy was in force at the time the loss occurred. Questions of coverage are usually raised when

the case is new. Failure to raise questions promptly may be prejudicial to a company's rights. If it appears that the claim is covered, the case is assigned to an adjuster. Some companies establish a diary file instead of a claim file when a notice of an incident is received and the company is not certain that the facts require them to establish a claim file and record an estimate. For example, an insured under a liability policy may report an injury but the injury is not expected to result in a claim. The diary file items may be referred to as precautionary claims in the context of excess claims.

4.17 Claim file face sheets containing abstracts of coverage and loss notices are prepared along with information for later use in the development of statistics used for reserve analysis and product pricing. In addition to the line of business classification, claims are classified by state, location of risk, date of loss, and policy year. Coding of claims data is important because errors in coding data directly affect the reliability of information and the effectiveness of reserve developments, which the company and the auditor use to evaluate the adequacy of loss reserves. Among the most important dates that might affect loss reserve developments are the accident date, policy effective date, claim reporting date (date reported to company), claim recording date (date the claim is entered on the company's computer recording system), claim payment date, and claim reopening date (there may be more than one reopening date). Claims data must also be properly coded to meet the statutory reporting requirements of the annual statement and to provide statistics to support rate filings.

4.18 Smaller and "one-shot" claims are processed by less expensive methods. Usually a claim file is not prepared, and a separate reserve estimate is not recorded. All statistical and accounting matters are processed on the date of payment, and average reserve estimation methods are used between the report and settlement dates.

Claim Adjustment and Estimation

4.19 Claims adjusting involves (*a*) a field investigation, (*b*) an appraisal and negotiation of the claim subject to the appropriate supervision, and (*c*) approval by the company's claims department. Through an investigation, the adjuster determines, among other things, whether the claimed loss actually occurred, his or her estimate of the amount of the loss, whether the loss may be excludable under the terms of the policy, and whether the company has a right to recover part or all of the loss through salvage, subrogation, or reinsurance. Salvage is a contractual right of recovery that entitles the insurer to any proceeds from the disposal of damaged property for which the claim has been paid, such as the sale of a wrecked automobile to a junkyard. Subrogation is the legal right of the insurer to recover from a third party who may be wholly or partly responsible for the loss paid under the terms of the policy, such as recovery from an employee for the employer's loss covered by a fidelity bond. The basis for recovery from a reinsurer is set in the reinsurance contract.

4.20 Insurance companies use several different methods to adjust claims. Companies may use home or branch office adjusters, who are salaried employees of the company, or independent adjusters, who are professionals who charge fees for their investigation and adjustment service. Insurance companies may also join together to form an adjustment bureau to which they may refer claims. Subject to certain limitations, an adjustment bureau acts for each member company in the adjustment and negotiation of claims, with the company retaining the final authority for approval. Expenses of the adjustment bureau

are shared among members, usually based on the number or dollar volume of claims referred to the bureau for adjustment. Most companies use a combination of methods to adjust claims. They may have a claim branch office established for closer supervision and better control of the cost of adjustments in territories in which they have a larger concentration of risks. In the territories in which their business does not warrant the establishment of a claim branch office, they may use independent adjusters or join an adjustment bureau.

4.21 As soon as practicable, an adjuster estimates the total expected amount that is payable on a claim. Such an estimate may be determined by the average cost per case based on experience for the line of business, or may be based on specific information on the individual case. The estimate is revised in response to changes in experience or as investigations progress and further information is received.

4.22 Companies have different approaches to establishing reserves on individual claim files. For some companies the case reserve represents the amount the company would pay as a settlement based on the facts in the file at that time. Reserves based on that approach tend, in the aggregate, to be inadequate to pay the ultimate cost of the reported claims. For other companies, the claim reserve represents a "worst-case" view of the injury and the liability or coverage issues presented by the case. Reserves based on this approach tend, in the aggregate, to exceed the ultimate cost of the reported claims.

4.23 For most companies, the philosophy intended for individual claim reserving falls between the examples described above. For purposes of establishing an appropriate financial statement reserve, the most important factors to consider are (*a*) the historical adequacy or inadequacy of case reserves, (*b*) the consistency in the reserving approach followed by the company, and (*c*) the availability of an actuarial/statistical analysis of reserves.

4.24 High jury awards, malpractice claims, structured settlements, and the proliferation of environmental claims, such as those for injuries caused by Agent Orange and asbestos, have complicated the claim estimation process. Structured settlements potentially allow companies to ultimately pay lesser amounts on claims by purchasing annuities to pay settlements to claimants over future periods. The structured settlement allows a company to eliminate the reserve that was recorded for the claim, even if it exceeded the amount paid for the settlement. However, if the structured settlement is made to the claimant with recourse, the insurer is ultimately liable should account for the structured settlement as reinsurance receivable from a retroactive reinsurance contract. Environmental claims have affected companies indirectly through their participation in pools and associations, such as the significant reserves that the industry had to provide for black-lung claims. The advent of such claims has required a higher level claims-review process. Most companies now use a variety of higher level reviews, such as those by claims committees and in-house counsel.

Claim Settlement

4.25 Claim and claim expense payments originate with signed proofs of loss, releases, medical bills, repair bills, or invoices for fees of independent adjusters or lawyers. When these documents are received, they are reviewed and compared with the claim files before payment is authorized. Authorized payments are then posted to the face sheets.

4.26 Methods of payment vary among insurance companies. Approved documents may be forwarded to the cashier for draft or check preparation, or

the claim department may have authority to issue drafts. In many companies, authority to issue drafts may be given to field offices, adjusters, and sometimes agents; in those cases, copies of the drafts and related supporting documents are forwarded to the claims department. After processing, the supporting documents are filed in the related claim files.

4.27 Some companies record claims paid by checks or drafts when issued. Other insurance companies record claims paid when the drafts clear the bank. Source records are then forwarded to the data processing department for entry, usually in controlled batches, and totals of paid losses are posted to the general ledger. Changes in payment procedures or changes in the definition of payment date for coding purposes can affect loss reserve developments.

Reinsurance Receivable

4.28 Upon receiving a notice of a claim, the claims department generally determines whether there is any right of recovery under a reinsurance agreement. Daily reports show pro rata reinsurance information. Recoveries under quota-share reinsurance agreements are usually based on total claims figures period by period. Excess reinsurance is determined by claims adjusters based on reinsurance contracts. Recoveries under catastrophe reinsurance are usually determined based on data compiled by the statistical department; each catastrophe is usually assigned a code number and a recovery is recorded when the total of incurred claims exceeds the company's retention. Reinsurance arrangements on liability policies may include provisions such that if aggregate claims from a common occurrence exceed a retention, then the excess amounts are covered by the reinsurer. Recoveries under such aggregate excess reinsurance treaties are coded similarly to catastrophe claims. (Chapter 6 describes reinsurance contracts.)

4.29 When it is determined that there will be reinsurance receivable on a claim, the estimated amount receivable is usually recorded in the claim file and the data processing records. Notices of losses are sent to the reinsurers in accordance with terms of the reinsurance contracts. In most cases, reinsurers are notified only about losses reinsured individually—the facultative basis—and larger losses. Although some reinsurance contracts contain provisions for immediate recovery for losses over a stated amount, recoveries are normally settled monthly or quarterly, usually by being deducted from the premiums due to the reinsurers.

Salvage and Subrogation

4.30 After a claim has been settled, the possibility of salvage or subrogation may exist. Perhaps the simplest approach to determining the anticipated receivable is to estimate loss reserves using loss data that is net of salvage and subrogation recoveries. Many of the reserving methods for losses and loss-adjustment expenses, however, can also be used to estimate salvage and subrogation recoveries.

Claims Transaction Flow

4.31 The claims transaction flow in an insurance company is summarized as follows:

a. The insured reports the loss to his or her agent, who either prepares a loss report to be forwarded to the insuring company's home office or helps the insured prepare such a report. If the insuring company

has a central loss-reporting facility, the agency instead places the insured in contact with the facility, which will obtain the details of the loss from the insured and prepare a loss report. Insurance companies usually have separate departments to handle such claims; larger companies may even have separate departments to handle each kind of claim.

b. The loss is assigned a claim number and entered, either manually or through EDP media, on the company's loss register. Claim numbers are generally assigned sequentially or by policy number.

c. A file is established to accumulate pertinent data and correspondence.

d. Concurrent with establishing a file, a copy of the policy (called the daily) under which the claim is being made is examined to determine the amount of coverage and whether the claimant was, at the time of occurrence, insured against the kind of loss suffered. The copy of the daily may be included in the claim file for further reference and documentation.

e. An adjuster is assigned to investigate the loss. The adjuster may be an employee of the insurance company, its agent, or an independent professional. The adjuster helps determine the amount of loss, estimate the reserve required, and provide information such as photographs, police reports, medical reports, statements of witnesses, and any other pertinent items to substantiate the loss.

f. A reserve (case outstanding) is established for the estimated dollar amount of loss that will ultimately be paid on the claim. Reserves are difficult to estimate because in some cases the severity of a loss or the effects of injuries, which may become apparent at some future time, are not readily subject to current determination. Many companies have minimum, maximum, or average amounts of reserves established for reported claims derived from their experience of past claim settlements.

g. Reinsurance applicable to the claim is reviewed, and reinsurance-receivables are established if the claim is subject to the terms of a reinsurance agreement; if necessary, the reinsurers are notified. If salvage or subrogation rights may be available, the appropriate notation and controls should also be posted.

h. After negotiation with the claimant, a check or draft is issued for the amount of the adjusted claim. On receipt of payment, the claimant generally signs a release indicating that final settlement has been received.

i. If reinsurance applies, loss payments receivable are posted to the appropriate control for summary reporting to the reinsurers or, if necessary, a proof of loss requesting payment is prepared and forwarded to the reinsurers.

Components of Loss Reserves

4.32 Loss reserves are an insurer's estimate of its liability for the unpaid costs of insured events that have occurred. An insurance company's loss reserves consist of one or more of the components described below. All of these components should be considered in the loss-reserving process but may not have to be separately estimated.

Case-basis reserves—The sum of the values assigned by claims adjusters to specific known claims that were recorded by the insurance company but not yet paid at the financial statement date. This chapter describes the most common methods used by companies to establish case-basis reserves.

Case-development reserves—The difference between the case-basis reserves and the estimated ultimate cost of such recorded claims. This component recognizes that case-basis reserves, which are estimates based on incomplete or preliminary data, will probably differ from ultimate settlement amounts. Accordingly, a summation of case-basis reserve estimates may not produce the most reasonable estimate of their ultimate cost.

Incurred but not reported (IBNR)—The estimated cost to settle claims arising from insured events that occurred but were not reported to the insurance company as of the financial statement date. This component includes reserves for claims "in transit," that is, claims reported to the company but not yet recorded and included in the case-basis reserve.

Reopened-claims reserve—The cost of future payments on claims closed as of the financial statement date that may be reopened due to circumstances unforeseen at the time the claims were closed.

Sometimes, case-development reserves, IBNR, and the reopened-claims reserve are calculated as a single reserve and broadly referred to as IBNR. In addition to the basic components of loss reserves, a company will also need to estimate the effect of the following components:

Reserves for loss adjustment expenses (LAE). These include the following:

- *Allocated loss adjustment expenses (ALAE)*—Expenses incurred in the claim settlement process that can be directly associated with specific claims, such as legal fees or outside adjuster fees. If this reserve is estimated on a case basis, a reserve for ALAE development, IBNR, and reopened claims should be provided.
- *Unallocated loss adjustment expenses (ULAE)*—Expenses incurred in the claim settlement process that cannot be directly associated with specific claims, such as costs incurred by the insurer's claims operations to record, process, and adjust claims.

Reduction for salvage—The estimated amount receivable by the insurer from the disposition of damaged or recovered property. Potential salvage on paid and unpaid losses should be considered in this estimate.

Reduction for subrogation—The estimated amount receivable from third parties from whom the insured may have the right to recover damages. The insured, having collected benefits from the insurer, is required to subrogate such rights to the insurer.

Drafts outstanding—Some insurance companies may elect to pay claims by draft rather than by check and may not record the drafts as cash disbursed until the drafts are presented to the insurer by the bank. A liability for drafts outstanding is required only if cash disbursements and claim statistical information are not recorded concurrently, thereby creating a timing difference. Because the claim statistical information is updated to reflect the payment, no loss reserve is recorded for the claim; however, because the draft has not been presented, a drafts outstanding liability is required.

Reserves for assessments based on paid losses—The estimated amount of future assessments relating to payments on losses incurred prior to the financial statement date. An example is assessments by state workers' compensation second-injury funds. Such assessments are recorded as losses and should be considered in the loss reserving process.

Reinsurance receivables—Amounts that will be recovered from reinsurers for losses and LAE accrued, including IBNR losses accrued. Amounts receivable from reinsurers on paid and unpaid losses are generally classified as assets.

4.33 Many insurance companies do not separately value each of the reserve components listed above. Frequently, an insurance company's reserve for case development is combined with its reserve for IBNR claims. Reinsurance and other recoveries may be netted against claim payments in the insurance company's records. In those situations, initial reserve estimates are also net of recoveries; separate analysis is then performed to determine the appropriate amount to record as the reinsurance receivable asset. ALAE may be combined with loss payments and included in these components.

Estimating Methods

4.34 Various analytical techniques exist to assist management, consulting actuaries, and independent auditors in estimating and evaluating the reasonableness of loss reserves. These techniques generally consist of statistical analyses of historical experience and are commonly referred to as loss reserve projections.

4.35 Loss reserve projections are used to develop loss reserve estimates. Understanding and assessing the variability of these estimates and the reliability of historical experience as an indicator of future loss payments require a careful analysis of the historical loss data and the use of projection methods that are sensitive to the particular circumstances.

4.36 The data used for projections is generally grouped by line of business and may be further classified by attributes such as geographic location, underwriting class, or type of coverage to improve the homogeneity of the data within each group. The data is then arranged chronologically. The following are dates that are key to classifying the chronology of the data.

Policy date—The date on which the contract becomes effective (also referred to as the underwriting date).

Accident date—The date on which the accident (or loss) occurs.

Report date—The date on which the company first receives notice of the claim.

Record date—The date on which the company records the claim in its statistical system.

Closing date—The date on which the claim is closed.

4.37 After the data has been grouped by line of business and by chronology, it may then be arrayed to facilitate the analysis of the data, highlight trends, and permit ready extrapolation of the data. The following are examples of types of data that are commonly arrayed and analyzed:

- Losses paid
- Losses incurred
- Case reserves outstanding
- Claim units reported

- Claim units paid
- Claim units closed
- Claim units outstanding
- ALAE paid
- ALAE outstanding
- Salvage and subrogation recovered
- Reinsurance recovered
- Reinsurance receivable
- Premiums earned
- Premiums in force
- Exposures earned
- Policies in force

4.38 The data may be cumulative or incremental, gross or net of reinsurance, gross or net of salvage and subrogation, or combined with allocated loss adjustment data. The data may be stratified by size of loss or other criteria. Because claim data and characteristics such as dates, type of loss, and claim counts significantly affect reserve estimation, controls should be established over the recording, classification, and accumulation of historical data used in the determination of loss reserves. Exhibit B-2 in appendix B of the audit guide presents examples of such control procedures.

4.39 Loss reserve projections can be performed using a variety of mathematical approaches ranging from simple arithmetic projections using loss development factors to complex statistical models. Projection methods basically fall into three categories:

- Extrapolation of historical loss dollars
- Projection of separate frequency and severity data (the number of claims that will be paid or closed and the average costs of these claims)
- Use of expected loss ratios

4.40 Within each of these methods, there are a variety of techniques and loss data that may be used; there are also methods that combine features of these basic methods. No single projection method is inherently better than any other in all circumstances.

4.41 Following is a brief summary of some commonly used projection methods.

Method	*Basis*
Loss Extrapolation	
Paid loss	Uses only paid losses. Outstanding case reserves are not considered.
Incurred loss	Uses paid losses plus reserves on outstanding claims.
Average Severities	Uses various claim count and average cost per claim data on either a paid or incurred basis.
Loss Ratio	Uses various forms of expected losses in relation to premiums earned.

4.42 The decision to use a particular projection method and the results obtained from that method should be evaluated by considering the inherent assumptions underlying the method and the appropriateness of these assumptions to the circumstances. Stability and consistency of data are extremely im-

portant. Changes in variables, such as rates of claim payments, claim department practices, case-basis reserving adequacy, claim reporting rates, mix of business, reinsurance retention levels, and the legal environment, may have a significant effect on the projection and may produce distortions or conflicting results. Reference should be made to the section in this chapter titled "Changes in the Environment" [paragraphs 4.61 through 4.64] for a discussion of how changes in variables may affect the loss-reserving process. The results of any projection should be reviewed for reasonableness by analyzing the resultant loss ratios and losses per measure of exposure.

Illustrative Projection Data

4.43 The following tables are simple illustrations of the use of the loss extrapolation method to estimate ultimate losses, as well as the effects of considering the results of more than one projection. In these illustrations, the result of extrapolating incurred-loss data is compared with the result of extrapolating paid-loss data. These tables are presented solely for the purpose of illustrating the mathematical mechanics of the two projections. They do not illustrate the required analysis of the data, and consideration of internal and external environmental variables that may affect the claim payment and loss reserving process.

4.44 Table 1 presents an illustration of historical incurred-loss data. It reflects, as an example, that the sum of paid losses and case reserves outstanding at the end of 19X0 was $2,054; that sum increased to $2,717 in the next year and increased to $3,270 five years later.

4.45 This incurred-loss data is first used to calculate historical period-to-period incurred-loss development factors. These factors are used to compare the amount of incurred losses at successive development stages, and are illustrated in table 2, part 1.

4.46 The calculation of average historical period-to-period incurred-loss development factors may be based on the use of simple averages of various period-to-period factors or may be based on more complex weighting or trending techniques. These techniques can significantly affect the reserving process and require judgment, understanding, and experience. In this example, a simple average of the latest three period-to-period factors has been calculated and is presented in table 2, part 2.

Table 1

Case-Basis Incurred-Loss Data as of 12/31/X9

	Development Period (in months)									
Accident Year	*12*	*24*	*36*	*48*	*60*	*72*	*84*	*96*	*108*	*120*
19X0	$2,054	$2,717	$2,979	$3,095	$3,199	$3,348	$3,270	$3,286	$3,299	$3,301
19X1	2,213	2,980	3,269	3,461	3,551	3,592	3,631	3,643	3,651	
19X2	2,341	3,125	3,513	3,695	3,798	3,849	3,872	3,876		
19X3	2,492	3,502	3,928	4,177	4,313	4,369	4,392			
19X4	2,964	4,246	4,859	5,179	5,315	5,376				
19X5	3,394	4,929	5,605	5,957	6,131					
19X6	3,715	5,433	6,162	6,571						
19X7	4,157	5,912	6,771							
19X8	4,573	6,382								
19X9	4,785									

4.47 Once historical period-to-period incurred-loss development factors are calculated, future period-to-period incurred-loss development factors must be selected. The future period-to-period factors must reflect anticipated differences between historical and future conditions that affect loss development, such as changes in the underlying business, different inflation rates, or case-basis reserving practices. In the example, no differences are anticipated and the average historical factors have been chosen as the selected factors as shown in table 2, part 2. The selected future period-to-period factors are then used to produce ultimate incurred development factors. The ultimate factors are presented in table 2, part 3.

Table 2

Period-to-Period Incurred-Loss Development Factors as of 12/31/X9

Accident Year	*Development Period (in months)* 12-24	*24-36*	*36-48*	*48-60*	*60-72*	*72-84*	*84-96*	*96-108*	*108-120*	*Est. Tail*[*]
Part 1: Period-to-Period Historical Loss Development Factors										
19X0	1.323[†]	1.096	1.039	1.034	1.047	0.977	1.005	1.004	1.001	
19X1	1.347	1.097	1.059	1.026	1.012	1.011	1.003	1.002		
19X2	1.335	1.124	1.052	1.028	1.013	1.006	1.001			
19X3	1.405	1.122	1.063	1.033	1.013	1.005				
19X4	1.433	1.144	1.066	1.026	1.011					
19X5	1.452	1.137	1.063	1.029						
19X6	1.462	1.134	1.066							
19X7	1.422	1.145								
19X8	1.396									
Part 2: Period-to-Period Average Development Factors										
Simple Average of Latest Three										
	1.427	1.139	1.065	1.029	1.012	1.007	1.003	1.003	1.001	1.000
Selected Factors										
	1.427	1.139	1.065	1.029	1.012	1.007	1.003	1.003	1.001	1.000
Part 3: Ultimate Development Factors Selected for the Projection										
	1.828[‡]	1.281	1.125	1.056	1.026	1.014	1.007	1.004	1.001	1.000

4.48 The loss reserve analysis has now reached the point where an initial projection of ultimate losses, as well as an indicated provision for unreported losses for each accident year, can be made by using the historical incurred-loss data and the ultimate incurred-loss development factors. This initial projection of ultimate losses is presented in table 3.

4.49 Tables 4 and 5 present paid-loss data for the same company whose incurred-loss data was presented in table 1. The array of paid-loss period-to-period development factors presented in table 5 is derived from table 4 using the same calculation methods used for incurred losses in table 2. The importance of the use of a tail factor in this calculation is apparent from the period-to-period historical loss development factors calculated in table 5. The tail factor represents an estimate of the development of losses beyond the period

[*] Applies when the development period is determined to be longer than the period covered by the model (assumed to be 1.000 in this illustration).

[†] The 24-month developed losses are divided by the 12-month developed losses from table 1 ($2,717/$2,054 = 1.323).

[‡] The product of the remaining factors (1.427 × 1.139 × 1.065 × 1.029 × 1.012 × 1.007 × 1.003 × 1.003 × 1.001 × 1.000 = 1.828) or the product of the 12-24 selected factor times the 24-36 ultimate factor (1.427 × 1.281 = 1.828).

covered by the data array. In this instance, a tail factor of 1.01 was selected to project an additional 1 percent of losses to be paid from the tenth development year to ultimate. Selection of a tail factor requires careful judgment based on consideration of industry experience for the line of business, actuarial studies, case reserves, and any other relevant information.

4.50 The initial projection of ultimate losses, using the historical paid losses and the paid-loss ultimate development factors, is presented in table 6.

4.51 Table 7 compares the results of extrapolating paid-loss data (table 6) with the results of extrapolating incurred-loss data (table 3).

4.52 Although all accident periods should be analyzed and trends evaluated, it is clear that additional analysis of accident year 19X9 losses is required. The difference between the results obtained from the two different projections is significant. Initial inspection will trace the source of the difference to the high level of losses paid in 19X9 for accident year 19X9 relative to case-basis incurred losses for the same period. The loss reserving analysis must focus on whether the increase in payments represents an acceleration of payment activity or an increase in the overall level of losses incurred in 19X9. The benefit of using more than one projection is that it allows for this kind of analysis and comparison in the evaluation of loss reserves.

Table 3
Incurred-Loss Projection as of 12/31/X9

Accident Year	*Case-Basis Incurred Loss as of 19X9**	*Ultimate Incurred-Losses Development Factors*†	*Projected Ultimate Losses (2) × (3)*	*Projected Unreported Loss (4) − (2)*
(1)	(2)	(3)	(4)	(5)
19X0	$ 3,301	1.000	$ 3,301	$ 0
19X1	3,651	1.001	3,655	4
19X2	3,876	1.004	3,892	16
19X3	4,392	1.007	4,423	31
19X4	5,376	1.014	5,451	75
19X5	6,131	1.026	6,290	159
19X6	6,571	1.056	6,939	368
19X7	6,771	1.125	7,617	846
19X8	6,382	1.281	8,175	1,793
19X9	4,785	1.828	8,747	3,962
Total	$51,236		$58,490	$7,254

* From table 1.

† From table 2, part 3.

Table 4

Paid-Loss Data as of 12/31/X9

Accident Year	Development Period (in months) 12	24	36	48	60	72	84	96	108	120
19X0	$ 896	$1,716	$2,291	$2,696	$3,041	$3,096	$3,185	$3,235	$3,262	$3,276
19X1	872	1,840	2,503	2,973	3,261	3,429	3,538	3,589	3,624	
19X2	968	1,975	2,683	3,185	3,494	3,670	3,763	3,819		
19X3	968	2,130	2,968	3,571	3,942	4,147	4,274			
19X4	1,201	2,580	3,673	4,421	4,860	5,114				
19X5	1,348	2,996	4,207	5,115	5,632					
19X6	1,340	3,146	4,520	5,496						
19X7	1,384	3,428	4,960							
19X8	1,568	3,696								
19X9	2,243									

Table 5

Period-to-Period Paid-Loss Development Factors as of 12/31/X9

Accident Year	Development Period (in months) 12-24	24-36	36-48	48-60	60-72	72-84	84-96	96-108	108-120	Est. Tail*
Part 1: Period-to-Period Historical Loss Development Factors †										
19X0	1.915	1.335	1.177	1.128	1.018	1.029	1.016	1.008	1.004	
19X1	2.110	1.360	1.188	1.097	1.052	1.032	1.014	1.010		
19X2	2.040	1.358	1.187	1.097	1.050	1.025	1.015			
19X3	2.200	1.393	1.203	1.104	1.052	1.031				
19X4	2.148	1.424	1.204	1.099	1.052					
19X5	2.223	1.404	1.216	1.101						
19X6	2.348	1.437	1.216							
19X7	2.477	1.447								
19X8	2.357									
Part 2: Period-to-Period Average Development Factors										
Simple Average of Latest Three										
	2.394	1.429	1.212	1.101	1.051	1.029	1.015	1.009	1.004	1.010
Selected Factors										
	2.394	1.429	1.212	1.101	1.051	1.029	1.015	1.009	1.004	1.010
Part 3: Ultimate Development Factors Selected for the Projection †										
	5.127	2.142	1.499	1.237	1.123	1.069	1.039	1.023	1.014	1.010

* Applies when the development period is determined to be longer than the period covered by the model (assumed to be 1.010 in this illustration).

† Computations are the same as those explained in table 2.

Table 6

Paid-Loss Projection as of 12/31/X9

Accident Year	*Paid Losses as of 19X9*	*Ultimate Loss Development Factors*	*Projected Ultimate Losses (2) × (3)*	*Projected Unreported Losses**
(1)	(2)	(3)	(4)	(5)
19X0	$ 3,276	1.010	$ 3,309	$ 8
19X1	3,624	1.014	3,675	24
19X2	3,819	1.023	3,907	31
19X3	4,274	1.039	4,439	47
19X4	5,114	1.069	5,465	89
19X5	5,632	1.123	6,325	194
19X6	5,496	1.237	6,796	225
19X7	4,960	1.499	7,434	663
19X8	3,696	2.142	7,916	1,534
19X9	2,243	5.127	11,500	6,715
Total	$42,134		$60,766	$9,530

Table 7

Alternative Projections of Ultimate Losses and Unreported Losses as of 12/31/X9

Accident Year	*Ultimate Losses*		*Unreported Losses*	
	Incurred	*Paid*	*Incurred*	*Paid*
19X0	$ 3,301	$ 3,309	$ 0	$ 8
19X1	3,655	3,675	4	24
19X2	3,892	3,907	16	31
19X3	4,423	4,439	31	47
19X4	5,451	5,465	75	89
19X5	6,290	6,325	159	194
19X6	6,939	6,796	368	225
19X7	7,617	7,434	846	663
19X8	8,175	7,916	1,793	1,534
19X9	8,747	11,500	3,962	6,715
Total	$58,490	$60,766	$7,254	$9,530

Loss Adjustment Expense Reserves

4.53 Loss adjustment expense reserves are the costs that will be required to settle claims that have been incurred as of the valuation date. As explained in paragraph 4.32, loss adjustment expenses (LAE) can be classified into two broad categories: allocated loss adjustment expenses (ALAE) and unallocated loss adjustment expenses (ULAE).

* Represents the projected losses from table 6, column 4, less the recorded case-basis incurred losses from table 3, column 2.

ALAE Reserve Calculation Approaches

4.54 ALAE is generally analyzed by line of business; however, it is also important to monitor the composition of the paid ALAE by cost component. A shift in the composition of the costs in relation to the total might affect the statistical data used in the related loss projections. This shift would need to be considered in future loss reserve projections.

4.55 Many companies calculate ALAE reserves based on the relationship of ALAE to losses. Underlying this approach is a basic assumption that ALAE will increase or decrease in proportion to losses. The setting of reserves for ALAE based on the relationship of paid ALAE to paid losses is referred to as the "paid-to-paid ratio" approach. Separate ratios are normally developed for each accident year. Inflation in ALAE is not typically evaluated separately; rather, it is estimated to occur at the same rate as the rate of inflation in the losses. The validity of this assumption can be tested by reviewing historical relationships between ALAE and losses over time. The effects of a pattern of increasing or decreasing ratio of ALAE to losses should be considered in establishing ALAE reserves. An understanding of the claim department's operations and philosophy over time is essential to a proper interpretation of the data.

4.56 Other approaches to ALAE reserve calculation and analysis include (*a*) analyzing ALAE entirely apart from the related loss costs using methods that compare the development of ALAE payments at various stages and (*b*) using combined loss and ALAE data in situations where it appears likely that this would produce more accurate estimates (e.g., when the company has changed its claim defense posture so that defense costs increase and loss costs decrease). In this latter approach, statistical tests and projections are based on the combined data for losses and ALAE.

4.57 Some companies establish case-basis reserves for certain types of ALAE or increase case-basis loss reserves by a stated percentage to provide for ALAE. In either case, additional ALAE reserves should be provided for the development of case-basis reserves and IBNR.

ULAE Reserve Calculation Approaches

4.58 ULAE reserves are often provided for by using the calendar year paid-to-paid method rather than the accident year paid-to-paid method used for ALAE reserves. Although the paid-to-paid ratios establish the relationship of the ULAE payments to the loss payments, the timing of the ULAE payments is also critical to estimation of the ULAE reserves. For example, some companies assume that a portion of ULAE costs is incurred when a claim is placed on the books and the remaining portion is incurred when the claim is settled. For reported claims, the cost of placing the claim on the books has been incurred, so it is only necessary to provide a reserve for the remaining portion at settlement. For IBNR claims, it is necessary to provide for all of the ULAE. Some companies perform internal studies to establish the methods and ratios to be used in their calculations.

4.59 The ULAE reserves should provide for inflation. The assumption that ULAE will inflate at a rate equal to the rate at which losses inflate should be periodically reviewed. The rate should also be adjusted for expected technological or operational changes that might cause economies or inefficiencies in the claim settlement process.

4.60 If paid-to-paid ULAE ratios will be calculated for each line of business, a reasonable basis for allocating paid ULAE by line of business should be established.

Changes in the Environment

4.61 Loss reserve projections are used to estimate loss reporting patterns, loss payment patterns, and ultimate claim costs. An inherent assumption in such projections is that historical loss patterns can be used to predict future patterns with reasonable accuracy. Because many variables can affect past and future loss patterns, the effect of changes in such variables on the results of loss projections should be carefully considered.

4.62 Identification of changes in variables and consideration of their effect on loss reserve projections are critical steps in the loss reserving process. The evaluation of these factors requires the involvement of a loss reserve specialist as well as input from various operating departments within the company such as the marketing, underwriting, claims, actuarial, reinsurance, and legal departments. Management's use of a specialist in determining loss reserves is discussed in paragraphs 4.65 through 4.68 of this chapter.

4.63 Variables to be considered in evaluating the results of loss reserve projections include those variables affecting inherent and control risk described in appendix A. If changes in variables have occurred, mechanical application of loss projection methods may result in unreasonable estimates of ultimate claim costs. Changes in variables can be considered in the loss reserving process in a variety of ways, including—

- *Selection of loss projection method(s).* Loss projection methods vary in their sensitivity to changes in the underlying variables and to the length of the claim emergence pattern. When selecting a loss projection method, consideration should be given to how a change in the underlying data will affect that method. For example, if management has adopted a policy to defer or accelerate the settlement of claims, a paid-loss extrapolation method will probably produce unreliable results. In that case, an incurred-loss extrapolation or other methods may produce better estimates of ultimate losses.
- *Adjustment of underlying historical loss data.* In certain cases, the effect of changed variables can be isolated and appropriately reflected in the historical loss data used in the loss projection. For example, if policy limits are relatively consistent for all policies in a block of business, and if these limits have recently been reduced by a constant amount, historical loss data can be adjusted to exclude amounts in excess of the revised policy limits.
- *Further segregation of historical loss data.* Certain changes in variables can be addressed by further differentiating and segregating historical loss data. For example, if a company begins to issue claims-made policies for a line of business for which it traditionally issued occurrence-basis policies, segregation of data between the two types of policies should minimize the effect of the different reporting patterns. Such segregation should produce more accurate loss reserve projections for the occurrence-basis policies. (However, loss development data relating to the claims-made policies will be limited in the initial years.)

- *Separate calculation of the effect of variables.* The effect of certain changes in variables can be isolated and separately computed as an adjustment to the results of other loss projection methods. For example, if claim cost severity has increased (an increase in auto repair costs) or is expected to increase beyond historic trends, an additional reserve can be separately computed to reflect the effect of such actual or anticipated increases.
- *Qualitative assessments.* In many instances, the magnitude or effect of a change in a variable will be uncertain. The establishment of loss reserves in such situations requires considerable judgment and knowledge of the company's business. Following is an example of an environmental variable that may have uncertain effects on loss reserve estimates.

Superfund legislation enacted by Congress seeks recovery from anyone who ever owned or operated a particular contaminated site or from anyone who ever generated or transported hazardous materials to a site. These parties are commonly referred to as potentially responsible parties, or PRPs. Potentially, the liability can extend to subsequent owners or to the parent company of a PRP.

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. Third-party damages, legal defense costs, and cleanup expenses for non-Superfund sites will add significantly to this figure. 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 the courts. 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 the like. Even homeowners' policies are potentially exposed to the cleanup costs for leaks from underground heating oil storage tanks.

The development of environmental and similar claims may not follow the usual development pattern of general liability claims, with which they are usually grouped. When the activity of these claims is sufficient to distort the recorded development of the company, the distorting activity should be isolated from the development history so that an accurate projection of the remaining claims can be made. Management's process of assessing its environmental and similar exposure should include procedures to—

- Insure that all data elements are recorded on each incoming claim or precautionary notice.

- Assess the company's exposure to these types of liability claims by considering such factors as the types of risks historically written, layers of coverage provided, the policy language employed, and recent decisions rendered by courts.
- Determine whether any portion of potential liability costs is probable and reasonably estimable.

4.64 FASB Statement No. 5 and Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*, provide guidance for the accounting and disclosure of loss contingencies.

Use of Specialists by Management in Determining Loss Reserves

4.65 Management is responsible for making the accounting estimates included in the financial statements. As explained in the previous sections of this chapter, the process of estimating loss reserves is complex and involves many subjective judgments. Accordingly, the determination of loss reserves should involve an individual with a sufficient level of competence and experience in loss reserving, including knowledge about the kind(s) of insurance for which a reserve is being established and an understanding of appropriate methods available for calculating loss reserve estimates. These individuals are referred to as "loss reserve specialists" in this chapter. The specialist's level of competence and experience should be commensurate with the complexity of the company's business, which is affected by such factors as the kind(s) of insurance underwritten and the environmental and risk considerations listed in appendix A. Criteria that may be considered in determining whether an individual qualifies as a loss reserve specialist include the aforementioned as well as the following:

- Knowledge of various projection techniques, including their strengths and weaknesses and applicability to various lines of insurance
- Knowledge of changes in the environment in which the company operates, including regulatory developments, social and legal trends, court decisions, and other factors described in more detail in the appendix and the effect that these factors will have on the emergence and ultimate cost of these claims

4.66 The Casualty Actuarial Society (CAS) offers a course of study and examinations that are designed to train individuals to be, among other things, loss reserve specialists. In addition, the American Academy of Actuaries establishes qualification standards for its members who practice in this area. Although many casualty actuaries may therefore be qualified to be loss reserve specialists, other individuals, through their experience and training, may also be qualified. Training and experience should provide individuals with knowledge about different policy forms and coverages, current developments in insurance, and environmental factors that might affect the loss reserving process. Training and experience should also provide individuals with knowledge that will enable them to apply appropriate methods of estimating loss reserves. The extent of this knowledge and ability should be commensurate with the complexity and kinds of business written.

4.67 Many insurance companies use loss reserve specialists who are employees or officers of the company. In addition, many companies engage consulting casualty actuaries to either assist in the determination of the loss reserve estimate or to perform a separate review of the company's loss reserve

estimate. The scope of work to be performed by the consulting actuary is a matter of judgment by company management. Usually, the consulting actuary will issue a report summarizing the nature of the work performed and the results. Since 1990, the Annual Statement has required a Statement of Actuarial Opinion relating to loss and loss adjustment expense reserves.

4.68 Because the process of estimating loss reserves is complex and involves many subjective judgments, the absence of involvement by a loss reserve specialist in the determination of management's estimate may constitute a reportable condition and possibly a material weakness in the entity's internal control structure. SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit*, describes the auditor's responsibility to communicate reportable conditions to the audit committee. A discussion of the auditor's use of loss reserve specialists is included in paragraph 4.65 of this chapter.

Auditing Loss Reserves

Auditing the Claims Data Base

4.69 The historical experience of an insurance entity is generally the primary source of information on which loss reserve estimates are based; therefore, the creation of reliable data bases, within an insurance company, is extremely critical to the determination of loss reserve estimates. When evaluating loss reserves, the auditor should consider the reliability of the historical information generated by the insurance company.

4.70 The auditor should determine what historical data and methods have been used by management in developing the loss reserve estimate and whether he or she will rely on the same data or other statistical data in evaluating the reasonableness of the loss reserve estimate. After identifying the relevant data, the auditor should obtain an understanding of the internal control structure policies and procedures related to the completeness, accuracy, and classification of the loss data; assess control risk for assertions about loss reserves; and determine the nature, timing, and extent of substantive tests that will be performed for these assertions. Because claim data and characteristics such as dates and type of loss can significantly influence reserve estimation, the auditor should test the completeness, accuracy, and classification of the claim loss data. Exhibit B-2 in appendix B of this guide provides more extensive guidance on auditing the claims cycle.

Evaluating the Reasonableness of the Estimate

Selecting an Audit Approach

4.71 SAS No. 57 states that the auditor should obtain an understanding of how management developed the accounting estimates included in the financial statements. The loss reserve estimate is a significant estimate on the financial statements of an insurance entity. Accordingly, regardless of the approach used to audit the loss reserve estimate, the auditor should gain an understanding of how management developed the estimate. The auditor should use one or a combination of the following approaches in evaluating the reasonableness of the accounting estimates:

a. Review and test the process used by management to develop the estimate.

b. Develop an independent expectation of the estimate to corroborate the reasonableness of management's estimate.

c. Review subsequent events or transactions occurring prior to completion of fieldwork.

4.72 When auditing loss reserve estimates, usually approach *a*, *b*, or a combination of the two is used. Normally, approach *c* alone is insufficient to provide reasonable assurance because claims are usually reported to insurance companies and settled over a period of time extending well beyond a normal opinion date. However, approach *c* may provide additional information concerning the reasonableness of loss reserve estimates, particularly for short-tail lines of business, when used in combination either with approach *a* or *b* or with both.

4.73 When planning the audit, the auditor chooses to use either approach *a* or *b*, or a combination of both approaches, depending on his or her expectation of what approach will result in sufficient competent evidential matter in the most cost-effective manner. Either approach can be used and, depending on client circumstances, either approach may be effective. However, when management has not used the services of a loss reserve specialist in developing its loss reserve estimate, approach *a*, reviewing and testing management's process, is not appropriate. In this circumstance, approach *b*, developing an independent expectation, should be used.

Reviewing and Testing the Process Used by Management to Develop the Estimate

4.74 The auditor may assess the reasonableness of an accounting estimate by performing procedures to test the process used by management to make the estimate. This approach may be appropriate when loss reserve estimates are recommended by an outside loss reserve specialist and management accepts those recommendations, when loss reserve specialists employed by the company are responsible for recommending the estimates, or when both outside and internal specialists are used.

4.75 A company that uses an outside loss reserve specialist to develop loss reserve recommendations may engage the specialist to evaluate only the company's major lines of business or only certain components of the loss reserves. In either circumstance, the auditor should determine whether a different approach is needed for auditing the items not reported on by the loss reserve specialist.

4.76 If the auditor reviews and tests the process used by management to develop its estimate, and management's estimate differs significantly from the recommendations developed by its specialists, appropriate procedures should be applied to the factors and assumptions that resulted in the difference between management's estimate and the specialists' recommendations. Such procedures should include discussion with management and its specialists. It is management's responsibility to record its best estimate of loss reserves in the financial statements.

4.77 SAS No. 57 identifies the following as procedures the auditor may consider performing when using this approach. Some of the procedures listed below apply to the process management uses to supply data to the loss reserve specialist, some apply to the process used by the specialist to develop recommendations, some apply to the process used by management to review and evaluate those recommendations, and some apply to the process management uses to translate the specialist's recommendations into the loss reserve estimates recorded in the financial statements.

a. *Identify whether there are controls over the preparation of accounting estimates and supporting data that may be useful in the evaluation.* Controls over the preparation of accounting estimates may include—

- Procedures for selecting independent loss reserve specialists or hiring internal specialists, including procedures for determining that the specialist has the requisite competence in loss reserving, knowledge of the company's types of business, and understanding of the different methods available for calculating loss reserve estimates.
- Procedures for reviewing and evaluating the recommendations of the loss reserve specialist.
- Procedures to ensure that the methods used to calculate the loss reserve estimate are appropriate and sufficient in the circumstances.

Controls over the preparation of supporting data, in addition to those discussed in exhibit B-2 in appendix B of this guide, may include—

- Procedures for verifying that data used by the loss reserve specialist is appropriately summarized and classified from the company's claims data base.
- Procedures for ensuring that data actually used by the loss reserve specialist is complete and accurate.
- Procedures to substantiate and determine the appropriateness of industry or other external data sources used in developing assumptions (for example, data received from involuntary risk pools).

b. *Identify the sources of data and factors that management used in forming the assumptions, and consider whether such data and factors are relevant, reliable, and sufficient for the purpose, based on information gathered in other audit tests.* Sources of data and factors used may include—

- Company historical claims data from its own data bases, including changes and trends in the data.
- Company information on reinsurance levels and changes from prior years' reinsurance programs.
- Data received from involuntary risk pools such as the National Council on Compensation Insurance.
- Industry loss data from published sources.
- Internal company experience or information from published sources concerning recent trends in socioeconomic factors affecting claim payments, such as—
  - — General inflation rates and specific inflation rates for medical costs, wages, automobile repair costs, and the like.
  - — Judicial decisions assessing liability.
  - — Judicial decisions regarding noneconomic damages.
  - — Changes in legislation affecting payment levels and settlement practices.

Consider whether the company's data is sufficient to have adequate statistical credibility (e.g., to allow the "law of large numbers" to work for the company's

estimates). Consider whether the types of industry data used in developing assumptions are relevant to the company's book of business, considering policy limits, reinsurance retention, geographic and industry concentrations, and other appropriate factors.

c. *Consider whether there are additional key factors or alternative assumptions about the factors.* Key factors and potential alternative assumptions that might be considered include—
   - Changes in the company's experience or trends in loss reporting and settlements. Increases in the speed of the settlement of claims may lead to assumptions that paid development levels will be lower in the future, or may indicate changes in the company's procedures for processing claims that could lead to increased development in the future.
   - Divergence in company experience relative to industry experience. Such divergence might later result in company development experience that reduces the divergence or might be indicative of a change in a company's experience with a book of business.
   - Changes in a company's practices and procedures relating to recording and settling claims.
   - A company's reinsurance programs and changes therein.
   - Changes in a company's underwriting practices such as new or increased use of managing general agents.
   - New or changed policy forms or coverages.
   - Recent catastrophic occurrences.

d. *Evaluate whether the assumptions are consistent with each other, the supporting data, relevant historical data, and industry data.* Assumptions that should be evaluated include not only explicit assumptions but also the assumptions inherent in various loss projection methods.
   - Paid loss projection methods assume that a company's historical experience relating to the timeliness of settlement will be predictive of future results.
   - Reported (incurred) loss development projection methods assume that a company's experience in estimating case-basis reserves will be repeated in the future.

e. *Analyze historical data used in developing the assumptions to assess whether it is comparable and consistent with data of the period under audit, and consider whether the data is sufficiently reliable for the purpose.* Consider whether the company's past methods of estimating loss reserves have resulted in appropriate estimates and whether current data (for example, current-year development factors) indicate changes from prior experience. Consider how known changes in the company's loss reporting procedures and settlement practices have been factored into the estimate. Consider how changes in reinsurance programs, in the current period and during historical periods, have been factored into management's estimates.

f. *Consider whether changes in the business or industry may cause other factors to become significant to the assumptions.* Consider such changes as—
   - New lines of business and classes of business within lines.
   - Changes in reinsurance programs.

- Changes in the regulatory environment, such as premium rate rollbacks and regulation.
- Changes in the method of establishing rates and changes in methods of underwriting business.

g. *Review available documentation of the assumptions used in developing the accounting estimates, inquire about any other plans, goals, and objectives of the entity, and consider their relationship to the assumptions.* A company's practices concerning loss settlement, such as a practice of vigorously defending suits or of quickly settling suits, can have a significant effect on a company's loss experience.

h. *Consider using the work of a specialist regarding certain assumptions.* Using the work of a specialist is discussed in SAS No. 73, *Using the Work of a Specialist*, and in paragraphs 4.102 through 4.104 of this chapter.

i. *Test the calculations used by management to translate the assumptions and key factors into the accounting estimate.* Consider whether all lines of business and accident years are included in the loss reserve estimate. Consider how reinsurance receivable, salvage, and subrogation have been included.

Developing an Independent Expectation of the Estimate

4.78 Based on his or her understanding of the facts and circumstances, the auditor may independently develop an expectation of the estimate by using other key factors or alternative assumptions about those factors. This approach is required whenever management has not used the services of a loss reserve specialist in developing its loss reserve estimate and may be appropriate to assist the auditor in assessing the variability of the loss reserve estimates, even when management does use a loss reserve specialist. The auditor frequently develops independent projections because this method may result in a more cost-effective method of obtaining sufficient competent evidential matter.

4.79 When this approach is used, the auditor should use an outside loss reserve specialist (the auditor may also be a loss reserve specialist) to develop the independent expectation of the loss reserve estimate. The use of a specialist is discussed in paragraphs 4.102 through 4.104 of this chapter.

Analytical Procedures

4.80 Various analytical procedures may be used in the evaluation of loss reserve trends and data, such as the analysis of—

- Loss ratios.
- Loss frequency and severity statistics.
- Claim cost by exposure units.
- Adequacy/redundancy of prior year reserves.
- Average case reserves.
- Claim closure rates.
- Paid to incurred ratios.

4.81 Such analyses include comparison of trends and data with industry averages or other expectations. Evaluation would normally be performed by line of business and accident or report year.

Loss Reserve Ranges

4.82 As stated in SAS No. 57:

> Estimates are based on subjective as well as objective factors and, as a result, judgment is required to estimate an amount at the date of the financial statements. Management's judgment is normally based on its knowledge and experience about past and current events and its assumptions about conditions it expects to exist and courses of action it expects to take.

> Accordingly, loss reserves may develop in a number of ways and a reserve for a particular line of business or accident year may prove to be redundant or deficient when analyzed in a following period. Loss reserves considered to be adequate in prior periods may need to be adjusted at a later date as a result of events outside the control of the insurance company that create the need for a change in estimate. Such events include future court decisions and periods of inflation, in which rates may change significantly from period to period and affect the payout of claims. As a result of the circumstances described above, the need to adjust loss reserve estimates in future periods because of future events that are not predictable at the balance sheet date should not be interpreted as evidence of an error or poor loss reserving practices in the past.

4.83 Because the ultimate settlement of claims is subject to future events, no single loss reserve estimate can be considered accurate with certainty. An audit approach should address the inherent variability of loss reserve estimates and the effect of that variability on audit risk. The development of a single loss reserve projection, by itself, does not address the concept of variability and may not provide sufficient evidence to evaluate the reasonableness of the loss reserve provision in the financial statements. An analysis of the reasonableness of loss reserve estimates ordinarily should include an analysis of the amount of variability in the estimate. One way to perform this analysis is to consider a range of loss reserve estimates bounded by a high and a low estimate. The high and low ends of the range should not correspond to an absolute best-and-worst-case scenario of ultimate loss settlements, because such estimates may be the result of unlikely assumptions. The range should be realistic and therefore should not include the set of all possible outcomes but instead only those outcomes that are considered reasonable. Extreme projections should be critically analyzed and, if appropriate, be adjusted, given less credence, or discarded (this would apply to projections outside a cluster of other logical projections that fall within a narrower range).

4.84 Another way to address the variability of the loss reserve estimate is to develop a best estimate and to supplement it with qualitative analysis that addresses the variability of the estimate. Qualitative analysis involves consideration of the factors affecting the variability of loss reserves and integrating such factors into a determination of the range of reasonable estimates around a best estimate. Such factors, among others, include the mix of products underwritten, losses incurred by the insurance industry for similar coverages and underwriting years, and the correlation between past and current business written. In any analysis, a thorough working knowledge of the risk factors is a prerequisite to setting a realistic range. Whether the auditor prepares a formal reserve range or a selected estimate, factors affecting the variability of the recorded loss reserve should be considered. The audit procedures performed for this purpose will vary based on the characteristics of the business, the controls

the company uses to monitor such variability, and other audit procedures used.

4.85 The size of the loss reserve range will vary by line of business. For example, automobile physical damage claims may be estimated with greater precision than product liability claims. In extreme cases, the top-to-bottom range could extend to 50 percent and upward of the amount provided. An example of an extreme case might be a newly formed company that writes primarily volatile types of business. The results of operations in such a situation are sensitive to future fluctuations since the loss reserve estimate is based primarily on assumptions that will undoubtedly change over time. More important, however, is the strain that any extremely adverse loss development would place on such a company's surplus. In an opposite extreme case, the top-to-bottom range might only be 5 percent of the amount provided for a company that only writes automobile physical damage coverages.

4.86 When evaluating the variability of loss reserves for an entity, the auditor should be aware that variability within an individual risk group or line of business may be mitigated by the variability within other risk groups or lines of business. In other words, it is unlikely that ultimate claim settlements for each line of business will fall at the same end of the range.

Risk Factors and Developing a Range

4.87 Because loss reserves represent both reported and unreported claims that have occurred as of the valuation date, the auditor needs to gain an understanding of the company's exposure to risk through the business it writes as well as an understanding of environmental factors that may affect the company's loss development at the valuation date.

4.88 Some risk factors existing within the company that may affect the variability of the company's loss reserves are—

- *The frequency and severity of claims associated with a line of business.* Medical malpractice, directors' and officers' liability, and other lines of business that typically produce few claims with large settlement amounts tend to have a high degree of variability.
- *Policy characteristics.* Individual lines of business can be written on different policy forms. For example, loss reserving and its related variability for medical malpractice written on an occurrence basis will differ markedly when the policy is written on a claims-made basis, especially during the early years of conversion from an occurrence to a claims-made basis.
- *Retention levels.* The greater a company's retention level, the more variable the results are likely to be. This increased variability is due to the effect that one or several large losses can have on the overall book of business. For reinsurance assumed, the concepts analogous to retention levels are referred to as attachment points and limits.
- The mix of a company's business with respect to long-tail liability lines and short-tail property lines. Typically, loss reserves on business with longer tails exhibit greater variability than on business with shorter tails because events affecting ultimate claim settlements may occur at a later date.

4.89 Some external factors that may affect the variability of loss reserves are—

- Catastrophes or major civil disorders.
- Jury awards and social inflation arising from the legal environment in principal states in which a company's risks are underwritten.
- The effect of inflation.

4.90 Other risk factors that may affect the variability of loss reserve estimates are described in appendix A.

4.91 The auditor should obtain an understanding of both internal and external risk factors. This may be accomplished by a review of contracts, inquiries of underwriters, a review of pertinent trade publications, and any other procedures deemed necessary under the circumstances. The auditor should consider these factors in evaluating a reasonable loss reserve range. The best estimate may not necessarily be midway between the highest and lowest estimates in the range, because certain factors (for example, risk retention limits and retrospectively rated contracts) may reduce the variability at one end of the range but not at the other.

4.92 When analyzing the variability of loss reserves, the auditor should be aware of potential offsets that may serve to reduce the financial statement effects of misstatements in the recorded loss reserves. Two common examples are ceded reinsurance and retrospectively rated contracts (primary or reinsurance). Such offsets, if material, should be included in an analysis of reserve ranges to quantify the true income statement or balance sheet effect that results from an increase or decrease in loss reserves.

4.93 As noted previously in the discussion of internal risk factors and per-risk retention levels, a lower net retention level typically would translate into a lower variability of reserves. In addition, the auditor should consider the workings of all significant reinsurance ceded contracts and the effect that these contracts have on best estimates and high and low points in a range. In considering the effect of reinsurance ceded agreements on loss reserves, the auditor should also consider the effect on ceded reinsurance premiums. See paragraphs 4.108 through 4.110 of this chapter for a discussion of the effects of ceded reinsurance on loss reserve estimates.

4.94 A retrospectively rated feature in an insurance contract means that increases or decreases in incurred losses may be wholly or partially offset by changes to earned but unbilled premiums. As a result of such a clause, an increase in loss reserves may lead to a receivable for additional premiums while a decrease in loss reserves may be offset by a reduction in premiums.

Evaluating the Financial Effect of a Reserve Range

4.95 To determine the amount of variability that is significant to the financial statements, the financial leverage of a company should be analyzed. Financial leverage refers to items such as reserve-to-surplus ratios. The financial position of a company with a 2-to-1 reserve-to-surplus ratio is less affected by variability in its loss reserves than is a company operating at a 4-to-1 ratio.

4.96 Additionally, an analysis comparing the difference between recorded loss reserves and the high and low ends of a range with key financial statement balances, such as surplus or recorded loss reserves, might be performed. Combining financial leverage with other materiality factors pertinent to the company (for example, loan covenant agreements) may provide insights into the amount of variability that is acceptable to the auditor. Because of the imprecise nature of estimating loss reserves, the acceptable range of loss reserve estimates will generally be higher than that of a more tangible balance such as accounts receivable or payable.

4.97 According to SAS No. 47, *Audit Risk and Materiality in Conducting an Audit*, "If the auditor believes the estimated amount included in the financial statements is unreasonable, he should treat the difference between the estimate and the closest reasonable estimate as a likely misstatement and aggregate it with other likely misstatements." Therefore, if the recorded loss reserve is outside the realistic range, the difference between the recorded reserve and the nearer end of the realistic reserve range should be treated as an audit difference. This audit difference should be considered with any other audit differences to evaluate the materiality of the effects on the financial statements. If the difference is deemed material, the auditor should first ask management for additional information that may have been overlooked in the original evaluation. Then, if still necessary, the auditor should attempt to persuade management to make an appropriate adjustment. If management does not make an appropriate adjustment, the auditor should consider modifying his or her report on the financial statements.

4.98 SAS No. 47 also states, "Since no one accounting estimate can be considered accurate with certainty, the auditor recognizes that a difference between an estimated amount best supported by the audit evidence and the estimated amount included in the financial statements may be reasonable, and such difference would not be considered to be a likely misstatement." Accordingly, if the recorded loss reserve is within the reasonable range developed by the auditor, an audit adjustment may not be appropriate.

4.99 The significance of the variability within a realistic reserve range should also be evaluated against the financial statements. If the difference between the company's recorded reserve and the farther end of the reserve range is deemed significant, the auditor should consider extending audit procedures to obtain additional evidential matter relating to the reserve estimate.

4.100 Management must select a single loss reserve estimate that represents its judgment about the most likely circumstances and events. If management develops a reasonable range, the amount recorded should be the best estimate within that range. The auditor should obtain an understanding of the process used by management in arriving at this estimate. In determining the reasonableness of loss reserves, the auditor also should consider the consistency of reserve estimates and any changes in the degree of conservatism of recorded reserves. A change in the degree of conservatism of management's estimate may be indicative of a change in management's reserve process. SAS No. 32, *Adequacy of Disclosure in Financial Statements*, discusses the auditor's responsibility to consider whether the financial statements include adequate disclosure of material matters in light of the circumstances and facts of which the auditor is aware.

Auditor Uncertainty About the Reasonableness of Management's Estimate and Reporting Implications

4.101 Ordinarily, the auditor would look to historical data to obtain evidential matter that will provide reasonable assurance that management's estimate of loss reserves is reasonable in the circumstances. Such historical data may not currently exist for certain new companies, for companies writing significant amounts of new lines of business, or for companies with a low volume of claims. When the historical data is not sufficient to resolve uncertainty about the reasonableness of management's estimate of loss reserves and the auditor is unable to resolve that uncertainty through other means, the au-

ditor should consider whether management has adequately disclosed the uncertainty in the notes to the financial statements as required by FASB Statement No. 5 and paragraphs 4 and 6 of FASB Interpretation No. 14, and SOP 94-6. A matter involving an uncertainty is one that is expected to be resolved at a future date at which time conclusive evidential matter concerning its outcome would be expected to become available. Conclusive evidential matter concerning the ultimate outcome of uncertainties cannot be expected to exist at the time of the audit because the outcome and related evidential matter are prospective. In these circumstances, management is responsible for estimating the effect of future events on the financial statements, or determining that a reasonable estimate cannot be made and making the required disclosures, all in accordance with GAAP, based on management's analysis of existing conditions. Absence of the existence of information related to the outcome of an uncertainty does not necessarily lead to a conclusion that the evidential matter supporting management's assertion is not sufficient. Rather, the auditor's judgment regarding the sufficiency of the evidential matter is based on the evidential matter that is, or should be, available. If, after considering the existing conditions and available evidence, the auditor concludes that sufficient evidential matter supports management's assertion about the nature of a matter involving an uncertainty and its presentation or disclosure in the financial statements, an unqualified opinion ordinarily is appropriate. If the auditor is unable to obtain sufficient evidential matter to support management's assertions about the nature of a matter involving an uncertainty and its presentation or disclosure in the financial statements, the auditor should consider the need to express a qualified opinion or to disclaim an opinion because of a scope limitation. A qualification or disclaimer of opinion because of a scope limitation is appropriate if sufficient evidential matter related to an uncertainty does or did exist but was not available to the auditor for reasons such as management's record retention policies or a restriction imposed by management.

Use of Specialists by Auditors in Evaluating Loss Reserves

4.102 It is the auditor's responsibility to evaluate the reasonableness of the loss reserve established by management. The procedures that the auditor should consider in evaluating the reasonableness of the loss reserve are described in SAS No. 57. One of the procedures the auditor may consider in evaluating the reasonableness of the loss reserve is using the work of a specialist. SAS No. 73 provides guidance to the auditor who uses the work of a specialist in performing an audit of financial statements. It states that the auditor is not expected to have the expertise of a person trained for or qualified to engage in the practice of another profession or occupation. The Statement also states that the auditor should evaluate the relationship of the specialist to the client, including circumstances that might impair the specialist's objectivity. When a specialist does not have a relationship with the client, the specialist's work usually will provide the auditor with greater assurance of reliability. Although SAS No. 73 does not preclude the auditor from using the work of a specialist who is related to the client, because of the significance of loss reserves to the financial statements of insurance companies and the complexity and subjectivity involved in making loss reserve estimates, the audit of loss reserves requires the use of an outside loss reserve specialist, that is, a specialist who is not an employee or officer of the company. The term *loss reserve specialist* is defined in paragraphs 4.65 and 4.66 of this chapter. When the auditor has the requisite knowledge and experience in loss reserving, the auditor may serve as the loss reserve specialist. If the auditor does not possess

the level of competence in loss reserving to qualify as a loss reserve specialist, the auditor should use the work of an outside specialist.

4.103 In accordance with SAS No. 73, whenever the auditor uses the work of a specialist, the auditor should fulfill certain fundamental requirements. The auditor should satisfy himself or herself concerning the professional qualifications and reputation of the specialist by inquiry or other procedures. The auditor also should consider the relationship, if any, of the specialist to the client. An understanding should be established between the auditor, the client, and the specialist as to the scope and nature of the work to be performed by the specialist and the form and content of the specialist's report. The auditor has the responsibility to obtain an understanding of the methods or assumptions used by the specialist to determine whether the findings of the specialist are suitable for corroborating representations in the financial statements. These responsibilities apply to all the situations described in paragraph 4.104.

4.104 The following are descriptions of situations involving the presence or absence of a loss reserve specialist in management's determination of loss reserves and the recommended response by the auditor in each situation.

Situation 1—The company has no loss reserve specialist involved in the determination of loss reserves.

Auditor response to situation 1—As stated in paragraph 4.68, this situation may constitute a reportable condition and possibly a material weakness in the internal control structure. The auditor should use an outside loss reserve specialist to develop an independent expectation of the loss reserve estimate recorded by the company.

Situation 2—The company has an in-house loss reserve specialist who is involved in the determination of loss reserves and the company does not use an outside loss reserve specialist.

Auditor response to situation 2—The auditor would be required to use an outside loss reserve specialist to evaluate the reasonableness of the company's loss reserve estimate.

Situation 3—The company has no in-house specialist but involves an outside loss reserve specialist in the determination of loss reserves.

Auditor response to situation 3—The auditor should evaluate the relationship, if any, of the specialist to the company. If the specialist is related to the client, the auditor should perform additional procedures with respect to some or all of the specialist's assumptions, methods, or findings to determine that the findings are not unreasonable or should use an outside specialist for that purpose.

Situation 4—The company involves an in-house loss reserve specialist in the determination of loss reserves and involves an outside loss reserve specialist to separately review the loss reserves.

Auditor response to situation 4—The auditor could use the separate review performed by the outside loss reserve specialist.

Evaluating the Reasonableness of Loss Adjustment Expense Reserves

4.105 Evaluation of the reasonableness of LAE reserves involves many of the same skills that are needed to evaluate the reasonableness of loss reserves; therefore, such an evaluation ordinarily requires the use of an outside loss reserve specialist. Frequently, both ALAE reserves and ULAE reserves are cal-

culated based on formulas related to paid losses; therefore, in conjunction with the audit of loss adjustment expenses, the auditor should perform sufficient procedures to obtain assurance about the reliability of the paid-loss data. Although ALAE and ULAE frequently are calculated using formulas based on paid losses, they are calculated differently; accordingly, different procedures are used in the evaluation of these two types of reserves.

4.106 In most circumstances, a development test cannot be used as a test of the reasonableness of the ULAE reserve. The reasonableness of the ULAE reserve is primarily dependent on the application of sound techniques of cost accounting and expense allocation. The basis of this allocation should be reviewed by the auditor because the way that the company allocates its expenses will have an effect on the ULAE reserve calculation. This review should focus on the allocation of costs to the loss adjustment classification as well as the allocation within that classification to the individual lines of business.

Ceded Reinsurance Receivable

4.107 This section discusses certain concepts and procedures that the auditor should be aware of to make a proper evaluation of the reasonableness of reinsurance receivable. This section does not address the following items, which are discussed in chapter 6. Reference should be made to chapter 6 of this guide for information about—

- The purpose and nature of reinsurance.
- Forms and types of reinsurance.
- Generally accepted accounting practices for reinsurance transactions.
- Internal control structure considerations relating to ceded and assumed reinsurance and a description of audit procedures to verify the integrity of recorded transaction data pursuant to such agreements.

Understanding an Insurance Company's Reinsurance Program

4.108 Chapter 6 of this guide recommends that the auditor obtain an understanding of an insurance company's reinsurance program to properly perform audit procedures to verify the accuracy and completeness of recorded cessions and assess the ability of reinsurers to meet their financial obligations under such agreements. This understanding is also essential to properly evaluate the reasonableness of reinsurance receivable balances. The scope of this understanding should not be limited to the reinsurance program currently in effect but should also include reinsurance program(s) in effect during historical periods from which loss experience will be used to project current year ultimate losses and reinsurance recoveries.

4.109 Net loss development patterns will vary to the extent that current reinsurance arrangements (coverages, levels of retention, and type and form of reinsurance) differ from arrangements in effect during the claim experience period used to project losses. Accordingly, the effect of such differences on estimates of reinsurance receivables will need to be carefully assessed by the auditor. The level of complexity involved in making this assessment is largely dependent on the types of reinsurance used and the amount of experience available under the program.

4.110 Special difficulties arise in estimating reinsurance receivable on excess of loss reinsurance arrangements in which claim frequency is sporadic,

retention levels have changed, and aggregate excess of loss arrangements is used. Estimates of reinsurance receivables are generally easiest for primary coverages (first dollar coverage of either property or casualty business). Additionally, relying on expected loss ratios as a guide for estimating recoveries on excess reinsurance arrangements will not be very helpful if the pricing of such arrangements has varied from year to year with little correlation to the underlying economics of these agreements. Some companies separately project reinsurance receivable on IBNR losses by stratifying the data base by size of loss.

Disclosures of Certain Matters in the Financial Statements of Insurance Enterprises

Introduction

4.111 Most of the accounting principles related to disclosures for insurance enterprises were promulgated over twenty years ago when the insurance regulatory and business environments were less complex and volatile. Accordingly, the AICPA Accounting Standards Executive Committee (AcSEC) added a project to its agenda to consider whether new disclosures should be required in insurance enterprises' financial statements. SOP 94-5 is a result of that project.

Scope

4.112 SOP 94-5 applies to annual and complete sets of interim financial statements prepared in conformity with GAAP of property and casualty insurance enterprises as well as life and health insurance enterprises (including mutual life insurance enterprises), reinsurance enterprises, title insurance enterprises, mortgage guaranty insurance enterprises, financial guaranty insurance enterprises, assessment enterprises, fraternal benefit societies, reciprocal or interinsurance exchanges, pools other than public-entity risk pools, syndicates, and captive insurance companies. Furthermore, AICPA Auditing Interpretation No. 12, "Evaluation of the Appropriateness of Informative Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis" (AICPA, *Professional Standards*, vol. 1, AU section 9623.60–.79), requires auditors to apply the same disclosure criteria for statutory financial statements as they do for financial statements prepared in conformity with GAAP.

Relationship to Other Pronouncements

4.113 In some circumstances, the disclosure requirements in SOP 94-5 may be similar to, or overlap, the disclosure requirements in certain other authoritative accounting pronouncements issued by the Financial Accounting Standards Board (FASB), the American Institute of Certified Public Accountants (AICPA), and the Securities and Exchange Commission (SEC). For example—

- FASB Statement No. 5 requires certain disclosures related to loss contingencies, including catastrophe losses of property and casualty insurance companies.
- FASB Statement No. 60 requires certain disclosures about liabilities for unpaid claims and claim adjustment expenses and statutory capital.

- FASB Statement No. 113 requires certain disclosures about reinsurance transactions.
- SOP 94-6 requires disclosures about certain significant estimates.
- The SEC Securities Act Guide 6, *Disclosures Concerning Unpaid Claims and Claim Adjustment Expenses of Property-Casualty Insurance Underwriters*, requires disclosures of information about liabilities for unpaid claims and claim adjustment expenses.

The disclosure requirements in SOP 94-5 supplement the disclosure requirements in other authoritative pronouncements. SOP 94-5 does not alter the requirements of any FASB or SEC pronouncement.

Conclusions

4.114 The disclosure requirements in this section should be read in conjunction with "Illustrative Disclosures," (paragraph 4.123 through 4.126) and "Discussion of Conclusions," which is presented in appendix P of this Guide.

Permitted Statutory Accounting Practices

4.115 Insurance enterprises currently prepare their statutory financial statements in accordance with accounting principles and practices prescribed or permitted by the insurance department of their state of domicile. The NAIC currently has a project under way to codify statutory accounting practices through a complete revision of its *Accounting Practices and Procedures Manuals*, that, when complete, is expected to replace prescribed or permitted statutory accounting practices as the statutory basis of accounting for insurance enterprises (referred to hereafter as the "codification"). Therefore, the codification will likely result in changes to what is currently considered a prescribed statutory accounting practice. Furthermore, postcodification-permitted statutory accounting practices will be exceptions to the statutory basis of accounting.

4.116 Prescribed precodification statutory accounting practices include state laws, regulations, and general administrative rules applicable to all insurance enterprises domiciled in a particular state; the NAIC's *Annual Statement Instructions*; the NAIC's *Accounting Practices and Procedures Manuals*; the *Securities Valuation Manual* (published by the NAIC Securities Valuation Office); NAIC official proceedings; and the NAIC's *Examiners' Handbook*.

4.117 Permitted statutory accounting practices include practices not described in paragraph 4.116 but allowed by the domiciliary state insurance department. Insurance enterprises may request permission from the domiciliary state insurance department to use a specific accounting practice in the preparation of their statutory financial statements (*a*) when the enterprise wishes to depart from the prescribed statutory accounting practices, or (*b*) when prescribed statutory accounting practices do not address the accounting for the transaction.

4.118 The disclosures in this paragraph should be made for permitted statutory accounting practices for the most recent fiscal year presented, regardless of when the permitted statutory accounting practice was initiated. Insurance enterprises should disclose the following information about permit-

ted statutory accounting practices that individually or in the aggregate materially affect statutory surplus or risk-based capital, including GAAP practices when the permitted practices differ from the prescribed statutory accounting practices:

a. A description of the permitted statutory accounting practice

b. A statement that the permitted statutory accounting practice differs from prescribed statutory accounting practices

c. The monetary effect on statutory surplus

Insurance enterprises should disclose the following information about permitted statutory accounting practices, excluding GAAP practices used, when prescribed statutory accounting practices do not address the accounting for the transaction:

a. A description of the transaction and of the permitted statutory accounting practice used

b. A statement that prescribed statutory accounting practices do not address the accounting for the transaction

Liability for Unpaid Claims and Claim Adjustment Expenses

4.119 The liability for unpaid claims and claim adjustment expenses represents the amounts needed to provide for the estimated ultimate cost of settling claims relating to insured events that have occurred on or before a particular date (ordinarily, the statement of financial position date). The estimated liability includes the amount of money that will be required for future payments of (*a*) claims that have been reported to the insurer, (*b*) claims related to insured events that have occurred but that have not been reported to the insurer as of the date the liability is estimated, and (*c*) claim adjustment expenses. Claim adjustment expenses include costs incurred in the claim settlement process such as legal fees; outside adjuster fees; and costs to record, process, and adjust claims.

4.120 Financial statements should disclose for each fiscal year for which an income statement is presented the following information about the liability for unpaid claims and claim adjustment expenses:

a. The balance in the liability for unpaid claims and claim adjustment expenses at the beginning and end of each fiscal year presented, and the related amount of reinsurance recoverable

b. Incurred claims and claim adjustment expenses with separate disclosure of the provision for insured events of the current fiscal year and of increases or decreases in the provision for insured events of prior fiscal years

c. Payments of claims and claim adjustment expenses with separate disclosure of payments of claims and claim adjustment expenses attributable to insured events of the current fiscal year and to insured events of prior fiscal years

Also, insurance enterprises should discuss the reasons for the change in the provision for incurred claims and claim adjustment expenses attributable to insured events of prior fiscal years and should indicate whether additional premiums or return premiums have been accrued as a result of the prior-year effects.

4.121 In addition to the disclosures required by FASB Statement No. 5 and other accounting pronouncements, insurance enterprises should disclose management's policies and methodologies for estimating the liability for unpaid claims and claim adjustment expenses for difficult-to-estimate liabilities, such as for claims for toxic waste cleanup, asbestos-related illnesses, or other environmental remediation exposures.

Effective Date and Transition

4.122 SOP 94-5 is effective for annual and complete sets of interim financial statements for periods ending after December 15, 1994. Disclosures of information required by paragraph 4.120 should be included for each fiscal year for which an income statement is presented.

Illustrative Disclosures

4.123 The following illustrations are guides to implementation of the disclosures required by SOP 94-5. Insurance enterprises are not required to display the information contained herein in the specific manner or in the degree of detail illustrated. Alternative disclosure presentations are permissible if they satisfy the disclosure requirements of SOP 94-5.

Permitted Statutory Accounting Practices

4.124 The following is an illustration of disclosures that an insurance enterprise would make before the codification is complete, to meet the requirements of paragraph 4.118.

Note X. Permitted Statutory Accounting Practices

Property and Casualty Company, Inc., domiciled in ABC State, prepares its statutory financial statements in accordance with accounting practices prescribed or permitted by the ABC State Insurance Department. Prescribed statutory accounting practices include a variety of publications of the National Association of Insurance Commissioners (NAIC), as well as state laws, regulations, and general administrative rules. Permitted statutory accounting practices encompass all accounting practices not so prescribed.

The company received written approval from the ABC State Insurance Department to discount loss reserves at a rate of X percent for statutory accounting purposes, which differs from prescribed statutory accounting practices. Statutory accounting practices prescribed by ABC state require that loss reserves be discounted at Y percent. As of December 31, 19X3, that permitted transaction increased statutory surplus by $XX million over what it would have been had prescribed accounting practice been followed.[11]

Liability for Unpaid Claims and Claim Adjustment Expenses

4.125 The following is an illustration of information an insurance enterprise would disclose to meet the requirements of paragraph 4.120. (This illustration presents amounts incurred and paid net of reinsurance. The information may also be presented before the effects of reinsurance with separate analysis of reinsurance recoveries and recoverables related to the incurred and paid amounts.)

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[11] If an insurance company's risk-based capital (RBC) would have triggered a regulatory event had it not used a permitted practice, that fact should be disclosed in the financial statements.

Note X. Liability for Unpaid Claims and Claim Adjustment Expenses

Activity in the liability for unpaid claims and claim adjustment expenses is summarized as follows.

	19X5	*19X4*
Balance at January 1	$7,030	$6,687
Less reinsurance recoverables	1,234	987
Net Balance at January 1	5,796	5,700
Incurred related to:		
Current year	2,700	2,600
Prior years	(171)	96
Total incurred	2,529	2,696
Paid related to:		
Current year	781	800
Prior years	2,000	1,800
Total paid	2,781	2,600
Net Balance at December 31	5,544	5,796
Plus reinsurance recoverables	1,255	1,234
Balance at December 31	$6,799	$7,030

As a result of changes in estimates of insured events in prior years, the provision of claims and claim adjustment expenses (net of reinsurance recoveries of $X and $X in 19X5 and 19X4, respectively) decreased by $171 million in 19X5 because of lower-than-anticipated losses on Hurricane Howard, and increased by $96 million in 19X4 because of higher-than-anticipated losses and related expenses for claims for asbestos-related illnesses, toxic waste cleanup, and workers' compensation.

4.126 The following is an illustration of an insurance enterprise disclosure designed to meet the requirements of paragraph 4.121. (Additional disclosures about the liabilities for unpaid claims and claim adjustment expenses may be required under FASB Statement No. 5, FASB Interpretation 14, *Reasonable Estimation of the Amount of a Loss*, AICPA SOP 94-6, and SEC requirements.)

Note X. Environmental-Related Claims

In establishing the liability for unpaid claims and claim adjustment expenses related to asbestos-related illnesses and toxic waste cleanup, management considers facts currently known and the current state of the law and coverage litigation. Liabilities are recognized for known claims (including the cost of related litigation) when sufficient information has been developed to indicate the involvement of a specific insurance policy, and management can reasonably estimate its liability. In addition, liabilities have been established to cover additional exposures on both known and unasserted claims. Estimates of the liabilities are reviewed and updated continually. Developed case law and adequate claim history do not exist for such claims, especially because significant uncertainty exists about the outcome of coverage litigation and whether past claim experience will be representative of future claim experience.

Chapter 5
The Investment Cycle

5.01 A property and liability insurance company functions as a conduit of funds. It collect funds from those desiring protection from financial loss and disburses funds to those who incur such losses. During the period between receipt of funds and the payment of losses, the property and liability insurance company invests the funds.

5.02 The assets of a property and liability insurance company consist mainly of investments in bonds, stocks, mortgage loans, and real estate.

Regulation

5.03 Because insurance companies have a public responsibility to be able to meet their obligations to policyholders, state insurance statutes and regulations prescribe standards and limitations on investment activities. Regulatory requirements and restrictions vary by state. Most states require insurance companies to invest a certain percent of reserves in specified classes of investments. Once the minimums are met, the company may invest in other kinds of investments. Most states, however, specify a maximum percentage of assets that may be invested in particular classes of investments. State regulations may also prescribe methods for reporting investments, set requirements regarding matters such as the location and safeguarding of assets, and set limitations on investing in futures, futures contracts, and options. For example, a regulatory authority may require some investments to be deposited with the state insurance department as a condition for writing business in that state. Insurance statutes and regulations vary by state, but the regulations of the state of domicile have precedence; however, substantial compliance provisions in states such as New York must also be followed. The auditor should obtain an understanding of the statutory requirements concerning investments of the company that could affect the company's intent to hold certain investments to maturity.

Investment Alternatives

5.04 Insurers plan their investment strategy to complement their insurance business. Funds are invested so that the income from investments plus maturities meets the ongoing cash flow needs of the company. This approach, one of matching assets and liabilities, requires a correct mix of long- and short-term investments and is generally referred to as asset and liability management.

Short-Term Investments

5.05 In addition to holding long-term investments consisting of bonds, stocks, real estate, and mortgages, insurance companies generally maintain short-term portfolios consisting of assets with maturities of less than one year to meet liquidity needs. Short-term investments of property and liability insurance companies typically consist of commercial paper, certificates of deposit, Treasury bills, and money market funds.

5.06 *Repurchase agreements.* The use of repurchase agreements (repos) as a short-term investment has gained widespread acceptance. Repos involve the purchase of securities by the insurance company (lender) with the stipulation that they will be repurchased by the seller (borrower) at a specified price within a specified time. In such transactions, the underlying securities may be received by the lender or a third-party custodian; they may also be designated or held by the borrower on behalf of the lender as "collateral." The maturity of the agreement is fixed by the contract and depends on the needs of the borrower and the willingness of the lender. For example, agreements may be structured on a day-by-day basis whereby the terms are negotiated daily.

5.07 The difference between the purchase price and the repurchase price, or sale price, plus accrued interest on the security represents investment income.

5.08 *Securities lending.* Insurance companies occasionally loan their bonds and stocks to securities brokers or dealers for temporary purposes, generally to cover a broker's short-sale or fail transactions, the latter arising when securities are not delivered in proper form. In exchange for lending the securities, the company should receive cash collateral from the broker in an amount equal to or exceeding the market values of the securities on that day; this collateral is immediately invested for the company's benefit. The market values of the securities on loan should be closely monitored, and changes in excess of an agreed-upon range cause the release of the collateral or an increase in collateral. Securities lending has no effect on the valuation of securities for statutory accounting purposes, provided the amount of the collateral at least equals the required collateral as specified by the NAIC; however, if the collateral is less than required, the value of the securities would be written down.

Other Investment Alternatives

5.09 Insurance companies have been increasingly attracted to alternative investments as part of their overall investment management strategy. Among these alternatives are futures contracts and stock options.

5.10 *Futures contracts.* Investments in futures contracts are gaining widespread acceptance as a means to hedge against market risk and help maintain a company's liquidity. Futures contracts are legal agreements between buyers or sellers and clearinghouses of futures exchanges; they represent commitments to buy or sell financial instruments at specified dates and prices.

5.11 *Options on equity securities.* In recent years, option writing by insurance companies has increased. State laws and regulations differ on the kinds of options, if any, that insurance companies are permitted to write, but some states permit insurance companies to write *covered-call options*. These are options for securities that insurance companies own and can deliver if the options are exercised by the option buyers. If an insurance company writes a covered-call option, it transfers to the option buyer the right to benefit from appreciation of the security underlying the option above the exercise price. Insurance companies usually write covered-call options because they consider the premium received for writing the options to be either (*a*) a hedge against a decline in the market price of the underlying security or (*b*) an increase in yield on the underlying security.

5.12 The premium received for selling a call option is carried in a deferred option account and reported as a liability until the option is exercised, expired,

or is eliminated through a closing purchase transaction. For statutory accounting purposes, the underlying securities and deferred option account are valued at market value.

The Transaction Cycle

5.13 The investment cycle includes all functions relating to the purchase and sale of investments. The cycle encompasses investment income and gains and losses, as well as custody of investment and recordkeeping. The functions within this cycle may be segregated into separate subcycles for each major kind of investment (such as bonds, stocks, mortgages, and real estate) because of the different activities and considerations for each kind.

5.14 Except for differences caused primarily by the regulatory environment and investment objectives, the investment transaction cycle of property and liability insurance companies is generally similar to that found in other financial services industries.

Investment Evaluation

5.15 Most insurance companies have separate investment departments responsible for managing the companies' investable funds. The evaluation and subsequent purchase or sale of investments is based on the judgment of the company's investment and finance committees. Typically, the finance committee, which usually consists of top-level management, is responsible for all investment activity. An investment committee of the company's investment department is usually assigned the duty of evaluating investment transactions. In addition to such factors as market conditions, interest rates, and risk, the evaluation of investments includes consideration of the company's investment objectives, current and projected cash flows, and relevant state regulations. When regulatory compliance is in question, the transaction ordinarily should be referred to the legal department for evaluation.

Safekeeping

5.16 An insurance company's treasury department is usually responsible for the safekeeping of securities. Securities are either stored in a company vault to which access is limited to authorized personnel or are held in the custody of banks, securities depositories, or state departments of insurance. Coupon-bearing securities may be arranged in the vault by payment date to ensure that they are redeemed on a timely basis.

Recordkeeping

5.17 Investment-cycle journal entries are a basic input for the company's financial statements. Journal entries should be prepared accurately and promptly to ensure that the financial statements include all transactions in the proper period.

5.18 The accounting department prepares an investment purchases and sales journal, as well as interest-income and dividend-income lists. This information is recorded on a cash basis and is reconciled monthly with cash receipts and disbursements listed in the cashier's department. At the end of the period, journal entries are made to convert the information to the accrual basis by ac-

cruing for interest earned and dividends declared but not received and by recording investment transactions with trade dates before the end of the period but not settled until after that period ends.

5.19 EDP applications are used to record most data relating to investment activity. Investment service reports and evaluation data (such as yield and income analyses, expected income, and market rate changes) may be produced by the computer and can provide management with an important source of information for the evaluation of investments. Management reports can be generated that indicate whether investments owned are in compliance with regulatory requirements. Reports containing information on investment purchases and sales, even the current investment portfolio, can be generated, and computer techniques are available to inform management when coupons should be remitted for interest payments and when securities mature. Other uses of the computer in the investment area include the preparation of amortization tables, dividend reports, and subsidiary ledgers for the different classes of securities.

Accounting Practices

5.20 The specialized industry accounting principles for investments of insurance companies are specified in FASB Statement No. 60. FASB Statement No. 80, *Accounting for Future Contracts*, provides the standards of financial accounting and reporting for futures contracts. FASB Statement No. 97 establishes reporting standards for insurance enterprises of realized gains and losses on investments. FASB Statement No. 115 establishes standards of financial accounting and reporting by insurance companies for investments in equity securities that have readily determinable fair values and for all investments in debt securities. FASB Statement No. 115 requires that those investments to which it applies be classified in three categories at acquisition and that the appropriateness of the classification be reassessed at each reporting date. The categories established by FASB Statement No. 115 are as follows:

- Held-to-maturity securities
- Trading securities
- Available-for-sale securities

Held-to-Maturity Securities

5.21 Held-to-maturity securities are those debt securities for which the entity has the positive intent and ability to hold to maturity. Held-to-maturity securities should be measured at amortized cost. Amortized cost is the original cost of the security, reduced by amortization of premiums or increased by accretion of discounts. Amortization should be calculated using the interest method, which results in a constant effective yield. Other methods of amortization may be used only if the results obtained are not materially different from those that would result from the interest method. The current-year amortization or accretion should be recorded as a charge or credit to investment income.

5.22 FASB Statement No. 115 recognizes that, while sales or transfers of these debt securities should be rare, there are certain changes in, circumstances that may cause an entity to change its intent to hold a certain debt security to maturity. The Statement lists changes in circumstances that might prompt an entity to transfer a debt security classified as held-to-maturity to another category without calling into question its intent to hold other debt securities to

maturity in the future. Events other than those listed in the Statement may lead to permissible transfers as long as the events are "isolated, nonrecurring, and unusual for the reporting enterprise that could not have been reasonably anticipated." Payments of catastrophic claims by a property and liability insurer generally would not be considered such an event.

5.23 When debt securities are transferred from the held-to-maturity category to the trading category, the unrealized holding gain or loss at the date of the transfer should be recognized in earnings immediately. When a debt security is transferred from the held-to-maturity category to the available-for-sale category, the unrealized holding gain or loss should be recognized in a separate component of shareholders' equity. When debt securities are transferred from the trading category to the held-to-maturity category, the unrealized holding gain or loss will have already been recognized in earnings and should not be reversed. When debt securities are transferred from the available-for-sale category to the held-to-maturity category, the unrealized holding gain or loss at the date of the transfer should continue to be reported in a separate component of shareholders' equity but should be amortized over the remaining life of the security as an adjustment of yield in a manner consistent with the amortization of any premium or discount.

5.24 The following information should be disclosed regarding the sale or transfer of any debt securities classified as held-to-maturity—

- the amortized cost of the security sold or transferred,
- the related realized or unrealized gain or loss, and
- the circumstances leading to the decision to sell or transfer the security.

Realized gains and losses on sales of securities classified as held-to-maturity should continue to be reported in the income statement as a component of other income, on a pretax basis, in accordance with paragraph 28 of FASB Statement No. 97.

Trading Securities

5.25 Trading securities are debt and equity securities that are bought and held principally for the purpose of selling them in the near term. Trading securities should be measured at fair value in the statement of financial position, with unrealized holding gains and losses included in earnings. Fair value is the amount at which a financial instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. If a quoted market price is available for an instrument, the fair value to be used in applying FASB Statement No. 115 is the product of the number of trading units of the instrument times its market price.

5.26 Trading securities should include mortgage-backed securities that are held for sale in conjunction with mortgage banking activities as described in FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*. Other mortgage-backed securities not held for sale in conjunction with mortgage banking activities should be classified in accordance with the criteria cited in FASB Statement No. 115.

5.27 FASB Statement No. 115 notes that given the nature of trading securities, transfers into or from the trading category should also be rare. However, when such transfers occur, they should be accounted for as follows—

- When securities are transferred from the trading category to either the held-to-maturity category or the available-for-sale category, the

unrealized holding gain or loss at the date of the transfer will already have been recognized in earnings and should not be reversed.

- When securities are transferred into the trading category from either the held-to-maturity category or the available-for-sale category, the unrealized holding gain or loss at the date of the transfer should be recognized in earnings immediately.

Available-for-Sale Securities

5.28 Available-for-sale securities are debt and equity securities that are not classified as either trading securities or held-to-maturity securities. Available-for-sale securities should be measured at fair value, with unrealized holding gains and losses excluded from earnings and reported as a net amount in a separate component of shareholders' equity until realized. Realized gains and losses on sales of securities classified as available-for-sale should continue to be reported in the income statement as a component of other income, on a pretax basis, in accordance with paragraph 28 of FASB Statement No. 97.

5.29 Accounting for transfers of securities between the available-for-sale category and other categories is described in paragraphs 5.23 and 5.27 above.

Impairment of Securities

5.30 FASB Statement No. 115 requires that entities determine whether declines in the fair values of individual securities classified as either held-to-maturity or available-for-sale below their amortized cost bases are other than temporary. The Statement notes that if it is probable that the investor will be unable to collect all amounts due according to the contractual terms of a debt security not impaired at acquisition, an other than temporary impairment shall be considered to have occurred. If the decline in fair value is judged to be other than temporary, the cost basis of the individual security shall be written down to fair value as a new cost basis and the amount of the write-down shall be included in earnings (that is, accounted for as a realized loss). The new cost basis shall not be changed for subsequent recoveries in fair value. Subsequent increases in the fair value of available-for-sale securities shall be include in the separate component of equity pursuant to paragraph 13 of FASB Statement No. 115; subsequent decreases in fair value, if not an other-than-temporary impairment, also shall be included in the separate component of equity.

5.31 Declines in the values of securities that are other than temporary are also discussed in AICPA Auditing Interpretation, *Evidential Matter for the Carrying Amount of Marketable Securities* (AICPA, *Professional Standards*, vol. 1, AU section 9332) and in SEC Staff Accounting Bulletin (SAB) No. 59, *Accounting for Noncurrent Marketable Equity Securities*. SAB No. 59 (Topic 5M), sets forth the SEC staff's interpretation of the phrase "other than temporary." The SEC's staff does not believe that "other than temporary" should be interpreted to mean permanent. Topic 5M states that if a decline in market value has occurred, management should determine whether a write-down should be recorded. In evaluating whether a write-down should be recorded, numerous factors should be considered, including the following:

- The length of time and extent to which the market value has been less than cost
- The financial condition and near-term prospects of the issuer, including any specific events that may influence its operations
- The intent and ability of the company to retain its investment for a period of time sufficient to allow for any recovery in market value

5.32 The SEC has issued Financial Reporting Release No. 36, *Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures*, which sets forth the commission's views concerning several disclosure matters, such as disclosures for participation in high-yield financing, highly leveraged transactions, or non-investment-grade loans and investments, that should be considered by registrants in preparing management's discussion and analysis.

5.33 Mortgages are reported at amortized cost. Premiums or discounts are generally amortized over the mortgage loan contract (or in some cases, a shorter period based on estimated prepayment patterns) in a manner that will result in a constant effective yield. Interest income and amortization amounts that are recognized as an adjustment of yield are included as components of interest income. Commitment fees should be amortized on a straight-line basis over the commitment period and recognized as service fee income. Amounts included in income on the expiration of the commitment period should also be recognized as service fee income. Loan origination fees should be recognized over the life of the related loan as an adjustment of yield using the interest method. The property and liability insurance company should recognize the impairment of a mortgage loan by creating a valuation allowance with a corresponding charge to bad debt expense or by adjusting an existing valuation allowance with a corresponding charge or credit to bad debt expense. (FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, addresses the accounting by creditors for impairment of certain loans and applies to financial statements for fiscal years beginning after December 15, 1994.)

5.34 Real estate investments are reported at cost, less accumulated depreciation and an allowance for any impairment in value. Depreciation should be charged or credited to investment income. Changes in the allowance for impairment of value should be included in realized gains and losses. Allowances for uncollectible interest for mortgages and income from real estate investments are generally recorded against investment income.

Statutory Accounting Practices

5.35 Under SAP, equity securities are generally reported at the value published in the *Valuations of Securities* manual, which is the NAIC's Subcommittee on Valuation of Securities determination of "market" for each listed stock. Non-redeemable preferred stocks that are rated by the NAIC as #1-#3 are carried at amortized cost, as described in the *Valuations of Securities* manual. Common and preferred stocks are also subject to both qualitative and quantitative limitations as defined by the state of domicile to qualify as admitted assets.

5.36 In the event that an equity security is not listed in the *Valuations of Securities* manual, or is listed with no value, the property and liability insurance entity is required to submit sufficient information on these securities to the NAIC Securities Valuation Office for a determination of market value.

5.37 Under NAIC rules, investments in the common stock of subsidiaries or affiliates are generally valued on one of the following bases; however, practices and procedures prescribed by the state of domicile may differ. The NAIC *Accounting Practices and Procedures Manual for Fire and Casualty Insurance Companies*, lists the following alternatives for valuation of equity investments in subsidiaries—

- Statutory capital and surplus value for an insurance subsidiary whose common capital stock is not publicly traded.

- Net worth of a noninsurance subsidiary, adjusted to use only those assets of the subsidiary that would constitute admitted assets if owned directly by an insurance company.
- Net worth of a noninsurance subsidiary with its value adjusted for restrictions on down-stream insurance subsidiary and goodwill assets.
- Cost adjusted to reflect subsequent operating results of the subsidiary with its value adjusted for restrictions on down-stream insurance subsidiary and goodwill assets. Operating results of the noninsurance subsidiary should be in accordance with GAAP, and operating results for an insurance subsidiary should be in accordance with SAP.
- Market value for a partially owned subsidiary that is listed and publicly traded on a national securities exchange.
- Any other value that can be sustained to the satisfaction of the NAIC Subcommittee on Valuation.

In addition to the above, when the valuation of noninsurance subsidiaries uses financial information prepared in accordance with GAAP, the *Valuation of Securities* manual, section 4, requires that the subsidiary's financial statements for the most recent fiscal year must be audited by an independent certified public accountant in accordance with generally accepted auditing standards.

5.38 Under SAP, debt securities are carried at amortized cost, subject to the valuation standards of the NAIC, as described in the NAIC's *Valuation of Securities* manual. As with GAAP, amortization or accretion under SAP is calculated by the interest method. Debt securities that do not qualify for amortization under the *Valuation of Securities* manual are carried at the value listed in the manual, referred to as *Association Value* (made up of two parts: an actual or estimated market price and an NAIC Designation which is a rating for quality), or at book value, whichever is lower. Generally, nonqualifying debt securities are those that are in default or otherwise impaired as to principal or interest payments or some other valuation factor. Usually, the property and liability insurance company does not accrue interest income for debt securities in default or with interest or principal payment 90 days in arrears. Debt securities not listed in the manual, or obligations listed with no value, require the determination of an acceptable value that can be substantiated to the appropriate NAIC subcommittee or regulatory agency.

5.39 Requirements for carrying debt securities as admitted assets vary at the discretion of the states. A debt security must be classified as a nonadmitted asset if it fails a qualitative or quantitative limitation test or is otherwise unauthorized by the applicable state code.

5.40 Under SAP, options and futures contracts are generally classified as other admitted assets, and the types of contracts that are permitted, accounting considerations, investment limits and many other factors may differ from state to state. Gains and losses are either deferred, recognized, or used to adjust the basis of the hedged item. State regulations and directives, and the NAIC's *Accounting Practices and Procedures Manual* and *Valuations of Securities* manual provide guidance on statutory accounting practices.

5.41 Generally, for assets carried at amortized cost, any gain or loss on options and futures contracts intended to be a hedge is deferred until the ultimate disposition of the hedged item and is used to adjust the basis of the hedged item. If the hedge was not effective and the contract expires or is terminated through a closing transaction, the gain or loss is recognized cur-

rently as a realized gain or loss. Financial instruments that are off-balance-sheet items, such as interest-rate swaps, are disclosed in the notes to the financial statements.

5.42 Under SAP, first mortgages that are not in default with regard to principal or interest are carried at outstanding principal balance, or amortized cost if acquired at a discount or premium. Some states stipulate maximum loan values that limit the extent to which outstanding principal balances can be reported as admitted assets, and most states have restrictions that apply to the size of the individual loan in relation to the appraised value of the mortgaged property either at the origination date, the current valuation date, or both.

5.43 Procedures for amortizing discounts and premiums on mortgage loans are included in the *Valuation of Securities* manual. Loan origination fees, commitment fees, and other costs associated with acquiring mortgage loans that are expressed as a percentage of the loan amount or represent an adjustment to the current market rate of interest, are deferred and amortized in the same manner as premiums and discounts on mortgage loans. However, if these costs are not material or if they do not represent an adjustment to the current market rate of interest, they may be charged to operations when incurred.

5.44 For mortgages that are in default or being foreclosed, the carrying value is adjusted for unpaid interest and additional expenses such as legal fees, to the extent they are expected to be recovered from the ultimate disposition of the property. Nonrecoverable costs should be expensed in the period incurred. In the event that the value of the collateral for a mortgage loan in default is less than the carrying value, a valuation reserve is generally established for the estimated uncollectible amount.

5.45 Interest income on mortgage loans is recorded as earned, and contingent interest may be recorded as earned or as received. A portion of past due amount of interest due and accrued may be treated as a nonadmitted asset depending on the accrual and reserve policies of the property and liability insurance company and the regulations of the state of domicile. Mortgage interest that is 12 months past due is generally nonadmitted. Second mortgages generally are not admitted assets, although certain states may admit second mortgages if the property and liability insurance company also owns the first mortgage.

5.46 Under SAP, investment real estate and real estate acquired in satisfaction of debt are recorded at cost, less accumulated depreciation, not to exceed current estimated market value, and are subject to the restrictions and limitations specified by the state of domicile. When estimated market value is less than book value, depending on the practices prescribed by the state of domicile, the property and liability insurance company may be required to write down the investment, take part of the value as nonadmitted, or establish a reserve for specific properties as a liability. Any realized or unrealized gains or losses on real estate transactions are recognized as a component of net income after net gain from operations.

5.47 Real estate used in the entity's operation is carried at amortized cost, and the property and liability insurance company is required to charge itself imputed rent which is recorded as investment income and as an operating expense.

5.48 Under SAP these types of investments are generally reported in a manner similar to a subsidiary accounted for under the equity method. In addition, it may also be necessary to account for capital gains, return of capital, and dividends.

Special Risk Considerations

5.49 A key element to an effective audit is an understanding of the industry, operating environment, and accounting and internal control structure. Such understanding allows the auditor to assess audit risks and facilitate the design of effective and efficient audit tests.

5.50 Property and liability insurance companies may incur increased underwriting losses as a consequence of their willingness to adopt a less restrictive underwriting philosophy to obtain more premium dollars to invest. This would be done as long as investment income exceeds expected underwriting losses by a sufficient margin, which is known as *cash flow underwriting*. However, as losses continue to increase and interest rates decline, it has been necessary to revise this strategy. Although underwriters have reacted by raising prices and tightening underwriting standards, greater investment performance is required to offset the increased underwriting losses. In addition to understanding this operating environment, the auditor should consider the following audit risks relating to the investment cycle that may affect carrying values, pricing, and permanent impairments:

- Investment concentration, by issuer, industry, or other
- Investment liquidity, such as investments with terms and maturities not matched with claims obligations
- Investment valuation, such as improper or inadequate valuation methods, documentation, or impairments that are other than temporary, and significant amounts of investments that are not readily marketable
- Investment yield trends (that is, the indicated ability to manage the investment portfolio at maximum yields commensurate with prudent risk considerations)
- Investment policy, such as emphasis on speculative or high-risk investments
- Investment restrictions (that is, degree of compliance with regulatory or self-imposed restrictions)
- Investment repurchase agreements, such as (*a*) the risk that the seller-borrower may not be able to complete the transaction and repurchase the security—credit risk, or (*b*) the risk that the collateral is not secure—particularly if it remains with the seller-borrower. (Guidance on such matters is provided by the AICPA's *Report of the Special Task Force on Audits of Repurchase Securities Transactions*.)

Chapter 6
Reinsurance

6.01 Insurance companies bring together people and entities subject to insurable hazards and collect from them premium amounts expected in the aggregate to be sufficient to pay all losses sustained by the insureds during the policy periods. From the insurer's perspective, the number of insureds must be large enough and diverse enough for the law of averages to operate. Frequently, however, an insurance company may be offered or accept for business reasons insurance of a class or amount that does not permit the law of averages to operate or that could result in claims the insurer does not have the financial capacity to absorb. Such risks are spread among other insurance companies through reinsurance, which is the indemnification by one insurer of all or part of a risk originally undertaken by another insurer.

6.02 In addition to using reinsurance to spread the risk of its insurance contracts, an insurer may use reinsurance contracts to finance the growth of its business in terms of premiums written and loss reserve. In this regard, an insurance company's gross capacity (ability to write business) is limited by law or regulation based on the amount of its statutory surplus. The greater the ratio of premiums written or liabilities to such surplus, the less likely it is that the surplus will be sufficient to withstand adverse claim experience on business written. Through reinsurance contracts, an insurer can increase its ability to underwrite risks, thus effectively using reinsurance to facilitate the growth of its business.

6.03 The following are major reasons insurance companies enter into reinsurance contracts:

- To help balance their risks and capital
- To reduce their exposure on particular risks or classes of risks
- To protect against accumulations of losses arising out of catastrophes
- To reduce total liabilities to a level appropriate to their capital
- To provide financial capacity to accept risks and policies involving amounts larger than could otherwise be accepted
- To help stabilize operating results
- To obtain assistance with new products and lines of insurance
- To limit liabilities of captive insurance companies, created for the purpose of supplying insurance to noninsurance companies, to a level considered acceptable by the parent companies

For similar reasons, reinsurers also may transfer a portion of their assumed risks to other insurance and reinsurance companies, a practice known as *retrocession*.

Types of Reinsurance

6.04 Reinsurance transactions are between insurance entities, the ceding entity remains primarily liable to the policyholder. In addition, the ceding entity bears the risks that the reinsurer may be unable to meet its obligations for the risks assumed under the reinsurance agreement. The policyholder is generally not aware of any indemnity reinsurance transactions that may occur and continues to hold the original contract.

6.05 *Assumption reinsurance* agreements are legal replacements of one insurer by another and thereby extinguish the ceding enterprise's liability to the policyholder.

6.06 *Fronting* is an arrangement between two or more insurers whereby the fronting entity will issue contracts and then cede all or substantially all of the risk through a reinsurance agreement to the other insurer(s) for a ceding commission. Such arrangements may be illegal if the intent is to circumvent regulatory requirements. (SAS No. 54, *Illegal Acts by Clients*, addresses the auditor's responsibility for detection of illegal acts.) As with other indemnity reinsurance agreements, the fronting entity remains primarily liable to the policyholder.

6.07 In the United States there are basically three kinds of reinsurance entities: (*a*) *professional reinsurers*, which engage almost exclusively in reinsurance, although they are usually permitted by their charters and licenses to operate as primary insurance companies; (*b*) *reinsurance departments of primary insurance companies*, which function as units of primary insurers and engage in reinsurance; (*c*) groups or syndicates of insurers referred to as *reinsurance pools or associations*, which may be organized to provide their members with reinsurance protection and management for certain specialized, high-risk coverage or with general access to the reinsurance market for traditional lines of business. In addition, reinsurance intermediaries, including brokers, agents, managing general agents, and similar entities, facilitate reinsurance by bringing together ceding companies and reinsurers. Reinsurance intermediaries may underwrite, design, and negotiate the terms of reinsurance. They usually place reinsurance, accumulate and report transactions, distribute premiums, and collect and settle claims.

6.08 In addition to providing for a basic ceding commission, intended to reimburse the ceding insurer for the cost of underwriting the business, reinsurance contracts may also provide for contingent commissions or retrospectively rated premiums, which are intended to allow the ceding insurer to share in the profits or losses realized by the assuming reinsurer on the business subject to the contract. Reinsurance contracts additionally may provide for sliding scale commissions, or commission adjustments under a formula that allows increasing commissions as losses decrease and vice versa, subject to maximum and minimum limits. Contract provisions such as these may affect the risk transfer characteristics that determine how reinsurance contracts are accounted for.

Kinds of Reinsurance Contracts

6.09 Flexibility is one of the characteristics of the reinsurance business. Reinsurance contracts are usually negotiated individually and in practice no two contracts are exactly alike. Contracts are occasionally encountered that cannot be readily classified. However, the principal kinds of reinsurance are pro rata reinsurance and excess reinsurance.

6.10 *Pro rata reinsurance.* Pro rata reinsurance is a sharing, on a predetermined basis, by the insurer and the reinsurer of premiums and losses on a risk, class of risks, or particular portion of the insurer's business. In consideration of a predetermined portion of the insurer's premium or premiums, the reinsurer agrees to pay a similar portion of claims and claim-adjustment expenses incurred on the business reinsured. The reinsurer's participation in

the claims is set without regard to the actual frequency and severity of claims. Pro rata reinsurance can be effected by means of quota share or surplus share reinsurance.

6.11 *Quota share reinsurance.* Quota share reinsurance is a kind of pro rata reinsurance in which the ceding company cedes a proportional part (a percentage) of risks to the reinsurer, and in turn will recover from the reinsurer the same percentage of all losses on those risks. For example, under a 50-percent-quota-share treaty the reinsurer receives 50 percent of the insurer's premiums, less ceding commissions, and is obligated to pay 50 percent of each claim as well as the claim-adjustment expense incurred by the insurer. Such reinsurance is frequently used for new lines or by new companies; for example, a company just entering the casualty field may arrange for quota share reinsurance only for its casualty business.

6.12 *Surplus share reinsurance.* Surplus share reinsurance is insurance that reinsures on a pro rata basis only those risks on which the coverage exceeds a stated amount. Under a surplus treaty, an insurer might reinsure what it considers to be surplus exposure under each large dwelling policy that it writes. For example, the insurer might reinsure the amount of each dwelling policy above $25,000; the insurer would reinsure $15,000 on a dwelling policy for $40,000. Premiums and losses are shared by the reinsurer and the insurer on a pro-rata basis in proportion to the amount of risk insured or reinsured by each. The reinsurer would not participate at all in any losses incurred on policies with limits of $25,000 or less.

6.13 *Excess reinsurance.* Under excess reinsurance, the insurer limits its liability to all or a particular portion of the amount in excess of a predetermined deductible or retention. Thus, the reinsurer's portion of the loss depends on the size of the loss. The relationship between the premium and claims of the insurer and the reinsurer is not proportional. Excess reinsurance takes three basic forms: per risk basis, per occurrence basis, and aggregate basis.

6.14 *Excess of loss per risk reinsurance.* Excess of loss per risk reinsurance requires the insurer to pay all claims up to a stated amount or retention limit on each risk covered under the reinsurance, such as all fire policies written. The reinsurer reimburses the insured for the portion of any claim in excess of the insurer's retention, subject to the limit stated in the reinsurance agreement.

6.15 *Excess of loss per occurrence reinsurance.* Excess of loss per occurrence reinsurance requires the insurer to pay all claims up to a stated amount or retention limit on all losses arising from a single occurrence. The reinsurer pays claims in excess of the limits. One purpose of obtaining per occurrence excess reinsurance is to protect a company from the accumulation of losses arising from earthquakes, tornadoes, or similar occurrences. Such reinsurance is also referred to as *catastrophe reinsurance*.

6.16 *Aggregate excess of loss reinsurance.* Aggregate excess of loss reinsurance requires the insurer to pay all claims during a specified period up to a predetermined limit for the period on all its business or any definable portion of the claim. This is usually expressed as a loss ratio (for example, reinsurance against losses that would cause a company's loss ratio to exceed 75 percent). Such reinsurance is also referred to as *stop loss reinsurance*.

Bases of Reinsurance Transactions

6.17 Reinsurance is transacted either on a facultative or a treaty basis. Under *facultative reinsurance*, each risk or portion of a risk is reinsured indi-

vidually, and the assuming company has the option to accept or reject each risk. Risks are separately underwritten by the assuming company in much the same manner as if a direct policy were being issued. The assuming company therefore has all of the policy information necessary to maintain all of the accounting records, including gross premiums and reinsurance premiums, term of the policy, reinsurance commissions, and individual claims data. Because the assuming company must specifically obligate itself before assuming the risk, the company is aware of all of the risks assumed at any point. The assuming company maintains complete records about all facultative business assumed and, therefore, has information needed to account for premiums written and receivable, commissions incurred and payable, and losses and expenses incurred and payable.

6.18 Under *treaty-basis reinsurance*, any agreed portion of business written is automatically reinsured, thereby eliminating the need for the assuming company to accept or reject each risk. Because of the time lag in reporting by the ceding company, the assuming company is likely to be unaware of some of the risks it has assumed at a particular point. The reports received by the assuming company from the ceding company may be complete *bordereaus* (or listings) of pertinent information on each risk or summaries of risks.

6.19 If the ceding company reports only summarized information, the assuming company may not have complete information relating to reinsurance activities. For example, without knowing the reinsurance premiums by policy term, the assuming company cannot directly calculate its unearned premium reserve; but must use amounts reported by the ceding company. The assuming company, which has no direct relationship with the insured, must also depend on the ceding company to report the reinsured portion of reported claims and, in some quota-share-treaty accounts, the estimated liability for IBNR claims. Despite the lack of detailed information, the assuming company is responsible for properly accounting for the transaction.

6.20 Reinsurance may be transacted and serviced directly between the ceding and assuming companies or through reinsurance intermediaries, brokers, agents, or managing general agents. Reporting of information to the assuming company is negotiated as part of a reinsurance transaction involving an intermediary or broker.

Accounting Practices

6.21 FASB Statement No. 113 specifies the accounting by insurance enterprises for the reinsurance (ceding) of insurance contracts. Further, the FASB published an article *Accounting for Reinsurance: Questions and Answers about Statement 113*, in the February 26, 1993 issue of *FASB Viewpoints* containing 42 implementation questions and answers. The article is also included in Appendix D (Topic D-34) of the FASB's EITF Abstracts.

6.22 *Conditions for Qualifying for Reinsurance Accounting.* In general, FASB Statement No. 113 requires a determination of whether or not a reinsurance agreement, despite its form, qualifies for reinsurance accounting. To qualify, a reinsurance contract should indemnify the ceding enterprise from loss or liability relating to insurance risk. Paragraph 8 of FASB Statement No. 113 addresses determining whether a contract with a reinsurer provides indemnification against loss or liability relating to insurance risk. Paragraphs 9 to 11 of FASB Statement No. 113 address criteria for short-term contracts to

be accounted for as reinsurance. Paragraphs 12 and 13 of FASB Statement No. 113 address criteria for long-duration contracts to be accounted for as reinsurance.

6.23 In Issue No. 93-6, *Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises*, the FASB's EITF discussed and reached consensuses on several issues relating to accounting by insurers (ceding enterprises) for multiple-year retrospectively rated reinsurance contracts (RRCs) with reinsurers (assuming enterprises). Examples of these contracts may include transactions referred to as "funded catastrophe covers." Users of this guide should refer to those issues and the related consensuses in the FASB's EITF Abstracts.

Reporting Assets and Liabilities

6.24 *Assumption reinsurance.* These reinsurance agreements are legal replacements of one insurer by another and thereby extinguish the ceding enterprise's liability to the policyholder and should be accounted for by removing the related assets and liabilities from the financial statements of the ceding entity. Assumption reinsurance transactions may result in an immediate recognition of a gain or loss.

6.25 *Other reinsurance agreements.* Reinsurance agreements for which the ceding entity remains primarily liable to the contract holders would not result in the removal of the related assets and liabilities from the ceding entities' records. For these agreements, the ceding entity should report as assets, estimated reinsurance receivables and any prepaid reinsurance premiums arising from those agreements. Amounts receivable from and payable to an assuming entity should be offset only when a right of offset exists, as defined in FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts*.

6.26 Reinsurance receivables and prepaid reinsurance premiums should be recognized in a manner consistent with the related liabilities (estimates for claims incurred but not reported and future policy benefits) relating to the underlying insurance contracts. Assumptions used in estimating reinsurance receivables should be consistent with those assumptions used in estimating the related liabilities. As in all reinsurance contracts, the ceding entity should evaluate the financial soundness and the collectibility of reinsurance receivables, to make a determination that the reinsurer has the ability to honor its commitment under the contract.

6.27 The amounts of premiums ceded and recoveries under reinsurance agreements may be reported in the income statements as a separate line item, noted parenthetically on the face of the income statement, or disclosed in the footnotes to the financial statements.

Reporting Revenues and Costs

6.28 Paragraphs 21 through 25 of FASB Statement No. 113 provide guidance on recognition of revenues and costs for reinsurance of short-duration contracts. Paragraph 26 of FASB Statement No. 113 provides guidance on recognition of revenues and costs for reinsurance of long-duration contracts.

Reinsurance Agreements Not Qualifying for Reinsurance Accounting Under FASB Statement No. 113 or EITF 93-6

6.29 FASB Statement No. 113 does not specifically address accounting for reinsurance agreements that do not meet the conditions for reinsurance ac-

counting, other than to incorporate the provisions from FASB Statement No. 60, paragraphs 39 and 40 which continue in effect and are included in paragraph 18 of FASB Statement No. 113 as follows:

a. To the extent that a reinsurance contract does not, despite its form, provide for indemnification of the ceding enterprise by the reinsurer against loss or liability, the premium paid less the premium to be retained by the reinsurer shall be accounted for as a deposit by the ceding enterprise. A net credit resulting from the contract shall be reported as a liability by the ceding enterprise. A net charge resulting from the contract shall be reported as an asset by the reinsurer.

b. Proceeds from reinsurance transactions that represent recovery of acquisition costs shall reduce applicable unamortized acquisition costs in such a manner that net acquisition costs are capitalized and charged to expense in proportion to net revenue recognized.[12] If the ceding enterprise has agreed to service all of the related insurance contracts without reasonable compensation, a liability shall be accrued for estimated excess future servicing costs under the reinsurance contract. The net cost to the assuming enterprise shall be accounted for as an acquisition cost.

6.30 *Experience-rated refunds.* Some reinsurance agreements provide for experience-rated refunds, which allows the ceding entity to participate in the profits of the reinsured business. In general, experience refunds are determined by the assuming entity by deducting from premiums assumed claims or losses incurred and a predetermined reinsurance profit (expense and profit charge). Most experience-rated reinsurance agreements will have stated terms for calculation formulas and other factors to be included.

Disclosures

6.31 Paragraphs 27 and 28 of FASB Statement No. 113 prescribe information that should be disclosed regarding reinsurance activities.

Statutory Accounting Practices

6.32 Under statutory accounting practices, as under generally accepted accounting principles, the essential ingredient of a reinsurance contract is the indemnification of risk. A number of states regulate reinsurance arrangements by disallowing the recognition of increased surplus resulting from non-risk-shifting arrangements. In general, the accounting treatment by ceding companies for reinsurance transactions is opposite from that of transactions that arise from writing direct business, and the amounts of the reinsurance transactions are netted against the direct amounts for financial statement presentation (for example, the premium accounts are netted against the direct amounts for premiums related to insurance ceded). The assuming company's accounting for reinsurance normally parallels the original accounting for direct business.

6.33 The terms *unauthorized reinsurer* and *nonadmitted reinsurer* refer to a reinsurer not authorized or licensed to do business in the state in which the ceding company is domiciled. Licensed companies can write direct business in the state; if licensed, a company is also authorized to assume reinsurance in that state. A nonlicensed company can assume reinsurance if the state authorizes it to do so, and it is then considered to be an authorized reinsurer. In stat-

[12] Paragraph 29 of FASB Statement No. 60 addresses recognition of acquisition costs.

utory financial statements, the ceding company cannot obtain surplus credit for unearned premiums ceded to and losses recoverable from an unauthorized reinsurer unless collateralized by assets held, a letter of credit, or other forms of collateral. A ceding company must establish a liability for unauthorized reinsurance in an amount equal to the excess of the reserve credits taken over the funds held for the business ceded. Schedule F of the statutory filing includes an aging of reinsurance receivables from authorized companies on paid losses, the calculation of a surplus penalty being distributed by reinsurers based on the aging, and disclosure of the amount of receivables.

Special Risk Considerations

6.34 Reinsurance contracts can be complex documents. A ceding company does not discharge its obligations to the insureds through reinsurance but only obtains the right to reimbursement from the assuming company. Therefore, the ceding company faces the risk that the assuming company may not have the financial capacity or stability to meet its obligations when they are due. An absence of an adequate reinsurance program may expose an insurance company (the ceding company) to substantial risks in relation to the company's financial position, particularly if the company's risks are concentrated geographically or by kind of risk. Also, a lack of sufficient experience to manage and underwrite assumed reinsurance may expose the assuming company to substantial risks in relation to the company's financial position. Therefore, the auditor should be aware that reinsurance programs may indicate (but do not necessarily confirm) the existence of increased audit risk.

6.35 The assumption of reinsurance requires special consideration of the accuracy and reliability of the data received from the ceding company, either directly or through a reinsurance intermediary. The extent of the detail in the information provided to the assuming company by the ceding company or the reinsurance intermediary can vary significantly in—

- Timeliness of the information submitted.
- Detail of information relating to policies, claims, unearned premiums, and loss reserves.
- Annual statement line-of-business classification.
- Foreign currency translation information on business assumed from companies domiciled in foreign countries (alien companies).

6.36 Information on IBNR claims and bulk reserves also may be reported by ceding companies under pro rata reinsurance arrangements. Generally, no IBNR is reported on nonproportional—that is, excess-reinsurance—arrangements. Based on the quality and comprehensiveness of the information received from the ceding company, the information provided may or may not be used by the assuming company.

Internal Control Structure* of the Ceding Company

6.37 The auditor of a ceding company should obtain an understanding of the entity's procedures for (*a*) evaluating the financial responsibility and stabil-

* SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55*, revises the definition and description of internal control and makes conforming changes to relevant terminology. SAS No. 78 was issued in December 1995 and is effective for audits of financial statements for periods beginning on or after January 1, 1997. This Guide will be amended to conform to SAS No. 78 nearer to the pronouncement's effective date.

ity of the assuming company, whether the assuming company is domiciled in the United States or in a foreign country, and (*b*) providing reasonable assurance about the accuracy and reliability of information reported to the assuming company and amounts due to or from the assuming company. The ceding company's control procedures to evaluate the financial responsibility and stability of the assuming company may include—

- Obtaining and analyzing recent financial information of the assuming company, such as—
  - Financial statements and, if audited, the independent auditor's report.
  - Financial reports filed with the SEC (United States), Department of Trade (United Kingdom), or similar authorities in other countries.
  - Financial statements filed with insurance regulatory authorities, with particular consideration of loss reserve development and the quality and liquidity of the company's invested assets.
- Obtaining and reviewing available sources of information relating to the assuming company, such as—
  - Insurance industry reporting and rating services.
  - Insurance department examination reports.
  - Loss reserve certifications filed with regulatory authorities.
  - Letters relating to the design and operation of internal control structure policies and procedures filed with regulatory authorities.
  - IRIS results filed with regulatory authorities.
- Inquiring about the assuming company's retrocessional practices and experience.
- Inquiring about the general business reputation of the assuming company and the background of its owners and management.
- Ascertaining whether the assuming company is authorized to transact reinsurance within the ceding company's state of domicile or, if not, whether letters of credit or other means of security are provided.
- Considering the need for and evaluating the adequacy of collateral from the assuming company on collateralized reinsurance contracts.

6.38 The ceding company's control procedures relating to the accuracy and reliability of information reported to the assuming company and amounts due to or from the assuming company are generally similar in nature to other control procedures for the direct recording of direct insurance transactions. (Those control procedures are described in appendix B.)

Control Environment

6.39 The control environment as related to reinsurance transactions of a property and liability insurance company represents the collective effect of various factors on the effectiveness of specific control policies or procedures of the entity. The auditor should consider such factors influencing inherent risk related to reinsurance assumed and ceded, including factors relating to management, product characteristics, underwriting approach, marketing strategies, financial objectives, and the economic and regulatory environment. Such factors might include the following:

- The property and liability insurance company uses complex reinsurance transactions at or near the end of the period to achieve financial performance goals or improve its surplus position.
- The property and liability insurance company is involved in a significant amount of international reinsurance, or reinsurers are in jurisdictions with foreign exchange controls.
- There are no executed contractual agreements between the ceding entity and the reinsurer.
- Reinsurance coverage is inadequate (it does not meet the business need or does not reflect management's intended reinsurance program).
- The ceding entity's reinsurers are in financial difficulty.
- Reinsurance has become unavailable at the property and liability insurance company's desired retention levels and costs.
- There are significant or unexpected changes in the entity's reinsurance programs.
- The reinsurance agreement does not transfer adequate economic risk where this was the intention of the parties.
- Risk assumed under treaty arrangements is excessive.
- Financial information received is inadequate, or not received on a timely basis.
- Regulations may not permit the treatment of certain reinsurance agreements as reinsurance.
- Significant reinsurance agreements involve wholly owned subsidiaries or other related parties.

Control Procedures

6.40 Control procedures are those policies and procedures, which in addition to the control environment and accounting system, management has established to provide reasonable assurance that specific objectives are achieved. Control procedures have various objectives and may be integrated into specific components of the control environment and the accounting system. In addition to control procedures, discussed in paragraph 6.39, relating to the evaluation of the control procedures of the reinsurer, the following are examples of typical internal control procedures and policies relating to reinsurance transactions:

- *Proper authorization of transactions and activities.* Written guidelines for reinsurance transactions are in place assigning appropriate responsibility for approval.
- *Segregation of duties.* Reinsurance transactions, claims processing, premium collection, key information systems functions, and general accounting activities should be appropriately segregated, and independent reviews should be conducted of the work performed.
- *Design of adequate control over documents and records.* There are procedures to ensure that fictitious or duplicate reinsurance transactions are not included in the records and to prevent or detect the omission of valid transactions.
- *Adequate safeguards of access to and use of assets and accounting records.* Data files and production programs have adequate safeguards against unauthorized access; and adequate safeguards exist over access to any collateral from the assuming entity that may be held by the ceding entity.

- *Independent checks on performance and proper valuation of recorded amounts.* Recorded insurance transactions are subject to independent testing or other quality control checks; reinsurance ceded transactions are periodically confirmed directly with the reinsurer; reviews are performed to determine that reinsurance transactions are valid and supported by appropriate documentation as required by the reinsurance agreement; and independent evaluations are performed on the adequacy of any collateral held from assuming entities on reinsurance agreements.

Accounting Systems

6.41 The third component of the internal control structure, the accounting system, consists of the methods and records established to identify, assemble, analyze, classify, record, and report an entity's transactions and to maintain accountability for related assets and liabilities.

6.42 The transaction flow of accounting records for reinsurance transactions usually encompasses all functions relating to underwriting, premium collection, commission processing, and claims payments.

Internal Control Structure* of the Assuming Company

6.43 A significant element of an assuming company's internal control structure that is related to assumed reinsurance is the assessment of the accuracy and reliability of data received from the ceding companies. Principal control procedures of the assuming company may include—

- Maintaining underwriting files with information relating to the business reasons for entering the reinsurance contracts and anticipated results of the contracts. The underwriting files may include—
  - Historical loss ratios and combined ratios of the ceding companies.
  - Anticipated loss ratios under the contracts.
  - Indications of the frequency and content of reports for the ceding companies.
  - Prior business experience with the ceding companies.
  - The assuming company's experience on similar risks.
  - Information regarding pricing and ceding commissions.
- Monitoring the actual results reported by the ceding companies and investigating the reasons for and the effects of significant deviations from anticipated results.
- Visiting the ceding companies to review and to evaluate their underwriting, claims processing, loss reserving, and loss-reserve-development-monitoring procedures.
- Obtaining the report of the ceding companies' independent accountants on policies and procedures (relating to ceding reinsurance) placed

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* SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55*, revises the definition and description of internal control and makes conforming changes to relevant terminology. SAS No. 78 was issued in December 1995 and is effective for audits of financial statements for periods beginning on or after January 1, 1997. This Guide will be amended to conform to SAS No. 78 nearer to the pronouncement's effective date.

in operation (and tests of operating effectiveness). See SAS No. 70, *Reports on the Processing of Transactions by Service Organizations.*

6.44 Additional control procedures of the assuming company may include—

- Obtaining and analyzing recent financial information of the ceding companies, such as—
  - Financial statements and, if audited, the independent auditor's report.
  - Financial reports filed with the SEC (United States), Department of Trade (United Kingdom), or similar authorities in other countries.
  - Financial statements filed with insurance regulatory authorities, with particular attention to loss reserve development.
- Obtaining and reviewing available sources of information on the ceding companies, such as—
  - Insurance industry reporting and rating services.
  - Insurance department examination reports.
  - Loss reserve certifications filed with regulatory authorities.
  - Letters relating to the design and operation of internal control structure policies and procedures filed with regulatory authorities.
- Inquiries about the general business reputation of the ceding companies and the background of their owners and managements.

Auditing Procedures for the Ceding Company

6.45 The independent auditor also should be aware of reinsurance issues that are discussed in the Subcommittee on Oversight and Investigations of the Committee on Energy and Commerce's report, *Failed Promises: Insurance Company Insolvencies* (issued February/1990).[13]

6.46 The ceding company's independent auditor should obtain an understanding of the ceding company's ability to honor its commitments under the reinsurance contract. Chapter 4 of this guide discusses how the auditor assesses control risk. If the auditor intends to rely on the prescribed procedures, the auditor should perform tests of the ceding entity's procedures to obtain reasonable assurance that they are in use and operating as planned.

6.47 The absence of adequate procedures by the ceding company to determine the assuming company's ability to honor its contractual commitments, or the failure to apply adequately designed procedures as planned, may constitute a reportable condition in the ceding company's internal control structure. SAS No. 60 discusses the auditor's responsibility for communication of a significant deficiency in the internal control structure to the audit committee. Based on his or her assessment of control risk, the auditor should consider performing substantive tests sufficient to evaluate the collectibility of amounts reported in the financial statements as recoverable from the assuming company. The auditor's tests may include certain of the procedures specified above but they are not necessarily limited to those procedures.

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[13] This paragraph also applies to the assuming company's independent auditor (refer to paragraph 6.49) and to the auditor of reinsurance intermediaries (refer to paragraph 6.34).

6.48 To obtain reasonable assurance whether reinsurance contracts are appropriately accounted for, the independent auditor of the ceding company should consider performing procedures for selected contracts, selected transactions, and related balances, including—

- Reading the reinsurance contract and related correspondence to—
  - Obtain an understanding of the business objective of the reinsurance contract.
  - Determine whether the contract indemnifies the ceding company against loss or liability, and meets the conditions for reinsurance accounting or whether it should be accounted for as a deposit.
- Tracing entries arising from selected reinsurance contracts to the appropriate records.
- Tracing the selected transactions to supporting documents and testing the related receivables and payables.
- Obtaining written confirmation of selected balances. In certain circumstances, confirmation of contract terms may be appropriate.

Auditing Procedures for the Assuming Company

6.49 An assuming company's independent auditor should obtain an understanding of the assuming company's procedures for assessing the accuracy and reliability of data received from the ceding companies. If the auditor intends to assess control risk as being less than maximum, he or she should evaluate the suitability of the assuming company's procedures for his or her purposes and test the procedures to obtain evidence that they are in use and operating as prescribed.[14]

6.50 The absence of adequate procedures by the assuming company to provide assurance regarding the accuracy and reliability of data received from the ceding company, or not applying adequately designed procedures that are in use and operating as prescribed, may constitute a reportable condition in the assuming company's internal control structure. Based on his or her assessment of control risk, the auditor should perform substantive tests sufficient to obtain assurance regarding the accuracy and reliability of the data received from the ceding companies. The auditor's substantive procedures may include, but would not necessarily be limited to, one or more of the following:

- Performing certain of the procedures described as control procedures in paragraph 6.44
- Meeting and review the work of the ceding companies' independent auditors (see paragraph .12 of SAS No. 1, section 543, *Part of Audit Performed by Other Independent Auditors*)
- Performing auditing procedures at the ceding companies or requesting their independent auditors to perform agreed-upon procedures
- Obtaining reports from the ceding companies' independent auditors on the ceding companies' internal controls relating to ceded reinsurance (see SAS No. 70)

6.51 The auditor's inability to perform the procedures considered necessary, whether as a result of restrictions imposed by the client or by circumstances

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[14] Refer to "Auditing Procedures for the Ceding Company" in paragraphs 6.45 through 6.48.

such as the timing of the work, the inability to obtain sufficient competent evidential matter, or an inadequacy in the accounting records, constitutes a scope limitation that may require the auditor to qualify the opinion or disclaim an opinion (see SAS No. 58). In such circumstances, the reasons for the auditor's qualification of opinion or disclaimer of opinion should be described in the audit report.

6.52 To determine whether reinsurance contracts are appropriately accounted for, the independent auditor of the assuming company should consider performing procedures for selected contracts, selected transactions, and related balances, including—

- Reading the reinsurance contract and related correspondence to—
  - Obtain an understanding of the business objective of the reinsurance contract.
  - Determine whether the contract should be accounted for as reinsurance or deposit
- Tracing entries arising from selected reinsurance contracts to the appropriate records.
- Tracing the selected transactions to supporting documents and testing the related receivables and payables.
- Obtaining written confirmation of selected balances. In certain circumstances, confirmation of contract terms may be appropriate.

Pools, Associations, and Syndicates

6.53 Participation in reinsurance pools, associations, and syndicates is in some respects similar to reinsurance, and the guidance in paragraphs 6.45 to 6.52 generally applies to audits of participating companies. Pools, associations, and syndicates often issue audited financial statements to participating companies, and auditors of participating companies may use the report of the independent auditor of the pool, association, or syndicate in their audits. SAS No. 1, section 543 provides guidance for such use.

Reinsurance Intermediaries

6.54 Reinsurance intermediaries' involvement may include evaluation, underwriting, negotiations, and fund transfers. The assuming and ceding companies should coordinate their control procedures with those of the intermediaries.

6.55 A company may delegate to a reinsurance intermediary the performance of the procedures described in the sections "Internal Control Structure of the Ceding Company," paragraphs 6.37 to 6.42 and "Internal Control Structure of the Assuming Company," paragraphs 6.43 and 6.44. The company, however, should have procedures to satisfy itself that the reinsurance intermediary is adequately performing those procedures. The guidance provided to the independent auditor in those sections may be applied.

6.56 In addition to the functions discussed in the previous paragraphs, a reinsurance intermediary may be authorized to collect, hold, disburse, or remit funds on behalf of an insurance company. The insurance company should have controls to provide reasonable assurance that the reinsurance intermediary is

adequately performing those functions; safeguarding the funds and, if required, appropriately segregating them; and settling accounts on a timely basis. The insurance company may accomplish this by obtaining a special report from the independent auditor of the reinsurance intermediary or by visiting the reinsurance intermediary and reviewing its controls that relate to those functions. The auditor of the insurance company should assess control risk in this area as described in chapter 4 of this guide.

6.57 The auditor should read the intermediary clauses in an assuming company's reinsurance contracts.[15] Such clauses, which identify the specific intermediaries or brokers involved in negotiating the contracts, communicating information, and transmitting funds, should state clearly whether payment to the intermediaries constitutes payment to the other parties to the reinsurance contracts. An example of such a clause, under which the reinsurer assumes the credit risks in the transmission of reinsurance funds, follows:

> _____ is hereby recognized as the Intermediary negotiating this contract. All communications (including but not limited to notices, statements, premiums, return premiums, commissions, taxes, losses, loss adjustment expenses, salvages, and loss settlements) relating thereto shall be transmitted to the ceding company or the reinsurers through _______________. Payments by the ceding company to the Intermediary shall be deemed to constitute payment to the reinsurers. Payments by the reinsurers to the Intermediary shall be deemed to constitute payment to the ceding company only to the extent that such payments are actually received by the ceding company.

Accounting for Foreign Property and Liability Reinsurance

6.58 The promulgation of rules and regulations by state insurance departments and the adoption of specialized insurance industry accounting standards by the FASB have resulted in considerable uniformity in accounting practices in the insurance industry in the United States. Outside the United States, insurance accounting and reporting practices vary widely. The diversity in insurance accounting and reporting practices of foreign insurance companies has led to questions on how U.S. insurance companies should account for property and liability reinsurance assumed from foreign companies (foreign reinsurance).

6.59 Reinsurers assuming business from domestic companies have historically had sufficient information to monitor and account for contract results. In contrast, some reinsurers assuming business from foreign companies do not receive such information, because in some foreign jurisdictions, insurance companies' accounting and reporting practices concerning periodic recognition of revenue and incurred claims are substantially different from U.S. practices. Therefore, reinsurers assuming business from foreign ceding companies cannot always obtain sufficient information to periodically estimate earned premiums for the business assumed from the foreign ceding companies.

6.60 A significant amount of reinsurance is transacted through syndicates organized by Lloyd's of London. Lloyd's syndicates report the amounts of premiums, claims, and expenses recorded in an under-writing account for a particular year to the assuming companies that participate in the syndicates.

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[15] Refer to "Auditing Procedures for the Ceding Company" in paragraphs 6.45 through 6.48.

The syndicates generally keep accounts open for three years. Traditionally, three years have been necessary to report substantially all premiums associated with an underwriting year and to report most related claims, although claims may remain unsettled after the account is closed. A Lloyd's syndicate typically closes an underwriting account by reinsuring outstanding claims on that account with a syndicate for the next underwriting year. The ceding syndicate pays the assuming syndicate an amount based on the unearned premiums and outstanding claims in the underwriting account at the date of the assumption and distributes the remaining balance to its participants.

Current Practices

6.61 Three methods are currently used in the United States to account for foreign property and liability reinsurance: the periodic method, the zero balance method, and the open year method.

Periodic Method

6.62 The periodic method of accounting for reinsurance provides for current recognition of profits and losses. It is used when ultimate premiums and the period of recognition can be reasonably estimated currently. Premiums are recognized as revenue over the policy term, and claims, including an estimate of claims incurred but not reported, are recognized as they occur. The periodic method is consistent with current practice for primary insurance and domestic reinsurance for which sufficient information is available to reasonably estimate and recognize earned premiums and related claims. (Refer to FASB Statement No. 60.)

6.63 Some foreign ceding companies maintain the information necessary to estimate earned premiums, incurred claims, and related expenses currently. As a result, U.S. reinsurers doing business with these foreign ceding companies are able to account for reinsurance assumed by applying the same periodic method of accounting that they use to account for domestic reinsurance. Although not all foreign ceding companies maintain and report current information necessary to estimate earned premiums, incurred claims, and related expenses, some U.S. reinsurers have sufficient experience with the foreign business assumed to estimate earned premiums. When earned premiums can be estimated, sufficient information usually exists to estimate incurred claims and related expenses. Anticipated results based on either the reinsurer's experience or reported data make it possible to reasonably estimate underwriting results and use the periodic method.

Zero Balance Method

6.64 Many foreign ceding companies do not maintain the information necessary to estimate earned premiums. As a result, U.S. reinsurers doing business with these foreign companies generally are not able to apply the periodic method of accounting. Some of these companies use the zero balance method, which is a modified cash basis of accounting. This method is similar to the cost recovery method described in FASB Statement No. 60, paragraph 14. Because of the inherent lag in reporting claims, profits reported by foreign ceding companies in early years often exceed the total profits that will ultimately be realized. To avoid reporting overstated profits, companies using this method adjust the records with arbitrary provisions for claims incurred in amounts that exactly offset the cash basis profits.

Open Year Method

6.65 Under the open year method, underwriting results of foreign reinsurance are not included in the income statement until sufficient information becomes available to provide reasonable estimates of earned premiums. The open year method is similar to the deposit method as defined in FASB Statement No. 60. Because the measurement period extends over more than one accounting period, premiums, claims, and expenses are not immediately included in operating results. Instead, they are accumulated and reported in the balance sheet as an open underwriting balance. The underwriting balance is disaggregated and reported in the income statement as premiums, claims, and expenses only when earned premiums become reasonably determinable. If it is probable that a loss has been incurred before an underwriting balance is closed, a provision for a loss generally is recorded. Examples of situations in which a provision may be recorded before an underwriting balance is closed include catastrophic losses, higher-than-expected claim frequency, significant unanticipated adverse events, or a negative open year account. The accounting treatment is similar to that for premium deficiencies described in FASB Statement No. 60, paragraph 32.

Comparison With Practices in Other Industries

6.66 Deferral of revenue occurs in industries that sell goods subject to rights of return. If a right of return exists, current recognition of a sale is not permitted unless the amount of future returns is reasonably estimable. If that amount is not reasonably estimable, recognition of income is postponed until the return privilege has substantially expired. Income recognition is also postponed for certain real estate sales through the use of the installment and cost recovery methods. Those methods are analogous to the open year method.

6.67 Methods that defer recognition of underwriting profits raise financial accounting issues concerning (*a*) whether premiums and claims should be reported as income currently, even though the related underwriting balance[16] is deferred, and (*b*) whether the underwriting balance should be recorded as deferred income or as an addition to claim liabilities. Most companies that follow the zero balance method record premium and claim amounts currently and defer recognition of profits by additions to claim liabilities. Although this presentation provides timely information on the volume of business being conducted by the enterprise, the usefulness of the information is limited because the related profit margins are not also reported.

6.68 Current accounting literature supports alternative methods of financial presentation when profit recognition is deferred. For example, recognition as income of both revenues and related costs is deferred under the completed contract method until the contract is substantially completed. However, if either the installment method or cost recovery method is used to defer the recognition of gain on the sale of real estate, the sale and related costs are ordinarily reported on the date of the transaction. The deferred profit is reported separately in the income statement as a deduction from sales in the year the transaction occurs and as a separate item of revenue in future years' income statements, when the profit is recognized.

6.69 Proponents of presenting premiums, claims, and expenses in the income statement when the amounts are reported to the reinsurer point out

[16] The term *underwriting balance* refers to the excess of reported premiums over reported claims and expenses. This amount is not intended to represent income realized on a contract.

that excluding those amounts from the income statement until an underwriting year is closed does not reflect the economic substance of current period activities under the reinsurance contract. In response to criticism that presentation of the amounts in the income statement may cause profit margins to be misstated, they argue that disclosure of profits deferred and profits recognized provides sufficient information for users to evaluate operating results.

6.70 Proponents of reporting deferred amounts in the balance sheet until the profits relating to the underwriting year are recognized point out that the income statement should reflect profit margins associated with the premium volume reported in the income statement, and that this can best be done by recognizing the related premiums in the periods the profits are recognized. They acknowledge that premiums, claims, and expenses associated with a contract in a period may be important information to users, but they argue that the information could be disclosed in the notes to the financial statements or in the statement of cash flows to avoid misstating the profit margins.

6.71 The periodic method should be used to account for foreign reinsurance except in the circumstance described in paragraph 6.72.

6.72 If, due to local revenue recognition policies, the foreign ceding company cannot provide the information required by the assuming company to estimate both the ultimate premiums and the appropriate periods of recognition in accordance with U.S. generally accepted accounting principles, then the open year method should be used.[17] The presence of uncertainties that may be inherent in estimating earned premiums is not an acceptable basis for using the open year method. As discussed in paragraph 6.65, premiums, claims, commissions, and related direct taxes should not be reported currently as income under the open year method; instead, they should be included in the open underwriting balance to which they pertain. The underwriting balances should be aggregated and included in the balance sheet as a liability. Each underwriting balance should be kept open until sufficient information becomes available to record a reasonable estimate of earned premiums. The underwriting balance should be disaggregated and reported in the income statement as premiums, claims, commissions, and related direct taxes when earned premiums are reasonably determinable.

6.73 If it becomes probable that a loss has been incurred before an underwriting balance is closed, a provision for the loss should be recorded.

6.74 The periodic and open year methods are not interchangeable in the same circumstances. The periodic method should be used to account for foreign reinsurance. Only if reasonable estimates cannot be made currently, for the reason discussed in paragraph 6.72, should the open year method be used. The periodic and open year methods are not alternative accounting principles as discussed in APB Opinion No. 20, *Accounting Changes*. Rather, one or the other is to be used depending on the circumstances. As such, changes between these methods are not accounting changes. In addition, changes from the periodic method to the open year method would be seldom.

6.75 The zero balance method should not be used because it results in misstatement of the income statement by arbitrarily recognizing revenues and costs. The method also causes the profit to be reported in periods other than those in which the related premiums, claims, and expenses are reported.

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[17] If the foreign ceding company maintains supplementary records that are sufficient to reasonably estimate earned premiums currently, then the U.S. assuming company should obtain the necessary information and use the periodic method to account for the foreign reinsurance.

Disclosures

6.76 Disclosure in the financial statements of an insurance company's accounting policies should include a description of the methods used to account for foreign reinsurance. In addition, for foreign reinsurance accounted for by the open year method, the following should be disclosed for each period for which an income statement is presented:

- The amounts of premiums, claims, and expenses recognized as income on closing underwriting balances
- The additions to underwriting balances for the year for reported premiums, claims, and expenses.

Also, the amounts of premiums, claims, and expenses in the underwriting account should be disclosed for each balance sheet presented.

Chapter 7

Taxes

Federal Income Taxation

7.01 In general, a property and liability insurance company is subject to the same federal income tax laws that apply to other commercial enterprises. There are, however, additional sections of the Internal Revenue Code (IRC) and related Treasury regulations that apply specifically to property and liability insurers. Sections 831 and 832 of the IRC apply to all property and liability insurance companies. This chapter is intended to familiarize the auditor with significant and unique features of property and liability insurance taxation including the provisions of the Tax Reform Act of 1986 (TRA '86) and the Omnibus Budget Reform Act of 1990 (OBRA '90).

Recent Tax Legislation

7.02 Property and liability insurance companies taxation has been among one of the primary targets of recent tax reforms. In addition to the general corporate tax changes promulgated by TRA '86—particularly the changes in the alternative minimum tax computation—there were specific provisions affecting property and liability insurance companies. The changes are effective for taxable years after December 31, 1986, and relate primarily to loss-reserve discounting, unearned premium reserves, dividends, and tax-exempt interest. In 1990, property and liability insurance companies were required to take discounted salvage and subrogation into account on an accrual basis.

Provisions of OBRA '90 on Salvage and Subrogation

7.03 Through 1989, property and casualty companies were not required to accrue, for tax purposes, anticipated salvage and subrogation recoverable that was not in the course of liquidation. However, OBRA '90 required the accrual of salvage and subrogation on paid and unpaid losses, whether or not in the course of liquidation. Under IRS rules, salvage and subrogation is to be discounted using either discount factors published by the IRS or using the same factors used by the taxpayer in discounting its loss reserves.

7.04 The provisions relating to salvage and subrogation are generally effective for taxable years beginning after 1989. Companies that have not accrued anticipated salvage and subrogation in the past must have changed to the accrual method as of the beginning of their first taxable year beginning after 1989. However, only 13 percent of the previously accrued but unrecognized income must be taken into account as an accounting adjustment over four years. The other 87 percent of the change in method adjustment is subject to a "fresh start". For taxpayers that previously accrued salvage and subrogation, the law allows special deductions over 4 years equal to 87 percent of the discounted amount of salvage and subrogation previously accrued.

Provisions of TRA '86 on Property and Liability Insurance Companies

7.05 *Loss-reserve discounting.* Unpaid losses, including loss adjustment expenses, of a property and liability insurance company are subject to discounting for tax purposes. As a result, the deduction for unpaid losses is limited to

the increase in the amount of discounted unpaid losses. The amount of discounted unpaid losses is computed annually with respect to unpaid losses in each line of business (as contained in Schedule P of the annual statement) for each accident year. The discount periods are generally three years for property lines and ten years for liability lines of business.

7.06 The provisions relating to the treatment of loss-reserve discounting are generally effective for taxable years beginning after December 31, 1986. For unpaid losses on business outstanding before January 1, 1987, the computation of a company's change in unpaid losses for the first year is determined as if the discounting provisions were applicable during the previous year. The income resulting from this decrease in reserves was not included in taxable income and was referred to as a "fresh start."

7.07 An example of the fresh-start provision follows. Assume that at December 31, 1986, the company's undiscounted loss reserves were $1000, and at December 31, 1987, they were $2000. Under pre-1987 law, the company would be entitled to a deduction of $1000 in 1987, representing the increase in undiscounted loss reserves during the year. Assume also that on a discounted basis, the loss reserves would be $900 and $1800 at December 31, 1986, and December 31, 1987, respectively. Without the fresh-start provision, the company would be entitled to a deduction of only $800 (discounted loss reserves of $1800, less undiscounted loss reserves of $1000) in 1987. However, the provision allows companies to measure their increase or decrease in reserves for 1987 by utilizing the discounted amount at December 31, 1986. In this example, therefore, the increase in reserves for 1987 is $900 ($1800 less $900), or $100 greater than it would have been if the company had been required to utilize its undiscounted reserve amount at December 31, 1986. The release of the discount at December 31, 1986, is *never* included in taxable income.

7.08 Discounting methodology is specified in the IRC. The amount of the discounted unpaid losses is the present value of such losses determined by using (*a*) the undiscounted loss reserves, (*b*) an applicable rate of interest, and (*c*) the pattern of the payment of claims.

7.09 Generally, the amount of the undiscounted unpaid losses subject to discounting is that shown in the annual statement. However, in some cases, reserves (such as workers' compensation) are already discounted for annual statement purposes. TRA '86 requires that these reserves be grossed up and that an undiscounted loss reserve be calculated. The undiscounted amount of the loss reserve is used as the amount of unpaid losses to which the discounting rules are applied. Insurance companies are permitted to gross up these discounted loss reserves for tax purposes only if the discounting for annual statement purposes is identified as such and the discounting factors that were used are explained in the annual statement. In addition, tax reserves cannot exceed annual statement reserves due to differing discount rates.

7.10 The interest rate to use in calculating the discounted reserve is an annual rate determined by the Secretary of the Treasury. The annual rate for any calendar year is a rate equal to 100 percent of the average of the applicable federal midterm rates (AFR) effective at the beginning of each of the calendar months in the test period. The test period is the most recent five-year period ending before the beginning of the year for which the determination is made. Any month beginning before August 1, 1986, is excluded from the test period. For accident years beginning before or in 1987, the interest rate is 100 percent of the average AFR effective at the beginning of the last five calendar months

of 1986. Once an interest rate assumption is established for unpaid losses in a particular accident year, it continues to be used without change as claims for the accident year are paid.

7.11 The applicable loss-payment pattern is determined by the Secretary of the Treasury for each line of business by reference to the historical loss-payment pattern. Generally, the payment patterns are determined every five years based on published historical aggregate-loss-payment data or, at the company's election, each year based on its own historical loss-payment experience. For all years through 1991, the loss-payment patterns are based on 1985 data. Once a payment pattern has been applied to a particular accident year, it cannot be redetermined to adjust for more recent information. All losses are considered as being paid in the middle of the year. In place of the loss-payment-pattern provisions described above, an insurance company can make an irrevocable election to utilize its own historical loss-payment pattern (for example, the most recent experience as reported in its annual statement) in applying the general loss discounting rules for a taxable year. The election must be made for all lines of business for any determination year and applies for that determination year and the four succeeding calendar years. The determination year is defined as being calendar year 1987 and each fifth succeeding calendar year thereafter (such as 1987, 1992, 1997, and so forth). No election is permitted for any international or reinsurance line of business.

7.12 *Unearned premium reserve.* Under prior law, the entire annual change in a property and liability insurance company's unearned premium reserve was taken into account in computing its taxable income. In addition, property and liability insurers are entitled to deduct the expenses of issuing and selling new policies, such as policy acquisition expenses. Congress believed that allowing both a deferral of unearned premiums and a current deduction for the corresponding policy acquisition costs resulted in a significant mismatching of income and expense.

7.13 To provide for deferral of policy acquisition costs, TRA '86 permits only 80 percent of the annual change in the unearned premium reserve to be used in determining taxable income for taxable years beginning after December 31, 1986, for most lines of business. For certain financial guarantee businesses, the limitation is 90 percent. Congress deemed that the 20 percent not taken into account approximates policy acquisition costs. For example, in 1987, if an insurance company's unearned premium reserve increases from $50,000 to $60,000, the net deduction for unearned premiums will be $8,000 ($60,000 less $50,000 times 80 percent). Similarly, if the unearned premium reserve decreases in 1988 from $60,000 to $40,000, the insurance company will be required to include $16,000 (rather than $20,000, as under prior law) in determining taxable income. A property and liability insurer is also required to include in income 20 percent of its unearned premium reserve outstanding at the close of its last taxable year beginning before January 1, 1987. For most insurance companies, this is the balance at December 31, 1986. This amount will be included in income ratably over the six taxable years beginning after December 31, 1986.

7.14 *Dividends and tax-exempt interest.* TRA '86 requires a property and liability insurance company to prorate a specified portion of its investment income by reducing the deduction for losses incurred by 15 percent of its tax-exempt interest income and the deductible portion of dividends received. Dividends received from affiliates that are eligible for the 100-percent dividends-received deduction are also subject to proration if such dividends are

funded by tax-exempt interest income or by dividends not eligible for the 100-percent dividends-received deduction. The proration rule applies to taxable years beginning after December 31, 1986, but only to tax-exempt interest and dividends received or accrued on bonds or stocks acquired after August 7, 1986.

7.15 *Small property and liability insurance companies.* Under prior law, mutual property and liability insurance companies with certain gross receipts of no more than $150,000 were exempt from tax. TRA '86 provides that stock companies as well as mutual property and liability insurance companies are eligible for tax exemption. A company is exempt from tax if it has both net written premiums and direct written premiums of no more than $350,000 for the taxable year.

7.16 In addition, TRA '86 enacted a provision that allows both mutual and stock property and liability companies to elect to be taxed only on investment income. This election is available if either net written premiums or direct written premiums exceed $350,000 but neither amount exceeds $1,200,000. The amount of the net or direct written premiums is determined on a controlled group basis with a 50-percent rather than an 80-percent ownership test. These provisions are effective for taxable years beginning after December 31, 1986.

7.17 *Protection against loss account.* Under prior law, mutual property and liability insurance companies were permitted a protection against loss (PAL) account deduction. The PAL account, which was originally enacted to provide for the cyclical nature of the industry, is a memorandum account that allowed a mutual property and liability insurer to defer a portion of its underwriting income.

7.18 In an attempt to reduce the differences between mutual and stock companies, TRA '86 repeals the deduction for additions to the PAL account effective for taxable years beginning after December 31, 1986. Amounts in the PAL account at the close of the last taxable year beginning before January 1, 1987, are included in income in the same manner as under prior law.

7.19 *Alternative minimum tax.* For taxable years beginning after December 31, 1986, TRA '86 repealed the corporate add-on minimum tax and replaced it with an alternative minimum tax (AMT). In addition, TRA '86 requires a property and liability insurance company to take into account its AMT liability and regular tax liability in making estimated tax payments. As of 1990, adjusted current earnings (ACE) is used for calculating the alternative minimum tax.

7.20 *Adjusted current earnings.* For taxable years beginning after December 31, 1989, a preference based on reported book income was replaced by an adjustment referred to as the adjusted current earnings (ACE) adjustment. In short, ACE is equal to taxable income plus a number of adjustments and preferences, the most significant of which for property and casualty companies will be the inclusion of the untaxed portion of tax-exempt interest and the dividends-received deduction (DRD) applicable to portfolio stocks (70 percent DRD). The DRDs relating to companies in which the taxpayer owns at least 20 percent but less than 80 percent (80 percent DRD) and for which the taxpayer owns 80 percent or more (100 percent DRD) are not included in ACE. AMTI will be increased by 75 percent of the amount by which ACE, rather than book income, exceeds AMTI before this adjustment. For many property and liability companies, ACE can be approximated by simply adding 75 percent of tax-exempt interest and 75 percent of the 70 percent of the DRD to regular taxable income.

Statutory Accounting Practices and Taxable Income

7.21 A property and liability insurance company's taxable income is based in large part on its statutory financial statements. The underwriting and investment exhibit of the annual statement approved by NAIC is accepted by the IRS as the net income of the company; and insofar as it is not inconsistent with the provisions of the IRC, the exhibit is recognized and used as a basis for determining the gross amount earned from investment and underwriting income for tax purposes.

7.22 There are three other unique and prominent similarities between statutory and taxable income. First, commissions, premium taxes, and other costs of acquiring new business are fully deductible for tax purposes in the year that they are incurred, although the related income is included in subsequent tax periods. Second, direct charges or credits to statutory surplus are not included in determining taxable income. They include premiums past due from agents—unless they are bona fide bad debts currently chargeable to statutory expense—and the provision for unauthorized reinsurance. Third, premiums are included in taxable income only as they are earned, regardless of when they are received.

7.23 Although most of the accounting practices for determining taxable income as prescribed by the IRC follow statutory accounting practices, there are items that are always excluded from or are deductible in computing taxable income, such as tax-exempt interest received on certain bonds, and the dividends-received deduction. The IRC and regulations of the IRS also differ from statutory practices in certain respects for salvage and subrogation, policyholder dividends, and deposit premiums.

7.24 *Policyholder dividends.* Under statutory accounting practices, policyholder dividends are charged to expense on the date they are declared; the IRC permits policyholder dividends to be deducted on the date declared, the date payable, or the date paid, as long as the chosen method is consistently followed.

7.25 *Deposit premiums.* Deposit premiums are provisional payments by policyholders that are adjusted when the policies expire, based on the coverage provided. They are most commonly used for workers' compensation insurance. Statutory accounting practices allow several methods of recognizing deposit premiums. For federal income tax purposes, the includable portion of the premium is the amount received, less the amount of unabsorbed premium deposits that the company would be obligated to return to its policyholders at the close of the taxable year if all its policies were terminated at that date.

Special Income Tax Provisions

7.26 *Capital losses.* The IRC treats the deductions for capital losses of property and liability insurers differently from those of other corporate taxpayers in certain unusual circumstances. Property and liability insurers may claim ordinary deductions for capital losses resulting from the sale or exchange of capital assets in order to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders. Insurance companies use a prescribed calculation to determine whether securities were sold to meet abnormal losses. Capital losses are ordinary deductions to the extent that gross receipts from assets sold do not exceed the excess of cash-basis income over cash-basis expense.

GAAP Accounting for Income Taxes

7.27 In February 1992, the FASB issued FASB Statement No. 109, *Accounting for Income Taxes*. FASB Statement No. 109 supersedes Statement No. 96, *Accounting for Income Taxes*, and APB Opinion No. 11, *Accounting for Income Taxes*. The Statement is the result of a project to reconsider the accounting for income taxes under generally accepted accounting principles that was initiated by the FASB in 1982. The requirements of FASB Statement No. 109 significantly change the accounting for income taxes for most companies.

7.28 The most fundamental change contained in FASB Statement No. 109 is the change from the deferred method required by APB Opinion No. 11 to the asset and liability method of accounting for income taxes. Under the asset and liability method the emphasis in accounting for income taxes is on the balance sheet rather than on the income statement. The asset and liability method accounts for deferred income taxes by applying enacted statutory tax rates in effect at the balance sheet date to the temporary differences between the recorded financial statement balances and the related tax bases of assets and liabilities. The resulting deferred tax liabilities and assets are adjusted to reflect changes in tax laws and rates in the period of enactment.

Basic Principles of Accounting for Income Taxes

7.29 The following basic principles are applied in accounting for income taxes at the date of the financial statements:

- A current tax liability or asset is recognized for the estimated taxes payable or refundable on tax returns for the current year.
- A deferred tax liability or asset is recognized for the estimated future tax effects attributable to temporary differences and carryforwards.
- The measurement of current and deferred tax liabilities and assets is based on provisions of the enacted tax law; the effects of future changes in tax laws or rates are not anticipated.
- The measurement of deferred tax assets is reduced, if necessary, by the amount of any tax benefits that, based on available evidence, are not expected to be realized.

Temporary Differences

7.30 FASB Statement No. 109 introduces the term temporary difference. A temporary difference arises when the tax bases of assets and liabilities differ from those reported in the financial statements. Temporary difference is more comprehensive than the term *timing difference* as used in APB Opinion No. 11. For example, certain book/tax differences arising from purchase business combinations will be treated as temporary differences under FASB Statement No. 109 rather than as permanent differences.

7.31 For property and liability insurance companies, the more significant temporary differences include:

- *Deferred policy acquisition costs.* Because certain acquisition costs are deferred for financial statement purposes but expensed when incurred for tax purposes, a temporary difference exists in the amount of the deferred policy acquisition cost asset.
- *Unearned premium reserve.* Under TRA '86, only 80 percent of the change in the unearned premium reserve of a property and casualty

insurer is considered in computing taxable income. Thus, a temporary difference exists for the 20 percent nondeductible portion of the unearned premium reserve.

- *Loss and loss expense reserves*. TRA '86 requires the discounting of all property and casualty loss reserves and certain accident and health claim reserves. Generally, such reserves are not discounted for financial statement purposes. A temporary difference will exist in the amount of the difference between the financial statement reserves and the tax basis of reserves.
- *Investments*. Net unrealized gains or losses on investments in equity securities, as well as any permanent impairment write-downs of investments recognized in the financial statements, are considered temporary differences. Generally, market discount on bonds is not subject to tax until the bonds mature or are sold. The accrual of market discount for financial statement purposes creates a temporary difference for which deferred taxes should be recognized.

7.32 Items that will never have a tax consequence are not considered temporary differences. Examples of such items include tax-exempt interest and the dividends-received deduction.

7.33 Temporary differences ordinarily become taxable or deductible when the related asset is recovered or the related liability is settled. A deferred tax liability or asset represents the increase or decrease in taxes payable or refundable in future years as a result of temporary differences and carryforwards at the end of the current year.

7.34 FASB Statement No. 109 requires that a deferred tax liability be recognized for all taxable temporary differences and a deferred tax asset be recognized for all deductible temporary differences and operating loss and tax credit carryforwards. A *valuation allowance* should be recognized if it is more likely than not that some portion or all of the deferred tax asset will not be recovered.

7.35 Because FASB Statement No. 109 requires that calculations of deferred tax assets and liabilities be performed separately for each tax jurisdiction, detailed records of temporary differences may be required for each tax jurisdiction in which the entity is subject to income taxes. As the alternative minimum tax introduced by TRA '86 is deemed to be a separate but parallel tax system, detailed records of temporary differences under this system may also be required.

Changes in Tax Law

7.36 Under the asset and liability method, deferred taxes represent liabilities to be paid or assets to be received in the future. Accordingly, deferred tax assets and liabilities are adjusted to reflect a change in tax law or rates. The effect of the change is recognized as a component of income tax expense in the period the tax law change is enacted. In contrast, APB Opinion No. 11 generally considered the deferred tax balance to be a deferred credit or charge not to be adjusted for a change in the tax law or rates.

Financial Statement Presentation and Disclosure

7.37 Paragraphs 41 and 42 of FASB Statement No. 109 set forth financial statement presentation principles related to deferred tax assets and liabilities.

7.38 Separate balance sheet presentation of current refundable income taxes or income taxes payable and deferred income taxes for each tax jurisdiction (federal, state, and each foreign tax jurisdiction) should be made (for ex-

ample, a federal deferred tax asset should not be netted against a state deferred tax liability). The following components of the net deferred tax liability or asset recognized in the property and liability insurer's balance sheet should be disclosed:

- The gross amount of all deferred tax liabilities.
- The gross amount of all deferred tax assets.
- The amount of any valuation allowance reducing the amount of deferred tax asset and any change in the valuation allowance during the period.

7.39 Property and liability insurance entities registered with the SEC should disclose the approximate tax effect of each significant type of temporary difference and carryforward (before allocation of valuation allowances). Non-SEC registrants should disclose the types of significant temporary differences and carryforwards, but may omit disclosure of the tax effects for these items.

7.40 Whenever a deferred tax liability is not recognized because of certain exceptions under APB Opinion No. 23, *Accounting for Income Taxes-Special Areas* (as amended by FASB Statement No. 109), the following information should be disclosed:

- Description and cumulative amount of significant types of temporary differences for which a deferred tax liability has not been recognized, and the types of events that would cause those temporary differences to become taxable.
- Amount of unrecognized deferred tax liability for temporary differences related to investments in foreign subsidiaries and foreign joint ventures that are essentially permanent in duration, if determination of that liability is practicable, or a statement that determination is not practicable.
- The amount of the deferred tax liability for other temporary differences that is not recognized in accordance with the provisions of paragraphs 31 and 32 of FASB Statement No. 109.

7.41 Examples of temporary differences of property and liability insurance companies for which a deferred tax liability is not recognized unless it becomes apparent that those temporary differences will reverse in the foreseeable future:

- Excess book basis over the tax basis of an investment in a foreign subsidiary or foreign corporate joint venture that is essentially permanent in duration.
- Undistributed earnings of a domestic subsidiary or corporate joint venture that are permanent in duration and arose in fiscal years beginning on or before December 15, 1992.

7.42 The significant components of income tax expense for continuing operations for each period presented should be disclosed and may include the following:

- Current tax expense or benefit.
- Deferred tax expense or benefit (exclude other components that are disclosed separately).
- Investment tax credits and government grants.
- The benefits of operating loss carryforwards.
- Adjustments of a deferred tax liability or asset resulting from enacted changes in tax laws and rates or a change in the tax status of the property and liability insurance company.

- Adjustments to beginning balance of valuation allowances resulting from a change in circumstances that causes a change in the assessment of the realizability of the deferred tax asset in future years.
- Tax expense that results from allocating certain tax benefits either directly to (*a*) contributed capital or (*b*) goodwill or other noncurrent intangible assets of an acquired entity.

7.43 The amount of income tax expense or benefit amount allocated to (*a*) continuing operations, (*b*) discontinued operations, (*c*) extraordinary items, and (*d*) shareholders' equity should be disclosed. For example, the amount of income tax expense or benefit attributable to certain items whose tax effects are charged or credited directly to related components of shareholder's equity, such as translation adjustments under FASB Statement No. 52, *Foreign Currency Translation*, or changes in the carrying amount of available-for-sale securities under FASB Statement No. 115, should be separately allocated and disclosed.

7.44 SEC registrants are required to disclose a reconciliation using percentages or dollar amounts of the current year's tax expense attributable to continuing operations to the amount of tax expense computed by applying the federal statutory tax rate to pre-tax income from continuing operations of the current year. The estimated amount and nature of each significant reconciling item should be disclosed. Non-SEC registrants are required to disclose the nature of significant reconciling items. This is usually satisfied by a footnote describing the nature of the reconciling items without any quantitative disclosure.

7.45 The amounts and expiration dates of net operating loss and tax credit carryforwards should be disclosed. Further, a property and liability insurance company is required to disclose the amount of any valuation allowance for which subsequently recognized tax benefits will be allocated directly to (*a*) reduce goodwill or other non-current intangible assets of an acquired entity or (*b*) contributed capital.

7.46 A property and liability insurance company that joins in the filing of a consolidated tax return with its parent and affiliates must disclose in its separately-issued financial statements the method for allocating and settling the consolidated income taxes among the members of the group, which should be in accordance with the principles in FASB Statement No. 109. The aggregate amount of current and deferred tax expense and any tax-related balances due to or from affiliates also should be disclosed.

7.47 The objectives of auditing income taxes are to obtain reasonable assurance that—

- The provision for income taxes and the reported income tax liability or receivable are properly measured, valued, classified, and described in accordance with the generally accepted accounting principles.
- Deferred income tax liabilities and assets accurately reflect the future tax consequences of events that have been recognized in the property and liability insurance company's financial statements or tax returns (temporary differences and carryforwards).

7.48 The independent accountant should be aware that the tax laws specific to property and liability insurance companies, as well as to general corporate taxation, can change from year to year.

Internal Control Structure* and Possible Tests of Control

7.49 It is generally more efficient and effective to assess control risk at the maximum for income taxes and take an entirely substantive approach. The independent accountant should, however, obtain an understanding of relevant internal control structure policies and procedures to plan effective substantive tests.

Substantive Tests

7.50 Substantive audit procedures may include the following:

- Obtain a schedule reconciling net income per books with taxable income for federal, state, and foreign income taxes. Agree entries to general ledger and supporting documents as appropriate. Consider the reasonableness of the current tax account balances.
- Examine prior year income tax returns, and ascertain the latest year for which returns have been examined. Review recent Revenue Agent Reports, if any, and consider current treatment of items challenged by the taxing authorities in prior years.
- Update or review the schedule of cumulative temporary differences, reviewing for propriety, and test the reasonableness of the income tax amounts.
- Review and determine the need for and appropriateness of any valuation allowance for deferred tax assets based upon available evidence. The auditor should recognize that institutions often may have a significant deferred tax asset resulting from the loan loss reserve. This asset should be evaluated based upon the likelihood of realization, taking into account the timing of the bad debt deduction, and the special operating loss carryforwards and carryback tax rules, if applicable.
- Consider the deductibility of transactions such as profit-sharing, bonus, contributions, or stock option transactions.
- Review classification and description of accounts to identify possible tax reporting differences, such as reserves for anticipated losses or expenses.
- Review the tax status and consolidated return requirements of subsidiaries.
- Review the status of current year acquisitions of other companies and their preacquisition tax liabilities and exposures.
- Review the utilization of carryforwards.
- Review the allocation, apportionment, and sourcing of income and expense applicable to state tax jurisdictions with significant income taxes.
- For separate financial statements of affiliates, review terms of all tax-sharing agreements between affiliated entities to determine proper disclosure and accounting treatment. The auditor should be cognizant of and consider whether the institution is in compliance with the regulatory accounting rules for intercompany tax allocation and settlement.

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* SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55*, revises the definition and description of internal control and makes conforming changes to relevant terminology. SAS No. 78 was issued in December 1995 and is effective for audits of financial statements for periods beginning on or after January 1, 1997. This Guide will be amended to conform to SAS No. 78 nearer to the pronouncement's effective date.

- Review schedule of net operating loss and other tax credit carryforwards.
- Review tax planning strategies and assumptions utilized in the calculation of deferred income taxes under FASB Statement No. 109.
- Test the roll-forward of tax balance sheet accounts. Consider vouching significant tax payments and credits.
- Review reconciliation of prior year tax accrual to the actual filed tax return. Determine the propriety of adjustments made in this regard and consider the impact on current year's tax accrual.
- Evaluate tax contingencies and consider the appropriate accounting treatment and disclosure requirements for these items under FASB Statement No. 5.
- Ascertain whether changes in income tax laws and rates have been properly reflected in the tax calculations and account balances.
- Evaluate the adequacy of the financial statement disclosures.

Net Operating Loss and Tax Credit Carryforwards

7.51 FASB Statement No. 109 also changes the manner in which realization of the tax benefit of an operating loss carryforward is reported in the financial statements. Under APB Opinion No. 11, the tax benefit arising from the use of a net operating loss carryforward was classified in the income statement as an extraordinary item. FASB Statement No. 109, however, generally requires that the tax benefit of a loss carryforward be reported as a reduction of income tax expense.

Other Issues

7.52 The following discussion highlights other changes to current accounting practice required by FASB Statement No. 109 and specific implementation issues confronting the insurance industry.

Unrealized Gains and Losses

7.53 FASB Statement No. 109 does not significantly change the accounting for deferred taxes relating to unrealized gains and losses on marketable securities. As with previous practice, unrealized gains and losses are considered temporary differences for which deferred taxes computed under the Statement's intraperiod tax allocation provisions are measured and recorded through a direct charge or credit to stockholders' equity.

7.54 Deferred tax assets should be reduced by a valuation allowance if, based on the weight of available evidence, it is more likely than not (a likelihood of more than 50 percent) that some portion or all of the deferred tax asset will not be realized. The valuation allowance should be sufficient to reduce the deferred tax asset to the amount that is more likely than not to be realized. This is in contrast to the provisions of APB Opinion No. 11, which applied an "assured beyond any reasonable doubt" test for recognition of the tax benefits associated with unrealized capital losses.

7.55 Net unrealized gains and losses should be considered to be temporary differences. The period in which net gains and losses on marketable securities are realized is dependent upon management's future investment decisions.

Accounting for the "Fresh Start"

7.56 TRA '86 grants insurers a "fresh start" on the difference between ending 1986 undiscounted loss reserves and beginning 1987 discounted loss reserves, meaning that such difference need not be included in post-1986 taxable income. This creates a temporary difference that will result in deductible amounts in future periods.

7.57 Under APB Opinion No. 11, the FASB's Emerging Issues Task Force (EITF) concluded that the fresh-start adjustment should be treated as a permanent difference, the benefit of which is recognized in the income statement in future periods as the fresh start is recognized on the tax return. Under FASB Statement No. 109, the difference between the financial statement reserve liability and the tax basis of reserves (including fresh start) is a temporary difference.

Unearned Premium Reserve

7.58 TRA '86 provided that only 80 percent of the post-1986 change in the unearned premium reserve of a property and casualty insurer is taken into consideration in determining post-1986 taxable income. In addition, 20 percent of the ending 1986 unearned premium reserve must be included in taxable income ratably over a six-year period beginning in 1987.

7.59 TRA '86 creates a temporary difference equal to 20 percent of the December 31, 1986, unearned premium reserve. Under the tax law provisions, this amount is included in taxable income ratably over a six-year period beginning in 1987. A temporary difference will also exist in the amount of 20 percent of ending unearned premium reserve for each year subsequent to 1986, which should be scheduled as a deductible amount in the period(s) the premiums are earned.

The Alternative Minimum Tax

7.60 The alternative minimum tax may be the most significant and complex aspect of TRA '86. The objective of the AMT is to ensure that no taxpayer with substantial "economic income" can avoid paying tax by using exclusions, deductions, and credits. The FASB's Emerging Issues Task Force reached a consensus, as described in EITF Issue No. 87-8, *Tax Reform Act of 1986: Issues Relating to the Alternative Minimum Tax*, on several key issues relating to the accounting for the AMT under APB Opinion No. 11. Of primary significance was the decision to view the AMT as a separate but parallel tax system. The federal tax liability is considered to be the greater of the amount calculated under the regular tax system or the AMT system. However, the excess of the AMT over the regular tax is generally available as an AMT credit carryforward to future years.

7.61 Under FASB Statement No. 109, the AMT credit carryforward is reflected as a prepayment of regular tax and reported as a deferred tax asset subject to a valuation allowance.

APB Opinion No. 23: *Accounting for Income Taxes—Special Areas*

7.62 FASB Statement No. 109 changes the present practice of accounting for certain temporary differences identified in APB Opinion No. 23, including undistributed earnings of subsidiaries and corporate joint ventures and the amounts designated as policyholders' surplus of stock life insurance companies. FASB Statement No. 109 requires additional financial statement disclosures regarding these temporary differences.

Interim Financial Reporting

7.63 FASB Statement No. 109 amends FASB Statement No. 16, *Prior-Period Adjustments*, to eliminate the requirement to restate prior interim periods for the effects of new retroactive tax legislation. The effects of changes in tax laws or rates are to be recorded in the interim period in which the tax law change is enacted.

State Taxation

7.64 Various state governments tax property and liability insurers on premiums written and on income. Taxation methods and tax rates vary widely among the states. Many of the states apply different rates to different lines of insurance and differentiate between domestic insurers and foreign insurers.

7.65 *Premium taxes.* All states tax premiums. These taxes usually apply both to the companies that are domiciled in the state, called *domestic insurers*, and to the companies that conduct business in the state but are domiciled elsewhere, called *foreign insurers*. Some states, however, partially or totally exempt domestic insurers from premium taxes, and others allow domestic insurers special credits against premium taxes if they invest specified amounts of assets in domestic corporations. The premium tax base is generally direct premiums written less returned premiums on the business within the taxing state. The tax rates vary by state.

7.66 Some states require quarterly premium tax payments; however, most states require premium tax payments in February of the year following the year that the premiums were written. Insurers thus generally have substantial premium tax liabilities as of December 31 of each year. Rather than computing the liability on a state-by-state basis, most companies estimate their total premium tax payable using their historical ratio of total premium tax expense to total premiums written. This ratio is applied to current premiums written to compute the current premium taxes for the fiscal year. The total liability is then adjusted for prepaid premium taxes to arrive at the accrued premium tax liability. The company should evaluate the ratio annually, because shifts in the concentration of the company's business from state to state and changes in state tax laws can significantly affect an insurer's premium tax liability.

7.67 *State income taxes.* In addition to premium taxes of insurance companies, some states tax the net income of domestic insurers in one way or another. Some also tax the net income of foreign insurers. Generally, however, various methods are used to avoid double taxation. The methods include (*a*) allowing the insurer to elect to be taxed on either premiums or net income, (*b*) allowing a credit on one of the tax returns for taxes paid on the other, and (*c*) exempting domestic insurers from the premium tax.

7.68 States that tax the income in addition to or in place of the premium tax of property and liability insurance companies generally base the computation of taxable income on federal taxable income, with certain modifications. Apportionment and allocation of income by multistate companies are important considerations when accruing for such taxes.

7.69 The prior-year apportionment percentage is generally indicative of the current year for computing the accrual. Significant changes in the places in which the company does business, however, can affect apportionment and should be considered when testing the adequacy and reasonableness of the accrual for state franchise or income taxes.

Chapter 8

SAP to GAAP Reconciliation

8.01 Since the nineteenth century, state insurance regulatory authorities have been developing and prescribing financial reporting practices and procedures in the insurance industry to assist in discharging their regulatory responsibilities. Because of the legislative authority from which these accounting practices have evolved, they are generally referred to as *statutory accounting practices*. The NAIC has codified these practices in its publication, *Accounting Practices and Procedures Manual for Fire and Casualty Insurance Companies*. A major objective of state regulatory authorities is to protect the interests of policyholders. Accordingly, SAP is oriented toward demonstrating the solvency of insurance companies. Its emphasis on solvency has led to a focus on presenting the accounts of a company on a liquidation basis, rather than on a going-concern basis recognized under generally accepted accounting principles, and a focus on the balance sheet as it relates to a company's solvency, rather than on GAAP's focus on the balance sheet and other elements directly related to measuring performance and status of an entity.

8.02 For many years, the differences between GAAP and SAP were not a major concern. Because they are subject to extensive state regulation, insurance companies were specifically exempted from filing registration statements and periodic financial reports, which were required by the Securities Acts of 1933 and 1934. Consequently, many insurance companies did not prepare GAAP financial statements.

8.03 In the late 1950s and early 1960s, however, several insurance companies sought to raise capital in the financial markets; accordingly, they were required to file registration statements with the SEC. Also, several of the larger stock insurance companies sought to list their shares on the public stock exchanges. The Stock Exchange rules require those securities to be registered with the SEC, and the insurance companies became subject to the SEC's periodic reporting requirements for audited financial statements presented in conformity with GAAP. Accordingly, both the SEC and the accounting profession began focusing attention on the accounting practices of the insurance industry.

Differences Between SAP and GAAP

8.04 The differences between SAP and GAAP result from their differing emphases. GAAP is intended to report results of operations and financial condition on a going-concern basis, whereas SAP is designed to demonstrate solvency. Adequate statutory surplus provides protection to policyholders and permits a company to expand its premium writing. Accordingly, SAP places a great deal of emphasis on the adequacy of statutory surplus. This chapter describes the accounting treatments under SAP that differ from those under GAAP for major accounts and transactions of property and liability insurance companies. The AICPA's Auditing Standards Division has issued an Auditing Interpretation "Evaluation of the Appropriateness of Informative Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis"

(AICPA, *Professional Standards,* vol. 1, AU section 9623.60-.79) to provide guidance on evaluating disclosures in SAP financial statements.

8.05 Property and liability insurance companies may prepare their GAAP financial statements by adjusting their statutory financial statements for the differences between SAP and GAAP methods.

Investments

8.06 As discussed in chapter 5, investments constitute the major portion of an insurance company's assets, and bonds and stocks constitute the major portion of its investments. Statutory practices for valuing stocks and bonds have several unique features.

8.07 *Bonds.* Most property and liability insurance companies invest a significant share of their portfolios in debt securities. In general, under SAP, bonds are valued at original cost reduced by amortization of premiums or increased by accretion for discounts, unless there has been a decline in market value that is deemed to be other than temporary. SAP differs from GAAP in the procedures for identifying and valuing those bonds whose values are permanently impaired. The NAIC issues an annual report on securities valuation, *NAIC Securities Valuation*, which is used by all insurance companies to value their portfolios. Bonds that are not in good standing, that is, are in default regarding principal or interest, are specifically identified by the NAIC, and their year-end market values are listed in the report. For statutory reporting, companies holding such securities are required to write them down to the indicated market values through direct charges to statutory surplus. GAAP calls for professional judgment in identifying and valuing permanently impaired bonds. Any resulting write-off is recorded as a realized capital loss. The NAIC also assigns values to publicly traded bonds that may be higher or lower than quoted market values. However, if the NAIC has assigned a market value higher than its amortized cost, the bond should be carried at amortized cost.

8.08 In periods of increasing interest rates, the market values of insurance companies' fixed-interest-rate bonds generally fall such that the market values of their bond portfolios are significantly below their balance-sheet carrying values. Insurance regulators see no easy solution to this problem. If bonds were consistently measured at market values and the carrying values of bond portfolios were revised downward to market value, many insurance companies would be rendered technically insolvent by statutory standards. However, the sale of bonds in such a down market is highly unlikely. It would be imprudent for an insurance company to incur significant investment losses and corresponding reductions in equity when there may not be a compelling need to do so. Indeed, in justifying the practice of carrying bonds at amortized cost, the industry cites both its demonstrated ability and intent to hold these investments in bonds until maturity. Thus, with ultimate redemption at par envisioned for most issues, investment losses in bonds should be negligible if the intentions are carried out.

8.09 *Long-term investments.* An Auditing Interpretation, *Evidential Matter for the Carrying Amount of Marketable Securities* (AICPA, *Professional Standards*, vol. 1, AU section 9332), provides guidance in determining the evidence the auditor should obtain pertaining to the classification and the carrying amounts of marketable securities when market value is below cost. In addition, the SEC's Staff Accounting Bulletin No. 59 sets forth the staff's interpretation of the phrase *other than temporary* as used in the discussion of

impairment in FASB Statement No. 12, *Accounting for Certain Marketable Securities*. (FASB Statement No. 115 supersedes FASB Statement No. 12 and also includes a discussion of impairment of securities.) As discussed in chapter 5, the SEC's staff does not believe that *other than temporary* necessarily means permanent. The bulletin states that if a decline in market value has occurred, management should determine whether a write-down may be required and, unless evidence exists to support a realizable value equal to or greater than the carrying value of the investment, a write-down should be recorded. Factors that should be considered in evaluating the realizable value of the investment are discussed in chapter 5.

8.10 *Stocks.* Except for preferred issues with mandatory redemption features, stocks are carried at market value, with unrealized appreciation or depreciation recognized by a corresponding entry to equity. Under SAP, mandatory redemption preferred stock is carried at either cost or amortized cost, provided it is in good standing. For GAAP, investments in equity securities should be accounted for in accordance with FASB Statement No. 115. The treatment of declines that are other than temporary in the value of stocks under SAP and GAAP is the same as for bonds.

8.11 SAP does not recognize deferred taxes. Accordingly, deferred income taxes are not recorded for unrealized appreciation or depreciation as is required by GAAP.

Nonadmitted Assets

8.12 Certain resources that are recognized as assets under GAAP are required by SAP to be excluded from the balance sheet and are thus referred to as *nonadmitted assets*. These include nonliquid items; examples are equipment, furnishing and supplies, leasehold improvements, prepaid expenses, and agents' balances over ninety days due. In certain states, federal income tax recoverables are also nonadmitted. Such assets are generally entered in the insurance company general ledger accounts for control or other purposes, but are excluded from the statutory balance sheet by direct charges to surplus. For GAAP purposes, nonadmitted assets are restored to the balance sheet, subject to depreciation and the usual tests regarding recoverability and future benefit. (Chapter 1 also discusses nonadmitted assets.)

Acquisition Costs

8.13 For most insurance companies, except direct writers, the principal producers of new and renewal business are agents or brokers, who receive sales commissions from the companies according to schedules or contractual agreements. Commissions are usually paid in full at the effective dates or renewal dates of the related insurance contracts, and represent a major cost in the insurance companies' acquisition of business. There are also many other expenses involved in underwriting, issuing, and servicing insurance policies. For example, virtually all states levy premium taxes on property and casualty premiums, as discussed in chapter 7. All such costs are generally included in the term *acquisition expenses*. They are charged to current operations as incurred under SAP because liquidity considerations are deemed more important under SAP than the GAAP principle of matching expenses with revenues. Under GAAP, acquisition costs that vary with and are primarily related to the acquisition of new and renewal business are capitalized as deferred acquisition costs, as discussed in chapter 3; these costs are then charged to earnings in proportion to premium revenue recognized.

Premium Deficiencies

8.14 SAP does not require the loss recognition test for premium deficiencies that is required by GAAP. (The determination of premium deficiencies is discussed in chapter 3.)

Policyholder Dividends

8.15 GAAP requires policyholder dividends that are undeclared as of the balance sheet date to be estimated and accrued. Under SAP, however, policyholder dividends are not recorded as liabilities until declared.

Contingent Commissions

8.16 Property and liability insurance companies sometimes compensate agents or brokers by contingent commissions, which are based on the profit experience of the policies they have sold. Under some arrangements, if the experience is adverse, the agent or broker may be required to return the company commissions previously received. Under SAP, the reporting of estimated contingent commissions varies. Some companies accrue the estimates, whereas others report on a cash basis. However, GAAP requires contingent commissions to be accrued.

Loss Reserves

8.17 Both SAP and GAAP require that insurance companies report a provision for all incurred losses that are unpaid as of the balance sheet date, including losses incurred but not reported. The liability is based on management's estimate of the ultimate cost of settling each loss. The statutes of many states, however, require minimum reserves for certain lines, called *excess Schedule Preserves*, primarily bodily injury liability and workers' compensation. The minimum reserves are based on the company's actual loss ratio in the five years immediately preceding the most recent three years. The lowest ratios for these years, with a stipulated minimum ratio of 60 percent (65 percent for workers' compensation) and a maximum ratio of 75 percent, are used. The determined ratio is applied to earned premium for each of the three most recent calendar years. The minimum reserves are then compared with the estimated liabilities for each of the three years, and any excess of the minimum over the estimates is reported as a separate liability in the statements prepared under SAP. Any changes in the excess reserves are reported as charges or credits directly to surplus. When financial statements are prepared in accordance with GAAP, the entries are reversed, and the excess reserves are restored to retained earnings.

Reserves for Unauthorized Reinsurance

8.18 Under statutory accounting practices, when reinsurance is placed with a company not authorized to do business in a particular state, and therefore not subject to its jurisdiction and regulation, the ceding company must maintain and report a liability account (or accounts) for reserve credits taken and the losses recoverable that have been recorded to the extent it has not retained funds or obtained letters of credit. Assuming that there is appropriate reason to believe the assuming company is financially responsible, any such reserves established represent segregated surplus rather than a liability and should be added back to stockholders' equity under GAAP. If the assuming company is not considered to be financially responsible, a reserve for uncollectible reinsurance balances should be established under GAAP based on an anal-

ysis of the insured's exposure. Beginning December 31, 1989, Schedule F of the statutory filing includes an aging of reinsurance recoverables from authorized companies on paid losses, the calculation of a surplus penalty based on that aging, and disclosure of the amount of recoverables being disputed by assuming companies.

Deferred Taxes

8.19 Under SAP, reporting deferred taxes arising from temporary differences between statutory income before taxes and taxable income is not required. GAAP requires that deferred taxes be reported for temporary differences and carryforwards.

Other

8.20 Some other differences between SAP and GAAP are—

- *Pension accounting.* Some mutual property/casualty companies have not adopted FASB Statement No. 87, *Employers' Accounting for Pensions,* under GAAP. SAP allows the use of cash paid in accordance with funding requirements.
- *Accounting for leases.* Under SAP, generally all leases are treated as operating leases. Any assets relating to capitalized leases would be treated as nonadmitted assets. Under GAAP, FASB Statement No. 13, *Accounting for Leases*, provides guidance on accounting for leases.
- *Allowance for mortgage loans and real estate.* Although these loans are generally insignificant to most property and liability insurance companies, SAP does not require a provision for writedowns other than when principal and interest are at least ninety days overdue.

Summary

8.21 The major differences between SAP and GAAP are summarized as follows:

SAP	*GAAP*
a. Bonds are carried at promulgated amounts that are primarily at amortized cost; however, the NAIC requires certain bonds to be carried at market.	*a.* Bonds are carried at amortized cost provided the company has the ability and intent to hold the bonds until maturity and there is no decline, other than temporary, in the market value.
b. Common and preferred stocks are reported at values published by the NAIC, which are generally based on market values. Sinking-fund preferred stocks are carried at amortized cost; however, certain issues are required by the NAIC to be carried at market.	*b.* Common and nonredeemable preferred stocks are carried at market. By their terms, preferred stocks that must be redeemed by the issuing company are carried at amortized cost if the company has both the ability and intent to hold the stocks until redemption, and there is no decline, other than temporary, in the market value of the stock.

SAP	GAAP
c. Stocks of subsidiaries or affiliates are valued based on one of the following: • Statutory book values of the assets of the companies if held directly by the insurer • Net worth of the companies determined in conformity with GAAP, • Market values if the companies are publicly traded • Any other value that can be substantiated to the satisfaction of the NAIC subcommittee, The changes in values are reported as direct charges or credits to surplus	*c.* Majority-owned subsidiaries are consolidated. Investments in unconsolidated affiliates are generally accounted for on the equity method.
d. Nonadmitted investments are reported as a charge to surplus through unrealized depreciation of investment carrying value.	*d.* Adjustments of carrying values as a result of permanent impairment and declines in market values of stocks that are other than temporary are reported as realized losses.
e. Certain assets and certain reductions of liabilities are not recognized by the state insurance departments and, accordingly, are excluded from the balance sheet. Such assets, principally furniture and equipment, prepaid expenses, and certain receivable balances and, in certain states, federal income tax recoverables, are referred to as *nonadmitted* assets.	*e.* All assets are included at cost or recoverable amount.
f. Costs of acquiring policies are charged to expense when incurred (generally, at the beginning of the policy period).	*f.* Acquisition costs that vary with and are primarily related to new and renewal business are deferred and amortized over the policy period.
g. Policyholder dividends are reported as liabilities when declared.	*g.* Undeclared policyholder dividends at the balance sheet date are estimated and accrued.
h. Minimum liabilities for losses may be required for certain kinds of risks based on a statutory formula.	*h.* Liabilities for losses are based on estimates of the ultimate amount of losses to be incurred.
i. No deferred federal income taxes are required.	*i.* Deferred federal income taxes are provided for temporary differences and carryforwards.

Chapter 9

Auditor's Reports

General

9.01 Insurance companies engage independent auditors to report on financial statements issued to regulatory agencies, stockholders, policyholders, other financial statement users, or the general public.

9.02 SAS No. 58, *Reports on Audited Financial Statements*, applies to auditor's reports issued in connection with audits of financial statements that are intended to present financial position, results of operations, and cash flows in conformity with GAAP. Justification for the expression of the auditor's opinion rests on the conformity of his or her audit with generally accepted auditing standards and on his or her findings. The auditor's standard report states that the financial statements present fairly, in all material respects, an entity's financial position, results of operations, and cash flows in conformity with GAAP. This conclusion may be expressed only when the auditor has formed such an opinion on the basis of an audit performed in accordance with generally accepted auditing standards. The auditor's standard report also states that the financial statements are the responsibility of the company's management and that the auditor's responsibility is to express an opinion on the financial statements based in his or her audit.

Auditor's Reporting on Statutory Financial Statements of Insurance Enterprises

Introduction and Background

9.03 All states require domiciled insurance enterprises to submit to the state insurance commissioner an annual statement on forms developed by the NAIC. The states also require that audited statutory financial statements be provided as a supplement to the annual statements. Currently, statutory financial statements are prepared using accounting principles and practices "prescribed or permitted by the insurance department of the state of domicile," referred to in this section as prescribed-or-permitted statutory accounting.

9.04 The NAIC is in the process of codifying statutory accounting practices for certain insurance enterprises. When the NAIC completes the codification of statutory accounting practices (the codification), it is expected that the states will require that statutory financial statements be prepared using accounting practices "prescribed in the NAIC's *Accounting Practices and Procedures Manual*," referred to in this Guide as NAIC-codified statutory accounting.

9.05 SOP 95-5, *Auditor's Reporting on Statutory Financial Statements of Insurance Enterprises*, which was issued on December 21, 1995, is intended to apply to audits of statutory financial statements pre- and post-codification. The term statutory basis of accounting is used in the SOP to refer to whatever is accepted as the statutory basis of accounting; currently, that is prescribed-or-permitted statutory accounting. When codification is complete, it is expected that the statutory basis of accounting will be NAIC-codified statutory accounting.

9.06 SOP 95-5 applies to all audits of statutory financial statements of insurance enterprises that file financial statements with state insurance departments. Insurance enterprises that prepare statutory financial statements include property and casualty insurance enterprises. SOP 95-5 supersedes SOP 90-10, *Reports on Audited Financial Statements of Property and Liability Insurance Companies*. Auditors should not issue reports on statutory financial statements as to fair presentation in conformity with the statutory basis of accounting that include a disclaimer of opinion as to fair presentation in conformity with GAAP.

Prescribed-or-Permitted Statutory Accounting

9.07 Prescribed statutory accounting practices currently are included in state laws, regulations, and general administrative rules applicable to all insurance enterprises domiciled in a particular state; the NAIC's *Annual Statement Instructions*; the NAIC's *Accounting Practices and Procedures Manuals*; the *Securities Valuation Manual* (published by the NAIC Securities Valuation Office); NAIC official proceedings; and the NAIC's *Examiners' Handbook*.

9.08 Permitted statutory accounting practices include practices not prescribed in the sources described in the preceding paragraph, but allowed by the domiciliary state insurance department. Insurance enterprises may request permission from the domiciliary state insurance department to use a specific accounting practice in the preparation of the enterprises' statutory financial statements (*a*) when it wishes to depart from the prescribed statutory accounting practices, or (*b*) when prescribed statutory accounting practices do not address the accounting for the transaction(s).

NAIC-Codified Statutory Accounting

9.09 The NAIC undertook the project to codify statutory accounting practices because the current prescribed-or-permitted statutory accounting model results in practices that may vary widely not only from state to state, but for insurance enterprises within a state. The codification is expected to result in a hierarchy of statutory accounting practices that will provide a comprehensive basis of accounting that can be applied consistently to all insurance enterprises. Current statutory accounting practices are considered an other comprehensive basis of accounting (OCBOA) under SAS No. 62, *Special Reports*. When codification is complete, it is anticipated that a statutory basis of accounting for insurance enterprises other than NAIC-codified statutory accounting will be considered neither generally accepted accounting principles (GAAP) nor OCBOA.[18] SAS No. 62, paragraphs 27 through 30, provides guidance on reporting on financial statements prepared on a basis of accounting prescribed in an agreement that results in a presentation that is not in conformity with GAAP or OCBOA. That guidance is for financial statements prepared in accordance with an agreement (for example, a loan agreement) and that form of report should not be used for statutory financial statements of insurance enterprises.

Other Relevant AICPA Pronouncements

9.10 During 1994, the AICPA issued the following two pronouncements that address statutory accounting practices and statutory financial statements.

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[18] When the codification is complete, certain amendments to SAS No. 62 would be required.

a. SOP 94-1, *Inquiries of State Insurance Regulators*, requires, for each audit, auditors to obtain sufficient competent evidential matter to corroborate management's assertion that permitted statutory accounting practices that are material to an insurance enterprise's financial statements are permitted by the insurance department of the state of domicile.

b. SOP 94-5, *Disclosures of Certain Matters in the Financial Statements of Insurance Enterprises*, requires insurance enterprises to disclose information about permitted statutory accounting practices in their financial statements.

General Distribution Reports

9.11 Under SAS No. 62, if an insurance enterprise's statutory financial statements are intended for distribution other than for filing with the insurance departments to whose jurisdiction the insurance enterprise is subject, the auditor of those statements should use the general distribution form of report for financial statements that lack conformity with GAAP. Paragraph 4 of SAS No. 1, section 544, *Lack of Conformity With Generally Accepted Accounting Principles*, requires the auditor to use the standard form of report described in SAS No. 58, modified as appropriate because of departures from GAAP.

9.12 Although it may not be practicable to determine the amount of difference between GAAP and the statutory basis of accounting, the nature of the differences is known. The differences generally exist in significant financial statement items, and are believed to be material and pervasive to most insurance enterprises' financial statements. Therefore, there is a rebuttable presumption that the differences between GAAP and the statutory basis of accounting are material and pervasive. Therefore, auditors should express an adverse opinion with respect to conformity with GAAP (refer to SAS No. 58, paragraph 67), unless the auditor determines the differences between GAAP and the statutory basis of accounting are not material and pervasive.

9.13 Paragraphs 68 and 69 of SAS No. 58 require an auditor, when expressing an adverse opinion, to disclose in a separate explanatory paragraph(s) preceding the opinion paragraph in his or her report (*a*) all of the substantive reasons for the adverse opinion, and (*b*) the principal effects of the subject matter of the adverse opinion on financial position, results of operations, and cash flows, if practicable.[19] If the effects are not reasonably determinable, the report should so state, and also should state that the differences are presumed to be material. Furthermore, the notes to the statutory financial statements should discuss the statutory basis of accounting and describe how that basis differs from GAAP.

9.14 After expressing an adverse or qualified opinion on the statutory financial statements as to conformity with GAAP, auditors may express an opinion on whether the statutory financial statements are presented in conformity with the statutory basis of accounting under SAS No. 1, section 544. If,

[19] SAS No. 32, *Adequacy of Disclosure in the Financial Statements*, defines practicable as "the information is reasonably obtainable from management's accounts and records and that providing the information in his report does not require the auditor to assume the position of a preparer of financial information." For example, if the information can be obtained from the accounts and records without the auditor substantially increasing the effort that would normally be required to complete the audit, the information should be presented in the auditor's report.

as anticipated, NAIC-codified statutory accounting becomes the statutory basis of accounting, an accounting practice that departs from that basis of accounting, regardless of whether required by state law or permitted by state regulators, would be considered an exception to the statutory basis of accounting. Accordingly, if such departures are material, the auditors should express a qualified or adverse opinion on the statutory financial statements just as they would under SAS No. 58 regarding conformity with GAAP.[20]

9.15 Following is an illustration of an independent auditor's report on the general distribution statutory financial statements of an insurance enterprise prepared in conformity with prescribed-or-permitted statutory accounting practices, which contains an adverse opinion as to conformity with GAAP, and an unqualified opinion as to conformity with the statutory basis of accounting. In this illustrative report, it is assumed that the effects on the statutory financial statements of the differences between GAAP and the statutory basis of accounting are not reasonably determinable.

Independent Auditor's Report

To the Board of Directors
ABC Insurance Company

We have audited the accompanying statutory statements of admitted assets, liabilities, and surplus of ABC Insurance Company as of December 31, 19X2 and 19X1, and the related statutory statements of income and changes in surplus, and cash flow for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described more fully in Note X to the financial statements, the Company prepared these financial statements using accounting practices prescribed or permitted by the Insurance Department of the State of [*state of domicile*],[21] which practices differ from generally accepted accounting principles. The effects on the financial statements of the variances between the statutory basis of accounting and generally accepted accounting principles, although not reasonably determinable, are presumed to be material.

In our opinion, because of the effects of the matter discussed in the preceding paragraph, the financial statements referred to above do not present fairly, in conformity with generally accepted accounting principles, the financial position of ABC Insurance Company as of December 31, 19X2 and 19X1, or the results of its operations or its cash flows for the years then ended.

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[20] See footnote 18.

[21] If, as anticipated, NAIC-codified statutory accounting becomes the statutory basis of accounting, this paragraph should be modified to state that the company prepared the financial statements using accounting practices "prescribed by the NAIC's *Accounting Practices and Procedures Manual*," or other appropriate language.

In our opinion, the financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and surplus of ABC Insurance Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flow for the years then ended, on the basis of accounting described in Note X.

Limited Distribution Reports

9.16 Prescribed-or-permitted statutory accounting for insurance enterprises currently is considered an OCBOA as described in SAS No. 62. If an insurance enterprise's statutory financial statements are intended solely for filing with state insurance departments to whose jurisdiction the insurance enterprise is subject, the auditor may use the form of report for financial statements prepared in accordance with a comprehensive basis of accounting other than GAAP. Paragraph 5f of SAS No. 62 recognizes that such reporting is appropriate even though the auditor's report may be made a matter of public record. However, that paragraph further states that limited distribution reports may be used only if the financial statements and report are intended solely for filing with the regulatory agencies to whose jurisdiction the insurance enterprise is subject. The auditor's report should contain a statement that there is a restriction on distribution of the statutory financial statements to those within the insurance enterprise and for filing with the state insurance departments to whose jurisdiction the insurance enterprise is subject.

9.17 Although auditing standards do not prohibit an auditor from issuing limited distribution and general distribution reports on the same statutory financial statements of an insurance enterprise, it is preferable to issue only one of those types of reports. Few, if any, insurance enterprises that do not prepare financial statements in accordance with GAAP will be able to fulfill all of their reporting obligations with limited distribution statutory financial statements.

9.18 Following is an illustration, adapted from paragraph 8 of SAS No. 62, of an unqualified auditor's report on limited distribution statutory financial statements prepared in conformity with prescribed-or-permitted statutory accounting practices.

Independent Auditor's Report

To the Board of Directors
XYZ Insurance Company

We have audited the accompanying statutory statements of admitted assets, liabilities, and surplus of XYZ Insurance Company as of December 31, 19X2 and 19X1, and the related statutory statements of income and changes in surplus, and cash flow, for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

> As described more fully in Note X to the financial statements, these financial statements were prepared in conformity with accounting practices prescribed or permitted by the Insurance Department of the State of [*state of domicile*],[22] which is a comprehensive basis of accounting other than generally accepted accounting principles.
>
> In our opinion, the financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and surplus of XYZ Insurance Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flow for the years then ended, on the basis of accounting described in Note X.
>
> This report is intended solely for the information and use of the board of directors and the management of XYZ Insurance Company and for filing with state insurance departments to whose jurisdiction the Company is subject and should not be used for any other purpose.

In accordance with paragraph 10 of SAS No. 62, the notes accompanying an insurance enterprise's statutory financial statements should contain a summary of significant accounting policies that discusses the statutory basis of accounting and describes how the basis differs from GAAP. However, the effects of the differences need not be quantified.

General and Limited Distribution Reports

9.19 The auditor should consider the need for an explanatory paragraph (or other explanatory language) under the circumstances described in paragraph 11 of SAS No. 58 and paragraph 31 of SAS No. 62 regardless of any of the following:

a. The type of report general or limited distribution

b. The opinion expressed unqualified, qualified, or adverse

c. Whether the auditor is reporting as to conformity with GAAP or conformity with the statutory basis of accounting

For example, in a general distribution report, an auditor may express an adverse opinion as to conformity with GAAP and an unqualified opinion as to conformity with the statutory basis of accounting, and also conclude there is a need to add an explanatory paragraph regarding substantial doubt about the insurance enterprise's ability to continue as a going concern; such paragraph should follow both opinion paragraphs.

9.20 As discussed in paragraph 37 of SAS No. 58 and paragraph 31 of SAS No. 62, in a separate paragraph of the auditor's report, the auditor may wish to emphasize a matter. When an insurance enterprise prepares its financial statements using accounting practices prescribed or permitted by the insurance department of the state of domicile and has significant transactions that it reports using permitted accounting practices that materially affect the insurance enterprise's statutory capital,[23] the auditor is strongly encouraged to include an emphasis-of-a-matter paragraph in the report describing the permitted practices and their effects on statutory capital.

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[22] If, as anticipated, NAIC-codified statutory accounting becomes the statutory basis of accounting, this paragraph should be modified to state that the company prepared the financial statements using accounting practices "prescribed by the NAIC's *Accounting Practices and Procedures Manual*," or other appropriate language.

[23] If, as anticipated, NAIC-codified statutory accounting replaces the prescribed or permitted statutory basis of accounting, such permitted practices would be considered departures from the statutory basis of accounting.

9.21 An example of an emphasis-of-a-matter paragraph follows:

> As discussed in Note X to the financial statements, the Company received permission from the Insurance Department of the [*state of domicile*] in 19XX to write up its property to appraised value; under prescribed statutory accounting practices property is carried at depreciated cost. As of December 31, 19X5, that permitted accounting practice increased statutory surplus by $XX million over what it would have been had the prescribed accounting practices been followed.

9.22 When an insurance enterprise issues financial statements prepared in accordance with accounting practices prescribed or permitted by insurance regulators ("statutory basis") in addition to, or instead of, financial statements prepared in accordance with GAAP, the auditor should evaluate whether informative disclosures in financial statements prepared on a statutory basis are appropriate. Auditing Interpretation No. 9 of SAS No. 62, *Evaluation of the Appropriateness of Informative Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis* (AICPA, *Professional Standards*, vol. 1, AU section 9623.60-.79), provides guidance on evaluating the appropriateness of disclosures in statutory basis financial statements. Auditors should follow the guidance outlined in the interpretation when reporting on statutory basis financial statements, including when reporting on financial statements of mutual life insurance enterprises, whether such financial statements are for filing with regulators or for general-purpose distribution.

Special Reports

9.23 In connection with regulatory requirements, states have required the filing of special reports, such as those on loss reserves and internal accounting control. In addition, independent auditors may provide other services in connection with regulatory requirements, such as NAIC examinations, market conduct examinations, or other services, to comply with state regulations. Special reports such as that illustrated in Exhibit A may also apply in other circumstances. Certain regulatory authorities may request opinions on loss reserves in connection with licensing applications or other planned transactions. For example, an insurance company holding a certificate of authority as surety on federal bonds may be required to submit to the U.S. Treasury Department a report by an independent auditor on its loss reserves.

Special Reports on Loss Reserves

9.24 Exhibit A illustrates an auditor's report expressing an opinion on a company's liabilities for unpaid losses and loss-adjustment expenses and the schedule of liabilities for unpaid losses and loss-adjustment expenses that would accompany the report.

9.25 The procedures performed to issue an opinion on the liabilities for unpaid losses and loss-adjustment expenses may be more extensive than those required for testing those accounts as part of an audit of the basic financial statements. Any such additional procedures are generally completed in conjunction with the general audit. Accordingly, an opinion on the liabilities for unpaid losses and loss-adjustment expenses ordinarily should have the same date as the report on the basic financial statements.

9.26 Because of the nature and significance of the liabilities for unpaid losses and loss-adjustment expenses in an insurance company, the form of opinion that is expressed on the liabilities for unpaid losses and loss-adjustment

expenses generally should be consistent with the opinion expressed on the audited financial statements. For example, if the report on the liabilities for unpaid losses and loss-adjustment expenses was qualified, the report on the audited financial statements should also be qualified.

9.27 Changes in estimates that are disclosed in the financial statements on which the auditor has reported should also be disclosed in the notes to the schedule of liabilities for unpaid losses and unpaid loss-adjustment expenses accompanying the auditor's special report. (See APB Opinion No. 20, *Accounting Changes*, paragraph 33.)

Exhibit A

Special Report on Loss Reserves[24]

Independent Auditor's Report

Board of Directors
X Insurance Company

We are members of the American Institute of Certified Public Accountants (AICPA) and are the independent public accountants of X Insurance Company. We acknowledge our responsibility under the AICPA's Code of Professional Conduct to undertake only those engagements which we can complete with professional competence.

We have audited the financial statements prepared in conformity with generally accepted accounting principles [*or prepared in conformity with accounting practices prescribed or permitted by the Insurance Department of the State of* ______________] of X Insurance Company as of December 31, 19X0, and have issued our report thereon dated March 1, 19X1. In the course of our audit, we have audited the estimated liabilities for unpaid losses and unpaid loss adjustment expenses of X Insurance Company as of December 31, 19X0, as set forth in the accompanying schedule including consideration of the assumptions and methods relating to the estimation of such liabilities.

In our opinion, the accompanying schedule presents fairly, in all material respects, the estimated unpaid losses and unpaid loss adjustment expenses of X Insurance Company that could be reasonably estimated at December 31, 19X0, in conformity with accounting practices prescribed or permitted by the Insurance Department of the State of ______________ on a basis consistent with that of the preceding year.

This report is intended solely for filing with regulatory agencies and is not intended for any other purpose.

[*Signature*]

[*Date*]

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[24] If a significant period of time has elapsed between the date of the report on the financial statements and the date he is reporting on the loss and loss adjustment expense reserves, the auditor may wish to include the following paragraph after the opinion paragraph: Because we have not audited any financial statements of X Insurance Company as of any date or for any period subsequent to December 31, 19X0, we have no knowledge of the effects, if any, on the liability for unpaid losses and unpaid loss adjustment expenses of events that may have occurred subsequent to the date of our audit.

X Insurance Company
Schedule of Liabilities for Losses and Loss Adjustment Expenses
December 31, 19X0

Liability for losses	$XX,XXX,XXX
Liability for loss-adjustment expenses	X,XXX,XXX
Total	$XX,XXX,XXX

Note 1—Basis of presentation

The above schedule has been prepared in conformity with accounting practices prescribed or permitted by the Insurance Department of the State of ____________. (Significant differences between statutory practices and generally accepted accounting principles for the calculation of the above amounts should be described but the monetary effect of any such differences need not be stated.)

Losses and loss adjustment expenses are provided for when incurred in accordance with the applicable requirements of the insurance laws [and/or regulations] of the State of ____________. Such provisions include (1) individual case estimates for reported losses, (2) estimates received from other insurers with respect to reinsurance assumed, (3) estimates for unreported losses based on past experience modified for current trends, and (4) estimates of expenses for investigating and settling claims.

Note 2—Reinsurance

The Company reinsures certain portions of its liability insurance coverages to limit the amount of loss on individual claims and purchases catastrophe insurance to protect against aggregate single occurrence losses. Certain portions of property insurance are reinsured on a quota share basis.

The liability for losses and the liability for loss adjustment expenses were reduced by $XXXX,XXX and $XXXX,XXX, respectively, for reinsurance ceded to other companies. Contingent liability exists with respect to reinsurance which would become an actual liability in the event the reinsuring companies, or any of them, might be unable to meet their obligations to the Company under existing reinsurance agreements.

Reports on Internal Control

9.28 Independent accountants may be engaged to report on a property and liability insurance company's internal control for purposes of meeting reporting requirements of state regulatory authorities. Statement on Standards for Attestation Engagements (SSAE) No. 2, *Reporting on an Entity's Internal Control Structure Over Financial Reporting*, provides guidance on the auditor's considerations and the form of report in such engagements. SAS No. 60 provides guidance in identifying and reporting conditions that relate to an entity's internal control structure observed during an audit of financial statements. In connection with an audit, the auditor may deem it necessary to issue a written report on material weaknesses separate from the report on reportable conditions. See Auditing Interpretation No. 1 of SAS No. 60, *Reporting on the Existence of Material Weaknesses* (AICPA, *Professional Standards*, vol. 1, AU section 9325.01–.07), for guidance.

Reports on NAIC Zone Examinations

9.29 Independent auditors are often engaged by regulatory authorities to perform or participate in NAIC zone examinations of insurance companies. The scope of such engagements typically includes (*a*) a general survey of operations and practices, (*b*) reporting on management's assertions regarding internal control structure policies and procedures over financial reporting, (*c*) tests of individual balance-sheet accounts, (*d*) tests of income and disbursement transactions, (*e*) tests of compliance with statutory requirements, and (*f*) a study of the treatment of policyholders. Such engagements generally do not constitute audits of financial statements in accordance with generally accepted auditing standards.

9.30 An independent auditor who is engaged for the NAIC zone examination may have already been engaged by the insurance company to audit and report on financial statements prepared either in conformity with GAAP or SAP. An independent auditor who has performed an audit in accordance with generally accepted auditing standards should also be in a position to issue a report on financial statements prepared on a statutory basis, which is the basis tested in NAIC zone examinations. Accordingly, when the auditor has performed an audit in accordance with generally accepted auditing standards, he or she should follow the guidance in SAS No. 62 concerning the form of report to be provided in the NAIC zone examination.

Market-Conduct Examinations

9.31 The NAIC has a market-conduct examination handbook, which specifies procedures to review insurance company practices that may adversely affect policyholders or claimants in the areas of sales and advertising, underwriting, risk rating, and claims. Independent auditors are sometimes engaged to participate in market-conduct examinations. The form of the report for such engagement would be a special report on applying agreed-upon procedures as specified in SAS No. 75, *Engagements to Apply Agreed-Upon Procedures to Specified Elements, Accounts or Items of a Financial Statement.*

9.32 The illustrative reports presented in this chapter are not intended to be representative of all the reports an auditor may issue. Rather, they are intended to serve as general guidance about some of the more common reports issued. The auditor should refer to applicable pronouncements for further guidance.

Letters for State Insurance Regulators to Comply With the NAIC Model Audit Rule

9.33 This section reflects the provisions of SOP 95-4, *Letters for State Insurance Regulators to Comply With the NAIC Model Audit Rule*. SOP 95-4 provides guidance to auditors on the form and content of communications with state insurance regulators. Such communications are required by the NAIC's *Annual Statement Instructions Requiring Annual Audited Financial Statements,* which incorporates the January 1991 *Model Rule (Regulation) Requiring Annual Audited Financial Reports* (reissued in July 1995) (hereinafter called the Model Audit Rule). The Model Audit Rule was designed by the NAIC to promote uniformity in state laws and regulations dealing with audits of insurance enterprises' statutory financial statements. Though some states have laws or regulations that differ from the Model Audit Rule, the SOP addresses only the requirements of the Model Audit Rule. The SOP applies to audits of financial statements of all insurance companies that file audited financial statements with state insurance departments in accordance with the NAIC's Model Audit Rule. This SOP should be applied to audits of statutory financial statements performed for periods ending on or after December 15, 1995. Early application is encouraged.

Awareness

9.34 Section 6 of the Model Audit Rule requires that the insurer notify the insurance commissioner of the state of domicile of the name and address of the insurer's independent certified public accountant (hereinafter referred to as *auditor*). In connection with that notification, the insurer is required to obtain an awareness letter from its auditor stating that the auditor:

a. Is aware of the provisions of the insurance code and the rules and regulations of the insurance department of the state of domicile that relate to accounting and financial matters.

b. Will issue a report on the financial statements in terms of their conformity to the statutory accounting practices prescribed or otherwise permitted by the insurance department of the state of domicile, specifying exceptions as appropriate.

9.35 The following is an illustration of the awareness letter:

To the Board of Directors of ABC Insurance Company:

We have been engaged by ABC Insurance Company (the Company) to perform annual audits in accordance with generally accepted auditing standards of the Company's statutory financial statements. In connection therewith, we acknowledge the following:

We are aware of the provisions relating to the accounting and financial reporting matters in the Insurance Code of [*name of state of domicile*] and the related rules and regulations of the Insurance Department of [*name of state of domicile*] that are applicable to audits of statutory financial statements of insurance enterprises. Also, after completion of our audits, we expect that we will issue our report on the statutory financial statements of ABC Insurance Company as to their conformity with accounting practices prescribed or permitted by the Insurance Department of [*name of state of domicile*].

This letter is furnished solely for filing with the Insurance Department of [*name of state of domicile*] and other state insurance departments and should not be used for any other purpose.

Change in Auditor

9.36 Section 6 of the Model Audit Rule requires that insurers notify the insurance department of the state of domicile within five business days of the dismissal or resignation of the auditor for the immediately preceding filed audited statutory financial statements. Within ten business days of that notification, the insurer also is required to provide a separate letter stating whether, in the twenty-four months preceding that event, there were any disagreements, subsequently resolved or not, with the former auditor on any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedure, which disagreements, if not resolved to the satisfaction of the former auditor, would have caused the auditor to make reference to the subject matter of the disagreement in connection with the auditor's opinion. The Model Audit Rule requires that the insurer provide the insurance department of the state of domicile a letter from the former auditor to the insurer indicating whether the auditor agrees with the statements in the insurer's letter and, if not, stating the reasons for the disagreement.

9.37 The following is an illustration of the change in auditor letter:

To the Board of Directors of DEF Insurance Company:

We previously were auditors for DEF Insurance Company and, under the date of [*report date*], we reported on the statutory financial statements of DEF Insurance Company as of and for the years ended December 31, 19X1 and 19X0.[25] Effective [*date of termination*], we are no longer auditors of DEF Insurance Company. We have read DEF Insurance Company's statements in its letter dated [*date of insurer's letter*], which is attached hereto, and we agree with the statements therein. [*However, if the auditor is* (a) *not in a position to agree or disagree or* (b) *does not agree with the insurer's statement, the auditor's letter should state that the auditor is not in a position to agree or disagree or that the auditor does not agree with such statements and give the reasons.*][26]

Qualifications

9.38 Section 12 of the Model Audit Rule requires the auditor to provide a letter to the insurer to be included in the annual financial report stating:

a. The auditor is independent with respect to the insurer and conforms with the standards of his or her profession as contained in the Code

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[25] If the auditor had not reported on any financial statements, the first sentence should be modified as follows:

We previously were engaged to audit the statutory financial statements of DEF Insurance Company as of and for the year ending December 31, 19X1.

[26] The insurer's letter may contain a statement, such as:

In connection with the audits of the statutory financial statements of the Company for the years ended December 31, 19X2 and 19X1, and the subsequent interim period through [*date of termination*], there were no disagreements with [*CPA Firm*] on any matter of accounting principles, statutory accounting practices prescribed or permitted by the Insurance Department of [*name of state of domicile*], financial statement disclosure, or auditing scope or procedures, which disagreements if not resolved to their satisfaction would have caused them to make reference to the subject matter of the disagreement in their reports.

of Professional Conduct and pronouncements of the AICPA and the Rules of Professional Conduct of the appropriate state board of public accountancy.

b. The background and experience in general and of the individuals used for an engagement and whether each is a certified public accountant.

c. The auditor understands that the annual audited statutory financial statements and his or her opinion thereon will be filed in compliance with the requirement of the Model Audit Rule and that the domiciliary commissioner will be relying on the information in the monitoring and regulating of the financial position of insurers.

d. The auditor consents to the workpaper requirements contained in the Model Audit Rule and agrees to make the workpapers available for review by the domiciliary commissioner or the commissioner's designee under the auditor's control.[27]

e. The engagement partner is licensed by an appropriate state licensing authority and is a member in good standing of the AICPA.

f. The auditor meets the qualifications and is in compliance with the "Qualifications of Independent Certified Public Accountant" section of the Model Audit Rule.

9.39 The following is an illustration of the qualification letter:

To the Board of Directors of GHI Insurance Company:

We have audited, in accordance with generally accepted auditing standards, the statutory financial statements of GHI Insurance Company (the Company) for the years ended December 31, 19X1 and 19X0, and have issued our report thereon dated [*date of report*]. In connection therewith, we advise you as follows:

a. We are independent certified public accountants with respect to the Company and conform to the standards of the accounting profession as contained in the Code of Professional Conduct and pronouncements of the American Institute of Certified Public Accountants, and the Rules of Professional Conduct of the [*state*] Board of Public Accountancy.

b. The engagement partner and engagement manager, who are certified public accountants, have [ ] years and [ ] years, respectively, of experience in public accounting and are experienced in auditing insurance enterprises. Members of the engagement team, most (some) of whom have had experience in auditing insurance enterprises and [*X*] percent of whom are certified public accountants, were assigned to perform tasks commensurate with their training and experience.

c. We understand that the Company intends to file its audited statutory financial statements and our report thereon with the Insurance Department of [*name of state of domicile*] and other state insurance departments in states in which the Company is licensed and that the insurance commissioners of those states will be relying on that information in monitoring and regulating the statutory financial condition of the Company.

While we understand that an objective of issuing a report on the statutory financial statements is to satisfy regulatory requirements, our audit was not planned to satisfy all objectives or responsibilities of insurance

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[27] Refer to Auditing Interpretation No. 1 of SAS No. 41, *Providing Access to or Photocopies of Working Papers to a Regulator* (AICPA, *Professional Standards*, vol. 1, AU section 9339.01–.15).

regulators. In this context, the Company and insurance commissioners should understand that the objective of an audit of statutory financial statements in accordance with generally accepted auditing standards is to form an opinion and issue a report on whether the statutory financial statements present fairly, in all material respects, the admitted assets, liabilities, and capital and surplus, results of operations and cash flow in conformity with accounting practices prescribed or permitted by the Insurance Department of [*name of state of domicile*]. Consequently, under generally accepted auditing standards, we have the responsibility, within the inherent limitations of the auditing process, to design our audit to obtain reasonable assurance that errors and irregularities that have a material effect on the statutory financial statements will be detected and to exercise due care in the conduct of the audit. The concept of selective testing of the data being audited, which involves judgment both as to the number of transactions to be audited and the areas to be tested, has been generally accepted as a valid and sufficient basis for an auditor to express an opinion on financial statements. Audit procedures that are effective for detecting errors, if they exist, may be ineffective for detecting irregularities. Because of the characteristics of irregularities, particularly those involving forgery and collusion, a properly designed and executed audit may not detect a material irregularity. In addition, an audit does not address the possibility that material errors or irregularities may occur in the future. Also, our use of professional judgment and the assessment of materiality for the purpose of our audit means that matters may exist that would have been assessed differently by insurance commissioners.

It is the responsibility of the management of the Company to adopt sound accounting policies, to maintain an adequate and effective system of accounts, and to establish and maintain an internal control structure that will, among other things, provide reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in conformity with accounting practices prescribed or permitted by the Insurance Department of [*name of state of domicile*].

The Insurance Commissioner should exercise due diligence to obtain whatever other information that may be necessary for the purpose of monitoring and regulating the statutory financial position of insurers and should not rely solely upon the independent auditor's report.

d. We will retain the workpapers prepared in the conduct of our audit until the Insurance Department of [*name of state of domicile*] has filed a Report of Examination covering 19X1, but not longer than seven years, and, on instructions from the Company, will make them available for review by the Insurance Department of [*name of state of domicile*].[28]

e. The engagement partner has served in that capacity with respect to the Company since [*year that current "term" started*], is licensed by the [*state name*] Board of Public Accountancy, and is a member in good standing of the American Institute of Certified Public Accountants.

f. To the best of our knowledge and belief, we are in compliance with the requirements of section 7 of the NAIC's *Model Rule (Regulation) Requiring Annual Audited Financial Reports* regarding qualifications of independent certified public accountants.

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[28] See footnote 27.

This letter is furnished solely for filing with the Insurance Department of [*name of state of domicile*] and other state insurance departments and should not be used for any other purpose.

Notification of Adverse Financial Condition

9.40 Section 10 of the Model Audit Rule requires that the auditor notify the insurer's board of directors or audit committee in writing within five business days of a determination that (*a*) the insurer has materially misstated its financial condition as reported to the domiciliary commissioner as of the balance-sheet date currently under examination or (*b*) the insurer does not meet the minimum capital and surplus requirements of the state insurance statute as of the balance-sheet date. The Model Audit Rule also requires the insurer to provide (*a*) to the insurance commissioner of the state of domicile a copy of the notification of adverse financial condition within five days of its receipt and (*b*) to the auditor evidence that the notification has been provided to the insurance commissioner. If the auditor receives no such evidence, the Model Audit Rule requires the auditor to send the notification to the insurance commissioner directly within the next five business days.

9.41 The following is an illustration of the auditor's notification of adverse financial condition letter when the audit is complete: [29]

To the Board of Directors of MNO Insurance Company:

We have audited, in accordance with generally accepted auditing standards, the statutory financial statements of MNO Insurance Company (the Company) as of December 31, 19X1 and 19X0, and have issued our report thereon dated [*date of report*].

In connection with our audit, we determined that capital and surplus reflected in the statement of admitted assets, liabilities, and capital and surplus of the Company as of December 31, 19X1, as reported on the 19X1 Annual Statement filed with the Insurance Department of [*name of state*] is materially misstated because [*provide explanation*]. Statutory capital and surplus of $____ reported on the 19X1 Annual Statement should be reduced by $____ as a result of the matter in the preceding sentence.[30]

If we do not receive evidence that the Company has forwarded a copy of this letter to the insurance commissioner of [*name of state*] within five business days of receipt, we are required to give the insurance commissioner a copy of this letter within the next five business days.

This letter is furnished solely for filing with the Insurance Department of [*name of state*] and should not be used for any other purpose.

Report on Internal Control

9.42 Section 11 of the Model Audit Rule requires that insurers provide the insurance commissioner of the state of domicile a written report describing sig-

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[29] A determination that financial statements filed with a state insurance department contain a material misstatement does not necessarily always occur when an audit is complete. The Model Audit Rule requires notification to be provided within five business days of such determination. The language in this illustrative letter should be modified depending on the relevant facts and circumstances.

[30] The wording of this paragraph is intended for those situations in which audit adjustments would not cause minimum capital and surplus of an insurer to fall below statutory requirements. The paragraph should be reworded if the company did not meet minimum capital and surplus requirements as presented on its Annual Statement as filed with the domiciliary commissioner.

nificant deficiencies in the insurer's internal control structure noted during the audit. Auditors should follow the guidance in SAS No. 60. Additionally, the Model Audit Rule requires insurers to provide a description of remedial actions taken or proposed to correct significant deficiencies, if not covered in the auditor's report. The reports on internal controls should be filed by the insurer within sixty days after filing the annual audited financial statements. No report is required to be issued if the auditor does not identify significant deficiencies.

Reports in Compliance With State Regulations

9.43 Additionally, the auditor should be familiar with the regulations and the required reporting of each state in which the insurance company writes premiums. For example, New York State Regulation No. 118, "Audited Financial Statements" provides filing information for the various classes of insurers. It also sets forth the procedures insurers must follow when filing for exemptions. The regulation further provides that an insurer must utilize the services of a certified public accountant who agrees by written contract to comply with the provisions of the Insurance Law. An example of a written contract letter to comply with New York Regulation 118 is provided in Exhibit B.

Exhibit B

Written Contract Letter to Comply With New York Regulation 118

To the Board of Directors of P and L Insurance Company:

You have designated [*name of CPA firm*] to act as independent certified public accountants to audit the financial statements of P and L Insurance Company. In that connection, we advise you as follows:

1. In performing our audit, we will comply with the provisions of Section 307(b) of the New York Insurance Law and Regulation 118 under that section and with the Code of Professional Conduct and pronouncements on professional standards of the American Institute of Certified Public Accountants.
2. On or before June 30, we will provide to you our report on the financial statements of P and L Insurance Company for the prior calendar year and our report on conditions relating to the Company's internal control structure that we observed during our audit of the financial statements.
3. Based on the authority granted by you herein to comply with Section 307(b) of the New York Insurance Law, we will report to the Superintendent of the Insurance Department of the State of New York within fifteen days following any determination by us of material misstatement of financial condition as reported to the Superintendent by P and L Insurance Company or failure of P and L Insurance Company to meet minimum capital and surplus requirements set forth in the New York Insurance Law. We will report any such determination to you immediately.
4. The workpapers prepared in the conduct of our audit and communications between the Company and us relating to our audit will be retained by us for a period of not less than five years after the period reported on and, on instructions of the Company, will be made available for review by the Superintendent of the New York Insurance Department.

This letter is furnished solely for you to comply with Regulation 118 (Part 89 of Title 11 of the Official Compilation of Codes, Rules, and Regulations of the State of New York) and should be used for no other purpose.

[*Signature*]

[*Date*]

Appendix A

Auditing*

Audit Objectives

SAS No. 57, *Auditing Accounting Estimates*, states that the auditor's objective when evaluating accounting estimates is to obtain sufficient competent evidential matter to provide reasonable assurance that—

a. All accounting estimates that could be material to the financial statements have been developed.

b. Those accounting estimates are reasonable in the circumstances.

c. The accounting estimates are presented in conformity with applicable accounting principles and are properly disclosed.

When auditing a property/liability insurance company, the auditor is primarily concerned with obtaining sufficient competent evidential matter to support the assertions inherent in a company's financial statements. SAS No. 31, *Evidential Matter*, describes the relationship between assertions embodied in the financial statements, audit objectives, and substantive audit procedures.

Audit Planning

In planning the audit, the auditor should obtain a thorough understanding of the company's overall operations including its claim reserving and payment practices. In addition, the auditor should obtain or update his or her knowledge of the entity's business and the various economic, financial, and organizational conditions that create risks for companies in the insurance industry.

The auditor performing or supervising the audit of loss reserves should have knowledge about loss reserving including knowledge about the kind(s) of insurance for which a reserve is being established and an understanding of the appropriate methods available for calculating loss reserves. Knowledge about loss reserving is ordinarily obtained through experience, training courses, and by consulting sources such as industry publications, textbooks, periodicals, and individuals knowledgeable about loss reserving. As stated in chapter 4 of this guide, if the auditor is not a loss reserve specialist, he or she should use the work of an outside loss reserve specialist in the audit. The auditor should obtain a level of knowledge about loss reserving that would enable him or her to understand the methods or assumptions used by the specialist.

Ordinarily, audit procedures performed to obtain sufficient evidence to support assertions about loss reserves are time consuming and may be performed most efficiently when initiated early in the fieldwork.

The auditor should determine that all loss reserve components, all lines of business, and all accident years that could be material to the financial statements have been considered in developing the overall reserve estimate. The components of loss reserves are described in chapter 4 of this guide.

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* SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55*, revises the definition and description of internal control and makes conforming changes to relevant terminology. SAS No. 78 was issued in December 1995 and is effective for audits of financial statements for periods beginning on or after January 1, 1997. This Guide will be amended to conform to SAS No. 78 nearer to the pronouncement's effective date.

The estimate of loss reserves will frequently affect other accounting estimates contained in the financial statements. The auditor should evaluate accounting estimates for such items as contingent commissions, retrospective premium adjustments, policyholder dividends, recoverability of deferred acquisition costs, premium deficiencies, state assessments based on losses paid, minimum statutory reserves, and the liability or allowance for unauthorized or uncollectible reinsurance.

Audit Risk and Materiality

Audit risk and materiality are the key criteria in determining the nature, timing, and extent of audit procedures to be performed and in evaluating whether the financial statements taken as a whole are presented fairly. Considerations of audit risk and materiality should be addressed in the planning stage of an audit and should be used to develop and support an audit approach. For most insurance companies, the largest liability on the balance sheet is loss reserves, and the largest expense on the income statement is incurred losses; therefore, both are material to the financial statements. In addition, loss reserve estimates are based on subjective judgments and, therefore, involve a high level of inherent risk. For these reasons, loss reserves typically are the area with the highest audit risk in a property and liability insurance entity.

SAS No. 47, *Audit Risk and Materiality in Conducting an Audit*, provides guidance on audit risk and materiality as they relate to planning and performing an audit. Materiality judgments are made in light of surrounding circumstances and necessarily involve both quantitative and qualitative considerations. The auditor's consideration of materiality is a matter of professional judgment and is influenced by the auditor's perception of the needs of a reasonable person relying on the financial statements. Some factors to be considered in establishing materiality levels for estimates such as loss reserves are the company's operating results and the company's financial position. The auditor should also consider the measurement bases that external financial statement users will focus on when making decisions.

SAS No. 47 defines audit risk as "the risk that the auditor may unknowingly fail to appropriately modify his opinion on financial statements that are materially misstated." In other words, audit risk is the risk that the auditor will give an unqualified opinion on financial statements that are materially incorrect. SAS No. 47 states that audit risk consists of three components:

1. *Inherent risk* is the susceptibility of an assertion to a material misstatement, assuming that there are no related internal control structure policies or procedures. The risk of such misstatement is greater for some assertions and related balances or classes than for others. In addition to those factors that are peculiar to a specific assertion for an account balance or class of transactions, factors that relate to several or all of the balances or classes may influence the inherent risk related to an assertion for a specific balance or class. Loss reserves generally are based on subjective judgments about the occurrence of certain events that have not yet been fully reported, developing trends, and the outcome of future events. Due to the subjectivity and inherent imprecision involved in making such judgments, estimating loss reserves requires considerable analytical ability and an extensive understanding of the business.
2. *Control risk* is the risk that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by the entity's internal control structure policies or procedures. That

risk is a function of the effectiveness of the design and operation of internal control structure policies or procedures in achieving the entity's broad internal control structure objectives relevant to an audit of the entity's financial statements. Some control risk will always exist because of the inherent limitations of any internal control structure. The degree of control risk associated with significant accounting estimates is usually greater than the risk for other accounting processes because accounting estimates involve a greater degree of subjectivity, are less susceptible to control, and are more subject to management influence. It is difficult to establish controls over errors in assumptions or estimates of the future outcome of events in the same way that controls can be established over the routine accounting for completed transactions. In addition, there is a potential for management to be biased about their assumptions; accordingly, a high level of professional skepticism should be exercised by the auditor. The likelihood that loss reserve estimates will contain misstatements of audit importance can be reduced by using competent people in the estimation process and by implementing practices to enhance the reasonableness of estimates, such as requiring that persons making the estimates retain documented explanations and other support for assumptions and methodologies used, and perform retrospective tests of past performance.

3. *Detection risk* is the risk that the auditor will not detect a material misstatement that exists in an assertion. Detection risk is a function of the effectiveness of an auditing procedure and of its application by the auditor. It arises partly from uncertainties that exist when the auditor does not examine 100 percent of an account balance or class of transactions and partly because of other uncertainties that exist even if he or she were to examine 100 percent of the balance or class. Such other uncertainties arise because an auditor might select an inappropriate auditing procedure, misapply an appropriate procedure, or misinterpret the audit results. These other uncertainties can be reduced to a negligible level through adequate planning and supervision and conduct of a firm's audit practice in accordance with appropriate quality control standards. Due to the relatively high inherent and control risk associated with loss reserves, detection risk is significant in the audit of loss reserves but may be mitigated by adequate planning, supervision, and conduct of the audit. Adequate planning should identify the existing inherent and control risk factors so that they may be adequately addressed in the audit.

This appendix identifies some of the matters that may influence audit risk in an audit of the financial statements of a property and liability insurance company. It emphasizes matters relevant to the premium cycle, the claims cycle, and the investment cycle.

Premium Cycle

- *Premiums*

— Principal lines of business written (property or liability, commercial or personal, and so on)

— Geographic, product, or other concentrations

— Rate-making environment and policies or practices

— Changes in product mix or emphasis

- — Extent of retrospectively rated or reporting-form business and the estimability and timeliness of retrospective revenue or expense determinations
- — Unusual, erratic, or substantial changes in premiums in force
- — Propriety of premium revenue-recognition methods used
- — Evidence or expectations of increased competition, market saturation, or declining demand
- — Significant accounting procedures performed at other locations, such as branch offices versus the home office
- — Principles and policies used by the company in recognition of premiums
- — Statistical coding system used to support underwriting functions
- *Receivables*
- — Suspense-account activity and condition (for example, large or old uncleared items or numerous outstanding debt and credit items)
- — Agent statement terms and financing arrangements (for example, extended credit terms, expense supplements, loans, and profit-sharing arrangements)
- — Agency concentration (for example, significant volume from limited numbers of agents)
- — Agency profitability (for example, derivation of substantial unprofitable business from particular agents)
- — Nonadmitted asset trends (for example, sizable past-due or uncleared balances)
- — Commission arrangements (for example, contingent commissions, or unusual commission structures that may encourage agent fraud)
- — Agent-binding authorities to accept underwriting risks or settle claims without prior approval
- — Agent commingling of insurer/insured funds collected in a fiduciary capacity (for example, use of third-party funds for operating or personal purposes)
- — Reasonableness of estimates for earned but unbilled premiums
- — Adequacy of premium installment payments to provide sufficient protection in the event of policy cancellation
- *Deferred policy-acquisition costs*
- — Nature of costs deferred, particularly those that vary indirectly with new business written
- — Frequency and adequacy of recoverability (premium deficiency) tests, particularly regarding line of business groupings and estimated loss-ratio projections
- *Reinsurance*
- — Changes in risk-retention levels, including catastrophic loss coverage
- — Financial responsibility, and stability of ceding or assuming reinsurers, intermediaries, "fronting" companies, pools and syndicates, and so on
- — Reliability, adequacy, and timeliness of financial reporting, particularly in the case of reinsurance assumed
- — Business purpose of the reinsurance transactions

Loss Reserves and Claims Cycle

- A company's product mix may have a significant effect on the variability of loss reserves. It is more difficult to estimate loss reserves for long-tail lines of business than it is to estimate reserves for short-tail

lines of business because events affecting ultimate claim settlement amounts will occur at a later date

- New products or new types of risks generally will add to the subjectivity of the loss reserving process because of the company's lack of experience with the new product and relative lack of relevant historical data
- Deductibles, policy limits, and the retention level of specific lines of business may have a significant effect on the volatility of losses to be settled
- Policy lines with a low frequency and high severity of claim settlements may exhibit more variability than policy lines associated with a high frequency and low severity of claim settlements
- Future inflation may result in ultimate loss settlements different from the amounts originally anticipated
- Social inflation, which arises from the legal environment, as well as recent jury awards have the potential to increase ultimate loss settlements
- The level and consistency of backlogs in processing claims affect the stability of loss reserve analyses
- The degree of management's optimism or skepticism when establishing loss reserve assumptions may lead to fluctuations in reserves
- The introduction of new policy forms may result in an unanticipated expansion of coverage. In addition, the company may lack historical data for losses under the new policy forms
- Changes in regulations may cause insurance companies to change their claims adjusting practices; for example, a change in regulations may require an increase in the waiting period before workers' compensation benefits begin, or "bad faith" claim settlement laws may alter settlement practices
- Catastrophic or unusual losses may distort historical experience. Reserves for catastrophic losses, particularly losses that occur near the end of the period, are difficult to estimate
- Insurance company cash flow considerations may result in a change in loss payment practices
- The quality and experience of personnel reviewing a company's loss reserves affect the overall control environment. For example, a company that employs a qualified actuary or an experienced loss reserve specialist to review reserves is usually better equipped to estimate loss reserves than is a company that uses a less qualified individual to perform that task
- The proper functioning of internal control structure policies and procedures over claim processing will reduce the possibility of error in the data underlying loss reserve estimates. The risk of error in the claims data base will be minimized if controls are functioning as designed
- The completeness and accuracy of a company's data base will affect the risk of misstatement in assertions about loss reserves
- The accuracy and reliability of claims data received from outside sources (i.e., cedents, reinsurers, voluntary and involuntary risk pools, etc.) will also affect the risk of misstatement in assertions about loss reserves
- The adequacy of information and data produced by a company is critical in projecting loss reserves. For example, a company capable of accumulating only basic data on premium and loss experience generally poses a greater risk, all other things being equal, than does

a company that is capable of accumulating and analyzing more sophisticated data

- Significant decentralization of operations and reliance on intermediaries may increase control risk
- A high level of delegation of claims processing or adjusting functions to intermediaries or outside adjusters, without adequate supervision, may result in inefficient claim handling and inappropriate case reserve estimates
- Changes in delegated responsibilities may result in changes in claims settlement patterns and thereby invalidate historical claim experience
- The quality of a company's underwriting and claims staff and its knowledge of the industry and control over the company's exposure to loss will have a significant effect on the loss reserving process
- Existing manual or computerized systems may not be able to cope with a change in the volume of claims
- Changes in the insurance company's claims processing system may invalidate the historical data used to develop and evaluate loss reserves. Types of changes that may have this result include—
  - Changes in claim classification, such as counting claimants instead of counting claims, considering reopened claims as IBNR claims rather than as development on reported claims, and changing the definition of claims closed without payment
  - Changes in settlement patterns, such as slowing down the payment of claims to increase the holding period of investable assets or speeding up the payment of claims to decrease the effects of inflation
  - Changes in case reserving methodologies, either explicit or implicit, such as a change from estimating case basis reserves on an ultimate cost basis to estimating case-basis reserves on a current cost basis
  - Changes in computerized information systems that result in faster or slower recognition and payment of claims

Investment Cycle

- Significant concentrations of credit risk with one counterparty or within one geographic area
- Significant use of derivative securities (including asset-backed securities or off-balance-sheet instruments), particularly without relevant in-house expertise
- High volumes of borrowing or lending of securities
- Relatively high volatility in interest rates
- Changes in the terms of government guarantees
- Actual prepayment experience that differs significantly from that anticipated
- Declines in the values of collateral underlying securities
- Changes in guarantor's claims processing
- Significant conversion options related to the collateral (for example, variable to fixed rates)
- Sales and transfers from the held-to-maturity securities portfolio
- High volume of transactions in the available-for-sale or trading securities portfolios
- Wash sale transactions

- Uncertainty regarding the financial stability of asset-backed securities services or of guarantors
- Investment liquidity (for example, investments with terms and maturities not balanced to meet policy claim obligations)
- Investment valuation (for example, improper or inadequate valuation methods or documentation and indications of potential or likely permanent impairment)
- Investment yield trends (that is, the indicated ability to manage the investment portfolio at maximum yields commensurate with prudent risk considerations)
- Investment policy (for example, undue emphasis in speculative or high-risk investment vehicles)
- Investment restrictions (that is, degree of compliance with regulatory or self-imposed restrictions)

Acquisition Costs

- Deferral of costs that vary with and are primarily related to the production of new and renewal business
- Capitalized acquisition costs appropriately amortized in relation to premiums earned
- Capitalized costs should be recoverable in relation to anticipated loss experience, anticipated earned premiums, and other factors
- The company's accounting policy for acquisition costs consistently applied

Other

- Adequacy of premium and claim cutoff procedures at interim and annual reporting dates
- Accuracy and thoroughness of statistical coding system used for underwriting (premium, loss, and expense) analysis
- Timeliness and adequacy of reconciliation procedures, particularly in balancing accounting and statistical records, including loss-development data
- Industry experience of principal officers and employees
- Statutory compliance and solvency
- Existence and extent of related-party transactions

Appendix B

Illustrations of Auditing Objectives and Procedures

Most of the independent auditor's work in forming an opinion on financial statements consists of obtaining and evaluating evidential matter concerning management's assertions in financial statements. Assertions are representations by management that are embodied in financial statement components. They can be either explicit or implicit and can be classified according to the following broad categories:

- *Existence of occurrence*—Whether the amounts exist at the balance sheet date and whether recorded transactions have occurred during the period
- *Completeness*—Whether all transactions and accounts that should be presented in the financial statements are included
- *Rights and obligations*—Whether assets are the rights of the company and liabilities are obligations of the company at the balance sheet date
- *Valuation and allocation*—Whether asset, liability, revenue, and expense items have been included in the financial statements at appropriate amounts
- *Presentation and disclosure*—Whether items in the financial statements are properly classified, described, and disclosed

There is not necessarily a one-to-one relationship between audit objectives and procedures. Some procedures may relate to more than one objective. On the other hand, a combination of procedures may be needed to achieve a single objective.

In selecting particular substantive tests to achieve the audit objectives that the auditor has developed, the auditor considers (1) his or her assessment of control risk, (2) the relative risk of errors or irregularities that would be material to financial statements, and (3) the expected effectiveness and efficiency of tests. These considerations include the nature or materiality of the items being tested, the kinds and competence of available evidential matter, and the nature of the audit objective to be achieved. Because of the large volume of transactions in the premium and claims cycle, audit sampling techniques—either statistical or nonstatistical—are often employed in applying certain tests.

The nature, timing, and extent of the procedures to be applied on a particular engagement are matters of professional judgment to be determined by the auditor based on the specific circumstances. However, the procedures adopted should be adequate to achieve the audit objectives developed by the auditor, and the evidential matter obtained should be sufficient for the auditor to form conclusions concerning the validity of the individual assertions embodied in the components of the financial statements. The combination of the auditor's assessment of control risk and results of substantive tests should provide a reasonable basis for the auditor's opinion.

These illustrations are not intended to be all-inclusive. As stated earlier, the auditor must determine procedures based on the specific circumstances. More detailed auditing issues and procedures are discussed in specific chapters of this guide.

Exhibit B-1

Premium Cycle

Financial Statement Assertions	*Audit Objectives*	*Examples of Selected Control Procedures and Techniques*	*Examples of Auditing Procedures*
Existence	● Premiums, commissions, and revenue and expense amounts recorded must relate to policies issued or in force during the period.	● Unissued policy forms are physically controlled. ● Policy applications are properly registered.	● Obtain evidence about proper issuance by— 1. Checking policy file for signed application and underwriting approval. 2. Tracing to master file data such as policy number, name, effective date, kind of policy, coverage limits, premium, payment mode, and agent. 3. Comparing premiums to cash receipts records. ● Check daily reports for underwriting approval, calculation of premiums and commissions, and proper recording of premium payments. ● Reconcile premiums and commissions to agents' reports. ● Trace selected premiums transactions to premium register to check that policy terms, lines of business, and premium amounts have been properly recorded. ● Reconcile monthly summary of premiums written—direct, assumed, and ceded—and related commission with general ledger.

(Continued)

Premium Cycle—continued

Financial Statement Assertions	*Audit Objectives*	*Examples of Selected Control Procedures and Techniques*	*Examples of Auditing Procedures*
			• Test that agents submitting applications are licensed, and inspect agency agreements.
Completeness	• Premium amounts include premiums from all policies and are accurately compiled.	• Policies are recorded on a timely basis in the detail policy records, and records are reviewed for recording of all policy numbers. • Guidelines are established for coding policies, and coding is reviewed for accuracy. • Input, output, and data center controls are maintained to ensure that all changes to detail policy records are processed properly.	• Test that premiums are recorded as described above. • Assess control over policy forms and policy issuance by— 1. Testing whether policies supplied to agents are promptly entered on policy control records. 2. Inspecting policy numbers issued and testing procedures for investigation of missing numbers. 3. Reconciling policy allotment register to underwriting reports of new business. 4. Testing whether daily reports are recorded before filing. • Check calculation of premiums to premium rate tables. • Compare ratios of commissions to premiums written with ratios of prior years, and investigate significant fluctuations.

	• Agents' balances include all amounts due to or from agents as of balance sheet date.	• Amounts included in commission calculations are reconciled to premiums written. • Detailed agent's accounts are reconciled to the general ledger.	• Test that premiums and commissions are recorded as described earlier. • Trace selected commission rates to commission schedules.
Rights and Obligations	• Return premiums, policyholder dividends, and retroactive premium adjustments are properly recorded.	• Policy endorsements and cancellations or other changes are approved; determinations of additional or return premiums are also reviewed. • Policyholder dividends, retrospective premiums, and experience-rated premiums are reviewed and approved. • Premium adjustments are compared with policy provisions, and dividends are compared with dividend declaration for compliance.	• Test the propriety of return premiums by inspecting evidence of cancellation on policy face and by obtaining evidence about adherence to company policy regarding cancellation method. • Test that policyholder dividends comply with authorization, and reconcile amounts with underlying policy records. • Inspect transactions on periodic reporting policies to test whether periodic reports are received according to terms of policies, audits required by policies are performed, and premium deposits and additional or return premiums are properly calculated and recorded. • Inspect premiums recorded for retrospectively rated policies to test whether company procedures and policy terms have been followed in determining premiums and whether claims data have been included in the calculations.

(Continued)

Premium Cycle—continued

Financial Statement Assertions	*Audit Objectives*	*Examples of Selected Control Procedures and Techniques*	*Examples of Auditing Procedures*
		• Premium and loss data underlying calculations are reconciled to the records, and calculations are reviewed and approved.	
	• Reinsured policies are properly identified, and premiums on ceded reinsurance are properly recorded and reported to assuming companies.	• Risks covered by reinsurance agreements are identified, properly designated, recorded in the premium billing and in-force files, and reported to the assuming company.	• Test whether risks in excess of retention amounts are reinsured. • Test computation of reinsurance premiums and commissions; trace to reinsurance records. • Trace information from premium rcords to reports sent to reinsurers. • Test the propriety of reinsuerance balances payable by reference to reinsurance agreements and policy records.

Valuation or Allocation	• Premium revenues and unearned premium reserve are recorded properly.	• Premium register is balanced periodically to update premiums in force. • Premiums written are recorded in the general ledger and are reconciled periodically to premiums entered in statistical records and the premium register • Return premiums are reviewed for reasonableness by comparison to original premiums.	• Inquire about the method for recognizing premium revenue and determining unearned premium reserves; check consistency of its application with prior years. • Inspect recording of unearned premium reserves by reconciling additions and deletions in force for selected periods back to original documentation and by checking calculation of unearned premiums. • Test that the unearned premium reserves are correctly reduced for ceded insurance.
	• Uncollectible agents' balances are identified and accounted for.	• Agents' balances are periodically aged in conformity with statutory requirements.	• Compare aged trial balance of agent's balances with similar trial balances of previous periods, and investigate significant fluctuations. • Test collectibility by inspecting subsequent collections or by inspecting history of receipts. • Evaluate the adequacy of the allowance for doubtful accounts, including suspense items.

(Continued)

Premium Cycle—continued

Financial Statement Assertions	*Audit Objectives*	*Examples of Selected Control Procedures and Techniques*	*Examples of Auditing Procedures*
		● Delinquent accounts are investigated and write-offs of bad debts and unreconciled items are approved. ● Advances to agents are approved in accordance with company procedures. ● Statements of transactions and balances are periodically sent to agents.	● Test whether agents' balances considered to be nonadmitted assets were properly excluded from the statutory statements and included in the GAAP statements only to the extent deemed collectible.
	● Acquisition costs are properly capitalized and amortized.	● Deferrable costs are properly capitalized and amortized. ● Amortization of deferred costs is compared for consistency with premium recognition.	● Inspect documentation of procedures for recording acquisition costs. ● Inspect the support for deferred acquisition costs. ● Test whether acquisition costs are properly capitalized and amortized on a consistent basis. Also test whether the balance at year-end is reasonably expected to be recovered.

Exhibit B-2

Claims Cycle

Financial Statement Assertions	*Audit Objectives*	*Examples of Selected Control Procedures and Techniques*	*Examples of Auditing Procedures*
Existence or Occurrence	● Paid claims relate to transactions during the period, and unpaid claims are recorded as of the balance sheet date.	● Initial entry of claims data is appropriately controlled. ● Claims are checked against daily reports for existence of coverage. ● Proper documentation and proof of loss are obtained before payment. ● Salvage and subrogation are noted in claims files and are followed up. ● Supporting data for claims and compliance with company policies are reviewed before approval of claim payments.	● For selected paid claims, inspect documentation of loss payments for approval and inspect canceled checks or drafts for proof of payments. ● Inspect documentation of selected paid claims supporting relevant accounting and statistical data, such as amounts, incurred dates, and coding. ● For selected unpaid claims (case-basis files), inspect documentation supporting relevant accounting data (such as amounts of reserves shown in the outstanding claims listing).

(Continued)

Claims Cycle—continued

Financial Statement Assertions	*Audit Objectives*	*Examples of Selected Control Procedures and Techniques*	*Examples of Auditing Procedures*
Completeness	• Records include all claims paid during the period and all reported claims unpaid as of the balance sheet date.	• Procedures are in effect to ensure that claims and related information are promptly reported to the claims department. • Prenumbered claim files are used or sequential claim numbers are assigned. • Appropriate controls of input, output, and other data are maintained to ensure that all claims are processed. • Detailed control records are maintained for all reported claims.	• Reconcile paid claims to the general ledger and appropriate subsidiary ledger and statistical records. • Select open claims (including reopened claims) from the files and test whether they are properly accounted for on the outstanding claims listing. • Reconcile unpaid claims (case basis) to the general ledger and appropriate subsidiary ledger and statistical records. Reconcile unpaid claim files to inventory. • Test whether claim processing cutoff at balance sheet date was proper and consistent with prior year. • From paid-loss transactions and the trial balance or master file of outstanding claims, test accumulation of data and balances by line of business and by accident or exposure period. • For selected claim files closed without payment, test whether they have been properly closed.

		• Statistical data are periodically reconciled to detail records. • Inventory of unpaid claims files is periodically reconciled to the master file for errors or omissions.	
Rights and Obligations	• Reserves and related balances under reinsurance assumed are properly recorded.	• Current information is maintained on the status of assumed and ceded reinsurance contracts • For facultative reinsurance, reported claims are reviewed for notification of the reinsurer. • For treaty reinsurance, reinsurance recoverable estimates are recorded on a reinsurance bordereau, which is forwarded to the reinsurer in accordance with contract terms.	• Review abstracts of significant reinsurance agreements. • Trace relevant accounting data to reports provided by ceding companies. • For significant treaties or groupings of treaties, obtain or prepare a development of losses. • Evaluate whether the IBNR reserve includes adequate provision of IBNR claims under reinsurance agreements.

(Continued)

Claims Cycle—continued

Financial Statement Assertions	*Audit Objectives*	*Examples of Selected Control Procedures and Techniques*	*Examples of Auditing Procedures*
	• Reinsurance recoverable on paid and unpaid losses is properly recorded.	• Reinsurance recoverable is regularly reconciled to detailed records. • Claims are reviewed for applicability of reinsurance, and the reinsurers are promptly notified. • Reinsurers are promptly billed as claims are paid. • Paid claims are accumulated for recoveries under excess contracts.	• Reconcile summary of reinsurance recoverable to general ledger. • Confirm selected balances with reinsurers. • Evaluate whether loss reserves have been properly reduced for reinsurance contracts. • Trace relevant accounting data to reports provided to assuming companies. • Review Schedule F, "Assumed and Ceded Reinsurance," of the annual statement, and investigate significant or unusual items.
	• Liability for outstanding drafts is properly recorded.		• Obtain a list of the unpaid drafts account as of the balance sheet date and reconcile to general ledger.

Assertion	Audit Objective	Control	Procedure
			• On a test basis, trace draft payments subsequent to balance sheet date back to list. • Agree prepaid drafts to paid drafts on a test basis, and test unpaid claims to list. • Review supporting documents for material drafts that have been outstanding for an unreasonable length of time.
Valuation or Allocation	• Paid losses and related accounts are recorded in the proper amounts. • Estimates of loss reserves are reasonable.	• Outstanding loss reserves are balanced to monthly claims activity. • Changes in outstanding loss reserves are promptly reviewed and recorded. • For case-basis reserves, open claim files, including previous estimates of unpaid claims, are regularly reviewed and analyzed for adequacy of reserves in light of current information.	• Test posting of losses paid, loss-adjustment expenses paid, and reinsurance recoverable for claim selected from claim register; reconcile to subsidiary registers and statistical records. • Reconcile the total amount of paid losses to cash disbursement records. • Test loss-reserve development by line of business. • Perform analytical procedures on losses incurred, losses paid, loss reserves, and loss ratios by line of business. • Review current reports of state insurance examiners and loss developments prepared for the annual statements and Schedule P, and investigate significant items.

(Continued)

Claims Cycle—continued

Financial Statement Assertions	*Audit Objectives*	*Examples of Selected Control Procedures and Techniques*	*Examples of Auditing Procedures*
		● Appropriate officials regularly develop and analyze reserves for each line of business by accident year or by other appropriate basis. Development and analysis includes IBNR claims, claims adjustment expenses, and reserves on reinsurance assumed. ● Factors and assumptions used in estimating loss reserves are documented and periodically reviewed for reasonableness.	● Obtain evidence about the company's method of determining the reserve for IBNR losses and evaluate its reasonableness. Determine if there have been any significant changes in the company's methods and procedures, and evaluate the effect of all current trends and conditions. ● Compare current IBNR reserve against claims reported in subsequent period, and investigate significant fluctuations. ● Compare company's IBNR loss-reserve development for prior periods with actual results, and investigate causes of significant discrepancies. ● Consider the use of an actuary.

Exhibit B-3

Investment Cycle

Financial Statement Assertions	*Audit Objectives*	*Examples of Selected Control Procedures and Techniques*	*Examples of Auditing Procedures*
Existence	● Securities and investment assets included in the balance sheet physically exist.	● Transactions settled after year-end are reviewed for recording in the proper period (as of the trade date). ● Custodial function is independent of investment and accounting functions and provides security commensurate with the risks involved. ● Securities and evidence of ownership held by the company are kept in vault with access limited to authorized personnel.	● Inspect and count the securities held on the client's premises as of the date that the securities amounts are reconciled to the general ledger control accounts. ● Obtain confirmations from the custodians of securities held for the client. Compare the confirmed lists with the trial balance and investigate discrepancies. ● Obtain confirmations that securities purchased under repurchase agreements but not delivered are being held by the sellers or the sellers' custodian on the company's behalf. ● Confirm with brokers the status of securities in transit. ● Compare the face amounts or number of shares and the cost of investments recorded in the investment ledger with forms and documents created at the time of purchase. Examine forms and documents for proper completion and authorization.

(Continued)

Investment Cycle—continued

Financial Statement Assertions	*Audit Objectives*	*Examples of Selected Control Procedures and Techniques*	*Examples of Auditing Procedures*
		● Reports and confirmations of securities held by outside custodians are reconciled to company records. ● Financial responsibility and capability of outside custodians are periodically reviewed.	● Obtain and read custodial agreements and available reports regarding the adequacy of the custodians' internal controls and financial stability.
Completeness	● Investment assets include all investments of the company.	● Buy and sell orders to brokers are compared to brokers' advices.	● Inspect and count securities held by the client. Obtain confirmation from custodian of securities held for the account of the client.
	● Investment amounts include all transactions during the period.	● Authorized lists of signatures, brokers, and so forth are maintained.	● Read finance committee minutes and test whether investment transactions have been properly authorized. ● Determine that only securities dealers approved by the finance committee are used.

	• Written policy statements detailing investment guidelines and limitations are prepared by designated levels of management. • Potential investment transactions are reviewed by an investment advisory committee and approved by a finance committee. • Questions concerning compliance with regulatory restrictions are referred to the legal department before transactions are executed.	• Compare investment yields during the period with expected yields based on previous results and current market trends; investigate significant discrepancies. • Test transactions settled after the end of the period for recording in the proper period (as of the trade date).
• Investment records are properly compiled, and totals are properly included in the investment accounts.	• Recorded amounts of investments are periodically compared to safekeeping ledgers and to current market values.	• Examine input and output data and balances in individual investment accounts to test whether transactions are properly recorded. • Compare investment totals to the client's reconciliation of the investment ledger to the general ledger control accounts. Investigate significant discrepancies and any large or unusual reconciling items.

(Continued)

Investment Cycle—continued

Financial Statement Assertions	*Audit Objectives*	*Examples of Selected Control Procedures and Techniques*	*Examples of Auditing Procedures*
		● Batch balancing, logging, and cash totals are used to provide assurance that all purchases and sales have been properly posted to master files.	
Rights and Obligations	● The company has legal title or similar rights of ownership.	● Securities and other evidence of ownership are in the company's name.	● Review legal department compliance records concerning statutory requirements and limitations. ● Examine securities to determine whether they are registered or payable to the company, an authorized nominee, or the bearer. ● Examine bonds to determine whether interest coupons due after the count date are attached.
Valuation or Allocation	● Investments are recorded at their proper amounts.	● Securities for which there is no active market are monitored for valuation at cost and are written down to market value when required.	● Compare recorded costs of investments to published market quotations at trade date. Consider reasonableness of commission rates, taxes, and so on. ● Compare recorded market values of investments to published market quotations at the end of the period.

	• Interim securities valuations are obtained from outside brokers. • Valuations for statutory reporting purposes are reviewed for conformity with NAIC published values. • Market prices for purchases and sales are compared with independent sources.	• Examine summaries of interest, dividend, and principal payments for indication of security value impairment. • Examine past-due bonds and notes for endorsements or evidence of reductions in principal through receipt of partial payments.
• Investment income and losses are recorded in the proper amounts.	• Unrealized gains and losses are substantiated by reconciliation with prior values. • Adjustments of investment accounts are reviewed and approved by an authorized official.	• Test determination of interest earned, accrued interest receivable, and amortization of discount or premium. • Test dividend income by reference to published dividend records. • Test computations of realized gains and losses by appropriate cost method. • Obtain financial reports of joint ventures or managed real estate and compare reported amounts of dividends, net rentals, and so on, to the records.

(Continued)

Investment Cycle—continued

Financial Statement Assertions	*Audit Objectives*	*Examples of Selected Control Procedures and Techniques*	*Examples of Auditing Procedures*
		• Interest and dividends are reviewed for accuracy by reference to reliable sources. • Income amounts are compared to cash receipts records and are reconciled to the bond and stock master listings. • Interest and dividends due but not received are reconciled to estimated and paid income lists.	• Review purchases and sales for indications of possible wash sales.
Presentation and Disclosure	• Investments are properly classified and disclosed.	• Realized capital gains and losses are properly recorded and classified. They are then submitted on a timely basis to the tax department.	• Test whether disclosures comply with GAAP. • Inquire about pledging, assignment, or other restrictions. • Read finance committee minutes. • Examine loan agreements.

Appendix C

Illustrative Financial Statements and Disclosures

Introduction

1. This appendix illustrates financial statements of a nonpublic property and liability insurance company and the accompanying disclosures that are unique to such companies. Disclosures concerning the company's pension plans, postretirement benefits other than pensions, stock options, lease commitments, long-term debt, extraordinary items, accounting changes, and other items that are not unique to property and liability insurance companies have been omitted for purposes of this guide. The format presented and the wording of the accompanying notes are only illustrative and are not necessarily the only possible presentations.

2. Except for the treatment of gains and losses described in FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, insurance companies that are SEC registrants should follow Article 7 of SEC Regulation S-X, which prescribes the form and content of financial statements. Also, the SEC's Financial Reporting Release (FRR) No. 20, *Rules and Guide for Disclosures Concerning Reserves for Unpaid Claims and Claim Adjustment Expenses of Property-Casualty Underwriters* requires property and liability insurance companies to disclose in financial statements filed with the SEC certain information concerning reserves for unpaid claims and claim adjustment expenses. The Exchange Act requires certain supplementary information with respect to quarterly financial data. Other SEC regulations also require additional disclosures (for example, details with respect to deferred acquisition costs).

3. GASB Statement No. 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues*, requires public entity risk pools to present additional information beyond these illustrative financial statements. This additional information includes reporting assessments receivable from pool participants for premium deficiencies, disclosures about revenues collected in anticipation of future catastrophe losses, the aggregate outstanding amount of claims outstanding that have been settled through the purchase of annuity contracts, and the pool risk transfer agreement. Also, outstanding claims by kind of contract and ten-year claims development information on a policy-year basis should be presented as required supplementary information.

4. FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, establishes disclosure requirements regarding accounting by creditors for certain impaired loans. Those requirements apply to financial statements for fiscal years beginning after December 15, 1994.

Exhibit C-1

The Property and Liability Insurance Company and Subsidiaries

Consolidated Balance Sheets
December 31, 19X2 and 19X1
(Dollars in thousands)

ASSETS	*19X2*	*19X1*
Investments (notes 1 and 2):		
Trading securities	$ 11,683	$ 11,259
Securities available for sale	1,006,279	953,507
Securities held to maturity	280,387	270,208
Mortgage loans on real estate (less allowance for credit losses, 19X2—$2,300; 19X1—$2,070)	472,509	398,426
Real estate, net of accumulated depreciation (19X2—$12,921; 19X1—$12,774) and less allowance for impairment of value (19X2—$1,173; 19X1—$1,150)	31,905	30,028
Total investments	1,802,763	1,663,428
Cash and cash equivalents	31,564	28,357
Accrued interest and dividends	31,358	27,568
Premium and agents' balances	55,295	56,212
Prepaid reinsurance premiums	21,345	18,739
Reinsurance receivables, net of uncollectible amounts	27,908	24,461
Deferred policy acquisition costs (note 1)	168,974	154,941
Property and equipment, at cost, less accumulated depreciation of $17,837 in 19X2 and $15,404 in 19X1 (note 1)	34,443	27,938
Other assets	128,577	107,378
TOTAL ASSETS	$2,302,227	$2,109,022

See accompanying notes to consolidated financial statements.

LIABILITIES	19X2	19X1
Losses and loss-adjustment expenses (note 1)	$1,183,343	$1,030,345
Unearned premiums (note 1)	493,833	482,619
Dividends to policyholders	3,087	4,042
Reinsurance funds withheld and balances payable	15,727	35,584
Accrued expenses	85,780	82,608
Federal income taxes payable (notes 1 and 5)	3,166	7,058
Deferred income taxes (notes 1 and 5)	34,084	35,133
Other liabilities	56,144	43,782
Total liabilities	1,875,164	1,721,171
SHAREHOLDERS' EQUITY (note 7)		
Common stock ($5 par value authorized—11,500 shares; issued—2,500 shares, including 200 shares in treasury in 19X2 and 19X1)	12,500	12,500
Paid-in capital	22,500	22,500
Retained earnings (notes 6 and 7)	390,815	351,521
Net unrealized appreciation on securities available for sale, net of deferred taxes (note 2)	5,748	5,830
Less treasury stock, at cost	(4,500)	(4,500)
Total shareholders' equity	427,063	387,851
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$2,302,227	$2,109,022

See accompanying notes to consolidated financial statements.

Exhibit C-2

The Property and Liability Insurance Company and Subsidiaries

Consolidated Statements of Income
For the Years Ended December 31, 19X2 and 19X1
(Dollars in thousands, except per share amounts)

	19X2	*19X1*
REVENUES		
Premiums earned	$656,517	$603,461
Premiums ceded	(85,632)	(78,715)
Net premiums earned (notes 1 and 3)	570,885	524,746
Net investment income	146,683	130,070
Net realized gains and losses on securities available for sale (notes 1 and 2)	84,776	32,272
Other	13,288	8,784
Total revenues	815,632	695,872
EXPENSES		
Losses and loss-adjustment expenses (notes 1 and 3)	509,568	432,413
Policyholder dividends (note 1)	4,833	7,395
Policy acquisition and other underwriting expenses (note 1)	211,239	185,834
Other	8,347	2,215
Total expenses	733,987	627,857
Income before income taxes	81,645	68,015
Provision (benefit) for income taxes (note 5)		
Current	26,108	16,291
Deferred	(1,007)	881
Total income taxes	25,101	17,172
NET INCOME	$ 56,544	$ 50,843
Per Share Data		
NET INCOME	$ 24.58	$ 21.18

See accompanying notes to consolidated financial statements.

Exhibit C-3

The Property and Liability Insurance Company and Subsidiaries

Consolidated Statements of Changes in Stockholders' Equity
For the Years Ended December 31, 19X2 and 19X1
(Dollars in thousands)

	Common Stock						
	Shares	*Amount*	*Paid-in Capital*	*Net Unrealized Appreciation on Securities Available for Sale*	*Retained Earnings*	*Treasury Stock*	*Total Shareholders' Equity*
Balance at January 1, 19X1	2,500	$ 12,500	$ 22,500	$ 3,942	$ 315,678		$ 354,620
19X1							
Net income					50,843		50,843
Dividends ($6.00 per share)					(15,000)		(15,000)
Net increase in unrealized appreciation of securities available for sale				1,888			1,888
Purchase of 200 shares of treasury stock						(4,500)	(4,500)
Balance at December 31, 19X1	2,500	$ 12,500	$ 22,500	$ 5,830	$ 351,521	$ (4,500)	$ 387,851
19X2							
Net income					56,544		56,544
Dividends ($7.50 per share)					(17,250)		(17,250)
Net decrease in unrealized appreciation of securities available for sale				(82)			(82)
Balance at December 31, 19X2	2,500	$ 12,500	$ 22,500	$ 5,748	$ 390,815	$ (4,500)	$ 427,063

See accompanying notes to consolidated financial statements.

Exhibit C-4

The Property and Liability Insurance Company and Subsidiaries

Consolidated Statements of Cash Flow
For the Years Ended December 31, 19X2 and 19X1
(Dollars in thousands)

	19X2	*19X1*
Cash flows from operating activities:		
Premiums collected	$ 619,862	$ 536,532
Losses and loss adjustment expenses paid	(356,570)	(352,411)
Underwriting expenses paid	(208,067)	(184,006)
Net realized gains on available-for-sale securities	142,893	126,860
Net (increase) decrease in trading securities	(424)	1,095
Income taxes paid	(30,000)	(21,300)
Miscellaneous receipts (payments)	45,249	25,171
Net cash provided by operating activities	212,943	131,941
Cash flows from investing activities:		
Purchases of available-for-sale securities	(721,334)	(274,765)
Proceeds from sales of available-for-sale securities	525,669	195,826
Purchases of held-to-maturity securities	(49,826)	(176,871)
Proceeds from maturities of held-to-maturity securities	60,005	146,080
Purchase of property and equipment	(7,000)	(2,356)
Net cash used in investing activities	(192,486)	(112,077)
Cash flows from financing activities:		
Payment of dividends	(17,250)	(15,000)
Purchase of treasury shares	—	(4,500)
Net cash used in financing activities	(17,250)	(19,500)
Net increase (decrease) in cash	3,207	364
Cash and cash equivalents at beginning of year	28,357	27,993
Cash and cash equivalents at end of year	$ 31,564	$ 28,357

Reconciliation of net income to net cash provided by operating activities

	19X2	19X1
Net income	56,544	50,843
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	2,580	2,389
Gains on sales of investment	(84,776)	(32,272)
Increase in accrued interest and dividends	(3,790)	(2,983)
Increase in premium and agents' balances	917	(718)
Increase in prepaid reinsurance premiums	(2,606)	(1,953)
Increase in reinsurance receivable	(3,447)	(892)
Increase in deferred policy acquisition costs	(14,033)	(10,963)
Increase in unpaid losses and loss adjustment expenses	152,998	112,991
Increase in unearned premiums	11,214	9,816
Decrease in dividends payable	(955)	(820)
Decrease in reinsurance funds withheld	(19,857)	(18,152)
Increase in accrued expenses	3,172	2,915
Decrease in income taxes	(4,941)	(3,156)
Decrease (increase) in other—net	(10,027)	24,896
Net cash provided by operating activities	$ 82,993	$131,941

See accompanying notes to consolidated financial statements.

Exhibit C-5

The Property and Liability Insurance Company and Subsidiaries

Notes to Consolidated Financial Statements
For the Years Ended December 31, 19X2 and 19X1

1. Nature of Operations and Summary of Significant Accounting Policies

Nature of Operations: The Property and Liability Insurance Company and subsidiaries (the Company) is a nonpublic insurance organization providing property and liability coverage to both domestic and foreign markets. The Company is principally involved in writing insurance for domestic commercial lines.

The significant accounting policies followed by the Company are summarized as follows:

Use of Estimates: The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Principles of Consolidation: The consolidated financial statements include the accounts, after intercompany eliminations, of the Company and its subsidiaries.

Basis of Presentation: The accompanying financial statements have been prepared in conformity with generally accepted accounting principles that differ from statutory accounting practices prescribed or permitted for insurance companies by regulatory authorities.

Trading Securities: Bonds, notes, and redeemable and non-redeemable preferred stock held principally for resale in the near term are classified as trading securities and recorded at their fair values. Realized and unrealized gains and losses on trading securities are included in other income.

Securities Held to Maturity: Bonds, notes, and redeemable and non-redeemable preferred stock for which the insurance company has the intent and ability to hold to maturity are reported at amortized cost, adjusted for amortization of premiums or discounts and other-than-temporary declines in fair value.

Securities Available for Sale: Bonds, notes, common stock, and redeemable preferred stock not classified as either trading or held-to-maturity are reported at fair value, adjusted for other than temporary declines in fair value, with unrealized gains and losses excluded from losses and reported as a separate component of stockholder's equity. Realized gains and losses are determined on the specific identification method.

Mortgage Loans on Real Estate: Reported at unpaid balances, adjusted for amortization of premium or discount, less a provision for credit losses.

Real estate: Reported at cost, less allowances for depreciation and impairment of value.

Interest Rate Futures: The Company uses interest rate futures contracts as part of its overall interest rate risk management strategy for certain in-

surance products. Gains and losses on futures contracts used in asset/liability management for identified positions are deferred and amortized over the remaining lives of the hedged assets or liabilities as an adjustment to interest income or expense. When the assets or liabilities underlying the futures contracts are disposed of or eliminated, any unamortized gains or losses are recognized concurrently.

Cash Equivalents: For the purpose of presentation in the company's statements of cash flow, cash equivalents are short-term, highly liquid investments that are both (*a*) readily convertible to known amounts of cash and (*b*) so near to maturity that they present insignificant risk of changes in value due to changing interest rates.

Recognition of Premium Revenues: Property and liability premiums are generally recognized as revenue on a pro rata basis over the policy term. The portion of premiums that will be earned in the future are deferred and reported as unearned premiums.

Deferred Policy Acquisition Costs: Commissions and other costs of acquiring insurance that vary with and are primarily related to the production of new and renewal business are deferred and amortized over the terms of the policies or reinsurance treaties to which they relate. Amortization in 19X2 and 19X1 was approximately $58,000,000 and $55,000,000, respectively.

Property and Equipment: Property and equipment is recorded at cost and is depreciated principally under the straight-line method over the estimated useful lives of the respective assets.

Insurance Liabilities: The liability for losses and loss-adjustment expenses includes an amount determined from loss reports and individual cases and an amount, based on past experience, for losses incurred but not reported. Such liabilities are necessarily based on estimates and, while management believes that the amount is adequate, the ultimate liability may be in excess of or less than the amounts provided. The methods for making such estimates and for establishing the resulting liability are continually reviewed, and any adjustments are reflected in earnings currently. The reserve for losses and loss-adjustment expenses is reported net of receivables for salvage and subrogation of approximately $17,527,000 and $16,276,000 at December 31, 19X2 and 19X1, respectively.

Participating Policies: Participating business represents 6 percent of total premiums in force and premium income at December 31, 19X2, and 8 percent at December 31, 19X1. The majority of participating business is composed of workers' compensation policies. The amount of dividends to be paid on these policies is determined based on the terms of the individual policies.

Reinsurance: In the normal course of business, the Company seeks to reduce the loss that may arise from catastrophes or other events that cause unfavorable underwriting results by reinsuring certain levels of risk in various areas of exposure with other insurance enterprises or reinsurers. Amounts recoverable from reinsurers are estimated in a manner consistent with the reinsured policy. The amount by which the liabilities associated with the reinsured policies exceed the amounts paid for retroactive reinsurance contracts is amortized in income over the estimated remaining settlement period using the interest method. The effects of subsequent changes in estimated or actual cash flows are accounted for by adjusting

the previously deferred amount to the balance that would have existed had the revised estimate been available at the inception of the reinsurance transactions, with a corresponding charge or credit to income.

Income Taxes: Income tax provisions are based on the asset and liability method. Deferred federal income taxes have been provided for temporary differences between the tax basis of assets and liabilities and their reported amounts in the financial statements. Such differences are related principally to the deferral of policy acquisition costs and the recognition of salvage and subrogation on an accrual basis.

Income per Share of Common Stock: Income per share of common stock is based on the weighted average number of shares of common stock outstanding during each year. The effect of stock options is not material to the computation of earnings per share.

2. Investments

Major categories of net investment income are summarized as follows:

	(Dollars in thousands)	
	19X2	*19X1*
Fixed maturities	$102,971	$ 94,267
Equity securities	8,005	7,154
Mortgage loans on real estate	41,984	32,906
Real estate	2,537	2,779
	155,497	137,106
Investment expenses	8,814	7,036
	$146,683	$130,070

The aggregate fair value, gross unrealized holding gains, gross unrealized holding losses, and amortized cost for available-for-sale and held-to-maturity securities by major security type at December 31, 19X2 and 19X1 are as follows:

Available-for-Sale Securities:

December 31, 19X2:

	Amortized Cost	*Gross Unrealized Gains*	*Gross Unrealized Losses*	*Fair Value*
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$ 155,534	$ 1,286	$ (4,797)	$ 152,023
Obligations of states and political subdivisions	112,966	83	(854)	112,195
Debt securities issued by foreign governments	24,133		(23)	24,110
Corporate debt securities	198,354	6,844	(2,984)	202,214
Equity securities	277,777	2,963	(857)	279,883
Mortgage-backed securities	180,205	4,289	(6,683)	177,811
Redeemable preferred stock	75,689	916	(582)	76,023
Non-redeemable preferred stocks	44,669	369	18	45,020
Total	$1,069,327	$16,750	$(16,798)	$1,066,279

December 31, 19X1:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$136,848	$ 2,983	$ (3,298)	$136,533
Obligations of states and political subdivisions	90,045	786	(1,069)	89,762
Debt securities issued by foreign governments	20,121	4	(13)	20,112
Corporate debt securities	292,330	5,989	(1,732)	296,587
Equity securities	168,323	6,297	(2,076)	172,581
Mortgage-backed securities	135,080	2,926	(37)	137,969
Redeemable preferred stock	75,588	1,426	(1,028)	75,986
Non-redeemable preferred stocks	23,694	327	7	24,014
Total	$942,029	$20,738	$ (9,260)	$953,507

Held-to-Maturity Securities:

December 31, 19X2:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$ 85,852	$ 9,681	$ (4,133)	$ 91,400
Obligations of states and political subdivisions	54,827	2,771	(1,896)	55,702
Corporate debt securities	159,238	4,718	(709)	163,247
Total	$299,917	$17,170	$ (6,738)	$310,349

December 31, 19X1:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$ 55,105	$ 2,138	$ (1,976)	$ 55,267
Obligations of states and political subdivisions	63,296	2,687	(2,859)	63,124
Corporate debt securities	168,747	5,293	(17,936)	156,104
Total	$287,148	$10,118	$(22,771)	$274,495

Securities with amortized cost (which approximates their fair value) of $19,530 and $16,940 were reported as cash equivalents in 19X2 and 19X1 respectively.

Gross realized gains and losses on sales of available for sale securities were:

	19X2	*19X1*
Gross unrealized gains:		
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$ 22,343	$ 20,983
Obligations of states and political subdivisions	29,999	39,017
Debt securities issued by foreign governments	62,129	46,739
Corporate debt securities	92,982	88,735
Equity securities	116,328	83,569
Mortgage-backed securities	31,705	39,617
Redeemable preferred stocks	8,296	3,261
Total	$363,782	$311,921
Gross realized losses:		
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$ 13,919	$ 18,442
Obligations of states and political subdivisions	10,604	4,797
Debt securities issued by foreign governments	31,291	6,649
Corporate debt securities	62,958	60,396
Equity securities	63,921	70,378
Mortgage-backed securities	27,392	19,681
Redeemable preferred stocks	10,876	4,718
Total	$142,893	$185,061

The scheduled maturities of available-for-sale and held-to-maturity securities at December 31, 19X2 were as follows:

Held-to-Maturity Securities:

	Amortized Cost	*Fair Value*
Due in one year or less	$ 81,666	$ 85,282
Due after one year through five years	83,921	86,321
Due after five years through ten years	76,893	78,567
Due after ten years	57,437	60,179
Total	$299,917	$310,349

Available-for-Sale Securities:

	Amortized Cost	*Fair Value*
Due in one year or less	$193,238	$199,896
Due after one year through five years	302,126	310,298
Due after five years through ten years	251,755	226,410
Due after ten years	200,950	198,632
Total	$948,069	$935,236

Bonds with an amortized cost of $100,000 were non-income producing for the year ended December 31, 19X2. At December 31, 19X2, bonds carried at an amortized cost of $43,684,000 were on deposit with regulatory authorities.

3. Reinsurance Activity

Substantial amounts of reinsurance are assumed, both domestic and foreign. Such reinsurance includes quota share, excess of loss, catastrophe, facultative, and other forms of reinsurance on essentially all property and casualty lines of insurance. The Company also cedes insurance to other companies and these reinsurance contracts do not relieve the Company from its obligations to policyholders. Failure of reinsurers to honor their obligations could result in losses to the Company; consequently, allowances are established for amounts deemed uncollectible. The Company evaluates the financial condition of its reinsurers and monitors concentrations of credit risk arising from similar geographic regions, activities, or economic characteristics of the reinsurers to minimize its exposure to significant losses from reinsurer insolvencies. At December 31, 19X2, reinsurance receivables with a carrying value of $8 million and prepaid reinsurance premiums of $5 million were associated with a single reinsurer. The Company holds collateral under related reinsurance agreements in the form of letters of credit totaling $5 million that can be drawn on for amounts that remain unpaid for more than 120 days.

The Company limits the maximum net loss that can arise from large risks or risks in concentrated areas of exposure by reinsuring (ceding) certain levels of risks with other insurers or reinsurers, either on an automatic basis under general reinsurance contracts known as "treaties" or by negotiation on substantial individual risks. Ceded reinsurance is treated as the risk and liability of the assuming companies.

The effect of reinsurance on premiums written and earned for 19X2 and 19X1 is as follows:

(Dollars in thousands)

	19X2		*19X1*	
	Written	*Earned*	*Written*	*Earned*
Direct	$ 477,836	$457,828	$420,580	$415,369
Assumed	206,814	198,689	207,328	188,092
Ceded	(102,551)	(85,632)	(86,100)	(78,715)
Net	$ 582,099	$570,885	$541,808	$524,746

The amounts of recoveries pertaining to reinsurance contracts that were deducted from losses incurred during 19X2 and 19X1 were approximately $4,892,000 and $3,232,000, respectively.

4. Liability for Unpaid Claims and Claim Adjustment Expenses

Activity in the liability for unpaid claims and claim adjustment expenses is summarized as follows:

	(Dollars in thousands)	
	19X2	19X1
Balance at January 1	$1,030,345	$947,890
Less reinsurance recoverables	23,728	21,275
Net Balance at January 1	1,006,617	926,615
Incurred related to:		
Current year	509,843	429,294
Prior years	(275)	3,119
Total incurred	509,568	432,413
Paid related to:		
Current year	56,015	42,315
Prior years	300,555	310,096
Total paid	356,570	352,411
Net Balance at December 31	1,159,615	1,006,617
Plus reinsurance recoverables	23,728	23,728
Balance at December 31	$1,183,343	$1,030,345

As a result of changes in estimates of insured events in prior years, the provision of claims and claim adjustment expenses (net of reinsurance recoveries of $X and $X in 19X2 and 19X1, respectively) decreased by $275 in 19X2 because of lower-than-anticipated losses on Hurricane Howard, and increased by $3,119 in 19X1 because of higher-than-anticipated losses and related expenses for claims for asbestos-related illnesses, toxic waste cleanup, and workers' compensation.

5. Income Taxes

The U.S. Federal statutory income tax rate applicable to ordinary income is 34 percent for 19X2 and 19X1. The Company's effective federal income tax rate is less than the statutory rate due primarily to tax exempt interest, dividends-received deduction, and fresh start adjustments.

The components of the net deferred tax liability are as follows:

	(Dollars in thousands)	
	19X2	19X1
Deferred policy acquisition costs	$17,093	$17,298
Salvage and subrogation	12,901	11,736
Other	4,090	6,101
Deferred tax liability	$34,084	$35,135

The Company has net operating loss carryforwards for tax purposes of $35,297 and investment tax credit carryforwards of $49,396. The tax loss carryforwards (if not utilized against taxable income) and investment tax credit carryforwards expire beginning in 19XX and continuing through 19YY.

The Company paid income taxes of $30,000 in 19X2 and $21,300 in 19X1.

6. Dividends From Subsidiaries

The funding of the cash requirements of the Company (parent company) is primarily provided by cash dividends from the Company's subsidiaries. Dividends paid by the insurance subsidiaries are restricted by regulatory requirements of the domiciliary states. Generally, the maximum dividend that may be paid without prior regulatory approval is limited to the greater of 10 percent of statutory surplus (shareholders' equity on a statutory basis) or 100 percent of net investment income for the prior year. Dividends exceeding these limitations can generally be made subject to approval by various state insurance departments. The subsidiaries paid cash dividends to the Company of $24,754,000 and $22,100,000 in 19X2 and 19X1, respectively. At December 31, 19X2, the maximum dividend that may be paid to the Company in 19X3 without regulatory approval is approximately $146,000,000.

7. Statutory Net Income and Shareholders' Equity

Generally accepted accounting principles differ in certain respects from the accounting practices prescribed or permitted by insurance regulatory authorities (statutory basis). Statutory net income was approximately $35,681,000 and $52,735,000 in 19X2 and 19X1, respectively, and statutory shareholders' equity was approximately $347,237,000 and $299,720,000 at December 31, 19X2 and 19X1, respectively.

8. Contingencies

In November 1988, California voters passed Proposition 103, requiring insurers doing business in that state to roll back property/casualty premium prices to November 1987 levels, less an additional 20 percent discount. Insurers challenged the constitutionality of Proposition 103, and in May 1989 the California Supreme Court upheld the proposition in large part. However, the Court also ruled that the rollback provision does not apply to an insurer who demonstrates through rate filings that the rate rollback would not allow a "fair and reasonable return." The Company filed for exemption from the rate rollback for all lines affected by Proposition 103. In September 1989, the California Insurance Commissioner announced that the Company would be afforded a hearing and, using different assumptions and methods than prescribed for the original filing, determined that the Company should roll back its rates and refund premiums of $19 million. The Company disagrees with the Commissioner's methods and conclusions, and no provision for potential rate rollbacks or premium refunds is reflected in the financial results.

In October 1989, the Commissioner suspended the individual hearings and began a consolidated hearing, in which the Company is participating, intended to define the generic issue of the methods to be used to calculate potential rate rollbacks and analyze future rate filings. Until the generic issues are resolved in the Commissioner's consolidated hearing, there will be uncertainty as to whether the Company will ultimately be required to roll back any of its rates or refund any premiums. Management believes such rate rollbacks and premium refunds, if any, would not have a material adverse effect on the Company's financial position.

9. Financial Instruments With Off-Balance-Sheet Risk and Concentrations of Credit Risk

At December 31, 19X2, the Company held unrated or less-than-investment grade corporate debt securities of $646,641,000 net of reserves for losses, with

an aggregate market value of $639,347,986. Those holdings amounted to 6% of the Company's corporate debt securities investments and less than 3% of total assets. The holdings of less-than-investment grade securities are widely diversified and of satisfactory quality based on the Company's investment policies and credit standards. The Company also invests in mortgage loans principally involving commercial real estate. At December 31, 19X2, 20% of such mortgages ($______) involved properties located in California and Arizona. Such investments consist of first mortgage liens on completed income-producing properties, and mortgages on individual properties do not exceed $______.

10. Fair Value of Financial Instruments

The following methods and assumptions were used to estimate the fair value of each class of financial instruments for which it is practicable to estimate that value:

Cash and Short Term Investments. For those short term instruments, the carrying amount is a reasonable estimate of fair value.

Investment in Securities. For investments in securities, fair values are based on quoted market prices or dealer quotes, if available. If a quoted market price is not available, fair value is estimated using quoted market prices for similar securities.

Mortgage Loans on Real Estate and Policy Loans. The fair value of mortgage loans on real estate is estimated using the quoted market prices for securities backed by similar loans, adjusted for differences in loan characteristics. The fair value of policy loans is estimated by discounting the future cash flows using the current rates at which similar loans would be made to contract holders with similar credit ratings and the same remaining maturities.

The estimated fair values of the Company's financial instruments which are not disclosed on the face of the balance sheet or elsewhere in the notes are as follows:

	19X2		*19X1*	
	Carrying Amount	*Fair Value*	*Carrying Amount*	*Fair Value*
Mortgage on real estate loans	$472,509	$474,163	$398,426	$401,582
Policy loans	19,862	20,974	18,623	19,953

Appendix D

Auditor's Reports

[The material that had been included in this appendix has been revised and moved to chapter 9 of the guide.]

Appendix E

NAIC Insurance Regulatory Information System (IRIS)*

The NAIC Insurance Regulatory Information System (IRIS) was developed to assist the state insurance departments in monitoring financial conditions of property and liability insurance companies. The system uses financial ratios to identify companies that may be having financial difficulties. Such "priority" companies can then be targeted for closer surveillance or perhaps for on-site examination.

Financial Ratios

Financial ratios can be categorized as overall ratios, profitability ratios, liquidity ratios, or reserve ratios. A brief description of each of the individual ratios and the acceptable results (based on the guidance in effect in December 1993) follows.

Overall Ratios

Premiums to Surplus. A company's surplus provides a cushion for absorbing above-average losses. The premium-to-surplus ratio measures the adequacy of this cushion. The higher the ratio, the more risk the company bears in relation to the surplus available to absorb loss variations. The results of this test should be less than 300 percent.

Change in Writings. Major increases or decreases in net premiums written indicate a lack of stability in the company's operations. A major increase in premium may signal abrupt entry into new lines of business or sales territories. In addition, such an increase in writings may indicate that the company is increasing cash inflow in order to meet loss payments. The usual range for this test is an increase or decrease of less than 33 percent.

Surplus Aid to Surplus. The use of surplus aid reinsurance treaties may be taken as an indication that company management believes surplus to be inadequate. In addition, the continued solvency of companies with a large portion of surplus deriving from surplus aid may depend upon the continuing cooperation of the reinsurer. The usual range for the test is less than 25 percent.

Profitability Ratios

Two-Year Overall Operating Ratio. The overall operating ratio is a measure of the operating profitability of an insurance company. Over the long run, the profitability of the business is a principal determinant of the company's financial solidity and solvency. The usual range for this test is less than 100 percent.

Investment Yield. In addition to measuring one important element in profitability, the investment yield also provides an indication of the general quality of the company's investment portfolio. The usual range for this test is over 5 percent.

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* Using the NAIC Insurance Regulatory Information System, National Association of Insurance Commissioners, Kansas City, Kansas.

Change in Surplus. The change in surplus is, in a sense, the ultimate measure of the improvement or deterioration of the company's financial condition during the year. The usual range for this test is from a decrease of 10 percent to an increase of 50 percent.

Liquidity Ratios

Liabilities to Liquid Assets. The ratio of liabilities to liquid assets is a measure of the company's ability to meet the financial demands that may be placed upon it. It also provides a rough indication of the possible implications for policyholders if liquidation becomes necessary. The usual range for this test is less than 105 percent.

Agents' Balances to Surplus. The ratio of agents' balances to surplus measures the degree to which solvency depends on an asset that frequently cannot be realized in the event of liquidation. In addition, the ratio is reasonably effective in distinguishing between troubled and solid companies. The usual range for this test is less than 40 percent.

Reserve Ratios

One-Year Reserve Development to Surplus. In addition to measuring the accuracy with which reserves were established one year ago, the ratio of one-year reserve development to surplus provides an indirect indication of management's opinion of the adequacy of surplus. The usual range for this test is less than 25 percent.

Two-Year Reserve Development to Surplus. The two-year reserve development to surplus ratio is calculated in a manner similar to the calculation in the one-year reserve development test. The two-year reserve development is the sum of the current reserve for losses incurred more than two years prior, plus payments on those losses during the past two years minus the reserves that had been established for those losses two years earlier. The usual range for this test is less than 25 percent.

Estimated Current Reserve Deficiency to Surplus. This ratio provides an estimate of the adequacy of current reserves. The usual range for this test is less than 25 percent.

Unusual circumstances precluded, a company would be considered a "priority" company if it failed four or more ratios. As previously discussed, the results of the NAIC IRIS financial ratios should be reviewed and results outside the usual ranges investigated and explained.

Appendix F
Examples of Development Data

A common approach to estimating loss reserves for occurrence policies is to compile a history of the development of losses for each accident year, reviewing the historical patterns and projecting the ultimate expected losses using such patterns. Similarly, for claims-made policies, report year would be substituted for accident year. Two examples of this approach are included herein.

Although such developments are very useful in testing loss-reserve estimates, the auditor should consider the adequacy of the company's data base and the stability of loss-payment patterns. The auditor should keep in mind that there are other methods, retrospective and prospective, that may be more appropriate or that should be used in conjunction with the historical development method.

Example A. Table 1 represents a compilation of historical incurred loss-development data arrayed by accident year, by development period. Development period 12, for example, displays the amount of incurred losses (paid plus outstanding) after twelve months. For 19X0, $8,123 was incurred at the end of twelve months. Likewise, the subsequent development periods display the incurred losses for a given accident year at the various points in time; for example, the developed loss for 19X2 at the end of forty-eight months (that is, 19X5) is $9,435, and the developed loss for 19X3 at the end of thirty-six months (also 19X5) is $8,208.

Table 2 provides an estimate of the IBNR reserve by (1) computing the "period-to-period development factors" (section I); (2) computing the average factor for each development period (section II); (3) computing a period-to-ultimate factor (section III), which is the product of the successive period-to-period development factors; (4) estimating ultimate expected losses by multiplying the period-to-ultimate factor by the losses incurred to date (section IV); and estimating the IBNR reserve (section VI) as the difference between the ultimate expected losses and losses incurred to date (Table 1).

This example considers only simple averages to derive the period-to-period factors. Actual applications of this approach also should consider weighted averages and averages of the more recent history (three or four years) in determining the appropriate period-to-period factors to be used. The use of various averages will aid in determining trends and minimizing the effects of random variation.

Example B. Example B demonstrates an approach similar to Example A, except that paid loss data are used rather than incurred loss data. The computations are made in the same manner as for Example A; however, the resulting estimate is an estimate of both the case and the IBNR reserves.

Example A—Table 1 Incurred Loss Data

Accident Year	Development Period (Months)									
	12	*24*	*36*	*48*	*60*	*72*	*84*	*96*	*108*	*120*
19X0	8,123	8,593	8,896	8,919	8,929	8,932	8,933	8,933	8,933	8,933
19X1	8,345	8,459	8,621	8,894	8,992	8,890	8,885	8,886	8,886	
19X2	8,603	9,033	9,524	9,435	9,500	9,545	9,546	9,546		
19X3	8,002	8,621	8,208	8,288	8,419	8,365	8,363			
19X4	9,620	10,191	9,684	9,750	9,731	9,734				
19X5	7,443	8,448	8,870	8,975	8,988					
19X6	7,815	9,435	9,735	9,582						
19X7	11,089	12,319	12,174							
19X8	11,323	12,684								
19X9	12,533									

Example A—Table 2 Period-to-Period Development Factor

Accident Year	12-24	24-36	36-48	48-60	60-72	72-84	84-96	96-108	108-120	Estimated Tail
	(Months)									
I. 19X0	1.058*	1.035	1.003	1.001	1.000	1.000	1.000	1.000	1.000	†
19X1	1.014	1.019	1.032	1.011	0.989	0.999	1.000	1.000		
19X2	1.050	1.054	0.991	1.007	1.005	1.000	1.000			
19X3	1.077	0.952	1.010	1.016	0.994	1.000				
19X4	1.059	0.950	1.007	0.998	1.000					
19X5	1.135	1.050	1.012	1.001						
19X6	1.207	1.032	0.984							
19X7	1.111	0.988								
19X8	1.120									
II. Average	1.092	1.010	1.005	1.006	0.998	1.000	1.000	1.000	1.000	
III. Ultimate	1.113‡	1.019	1.009	1.003	0.998	1.000	1.000	1.000	1.000	1.000
	19X9	*19X8*	*19X7*	*19X6*	*19X5*	*19X4*	*19X3*	*19X2*	*19X1*	*19X0*
IV. Ultimate Losses	13,949§	12,923	12,279	9,613§	8,966	9,733	8,363	9,546	8,886	8,933
V. Last Diagonal ** (paids + case outstanding)	12,533	12,684	12,174	9,582	8,988	9,734	8,363	9,546	8,886	8,933
VI. IBNR Reserve	1,416#	239	105	31	(22)	(1)	0	0	0	

The above triangle utilizes an "incurred-to-incurred" approach in developing an estimate for IBNR reserves.

* Twenty-four-month developed losses divided by twelve-month-developed loss from Table 1 (8,593 + 8,123 = 1.058).

† Applies only if development period is longer than the period covered by the model.

‡ The product of the remaining factors (1.092 × 1.010 × 1.005 × 1.006 × .988 × 1.000 = 1.113) or the product of the 12-24 average factor times the 24-36 ultimate factor (91.092 × 1.019 = 1.113).

§ The product of the developed losses times the ultimate factro (12,533 × 1.113 = 13,949; 9,582 × 1.003 = 9,613; etc.).

**Losses incurred to date from Table 1.

\# The difference between ultimate estimated losses and losses developed to date (13,949 × 12,533 = 1,416).

Example B—Table 1 Cumulative Paid Loss Data

Accident Year	Development Period (Months)								
	12	*24*	*36*	*48*	*60*	*72*	*84*	*96*	*108*
	($000)								
19X0	47	210	335	422	481	506	527	543	548
19X1	52	197	312	377	430	469	496	501	
19X2	52	185	273	348	407	437	479		
19X3	41	172	282	366	425	468			
19X4	41	203	319	410	479				
19X5	44	175	308	443					
19X6	44	174	282						
19X7	51	208							
19X8	68								

Example B—Table 2 Period-to-Period Development Factor

Accident Year	*(Months)* 12-24	*24-36*	*36-48*	*48-60*	*60-72*	*72-84*	*84-96*	*96-108*	*Estimated Tail*	
19X0	4.468	1.595	1.260	1.140	1.052	1.042	1.030	1.009	*	
19X1	3.788	1.584	1.208	1.141	1.091	1.058	1.010			
19X2	3.558	1.476	1.275	1.170	1.074	1.096				
19X3	4.195	1.640	1.298	1.161	1.101					
19X4	4.951	1.571	1.285	1.168						
19X5	3.977	1.760	1.438							
19X6	3.955	1.621								
19X7	4.078									
19X8										
19X9										
Average	4.121	1.607	1.294	1.156	1.080	1.065	1.020	1.009		
Ultimate	12.895	3.129	1.948	1.505	1.302	1.206	1.133	1.110	1.100	
	19X8	*19X7*	*19X6*	*19X5*	*19X4*	*19X3*	*19X2*	*19X1*	*19X0*	*Total*
Ultimate	877	651	549	667	624	565	543	556	515	
Last Diagonal	68	208	282	443	479	468	479	501	468	
Case + IBNR Reserve	809	443	267	224	145	97	64	55	47	2,149

The above triangle utilizes a paid loss approach in developing an estimate for total loss reserves. Note that both examples are prepared on an accident-year basis. Models can also be prepared on a policy-year basis.
Computations are the same as explained in Example A.
* Applies only if development period is longer than the period covered by the model.

Appendix G

Industry and Other Organizations

The following is a list of some of the industry organizations. These sources are useful to the auditor in obtaining an understanding of the insurance industry.

American Academy of Actuaries (AAA) was founded in 1965 to represent the profession by four specialty actuarial associations: The Casualty Actuarial Society, Conference of Actuaries in Public Practice, Fraternal Actuarial Association, and Society of Actuaries. It provides standards or criteria of competence as an actuary and promotes education in actuarial science, exchange of information among actuarial organizations, and maintenance of standards of conduct and competence. The Casualty Actuarial Society provides actuarial and statistical science in insurance other than life insurance.

American Insurance Association (AIA) acts as a high-level policy organization for large stock companies. It deals with broad questions of position on proposed legislation and regulation, establishment of good public relations, and methods of conducting the business.

Alliance of American Insurers (AAI) serves mutual insurance companies in a similar capacity as the American Insurance Association.

Independent Insurance Agents of America (IIAA) promotes agent education and supports legislation of interest to the public as well as the insurance industry and opposes legislation detrimental to members' interests.

Insurance Accounting and Systems Association (IASA) develops improved theory and practice with respect to insurance accounting and systems.

Insurance Information Institute (III) serves as the vehicle for a better public understanding and acceptance of the insurance business.

Insurance Service Office (ISO) acts as the bureau developing rates and forms for many lines of insurance.

National Association of Independent Insurers (NAII) represents independent property and liability agents of both stock and mutual insurance companies by sponsoring educational programs and seminars as well as by maintaining a legislative division in Washington, D.C.

National Association of Insurance Commissioners (NAIC) is an organization of the chief insurance regulatory officials of the fifty states, the District of Columbia, and four U.S. Territories. It provides a forum for the exchange of ideas and the formulation of uniform policy. The NAIC helps commissioners fulfill their obligations of protecting the interests of insurance policyholders.

National Association of Mutual Insurance Companies (NAMIC) comprises mutual fire and casualty insurance companies. The association gathers, compiles, and analyzes information on all matters relating to insurance and to the reduction and prevention of losses. It also conducts workshops and seminars on these matters.

National Association of Professional Insurance Agents (PIA) acts in a capacity similar to that of the Independent Insurance Agents of America.

National Council on Compensation Insurance (NCII) develops and administers rating plans and systems for workers' compensation insurance.

Reinsurance Association of America (RAA) acts as spokesperson for reinsurance companies in regulatory matters and in promotion of the interests of the industry.

Society of Insurance Accountants (SIA) provides a forum for discussion and dissemination of information on accounting, statistical, and management problems in the insurance industry.

Appendix H

Statement of Position

Auditing Property and Liability Reinsurance

[The text of this Statement of Position has been deleted from this appendix and incorporated into chapter 6 of the guide.]

Appendix I

Statement of Position 90-10

Reports on Audited Financial Statements of Property and Liability Insurance Companies

November 30, 1990

Amendment to
AICPA Audit and Accounting Guides
Audits of Property and Liability Insurance Companies

Issued by the Insurance Companies Committee
American Institute of Certified Public Accountants

[Superseded by the issuance of SOP 95-5, *Auditor's Reporting on Statutory Financial Statements of Insurance Enterprises,* which has been incorporated into chapter 9 of the Guide.]

Appendix J

Statement of Position 90-11

Disclosure of Certain Information by Financial Institutions About Debt Securities Held as Assets

November 30, 1990

Amendment to
AICPA Audit and Accounting Guides
***Audits of Banks*,**
***Audits of Finance Companies (Including Independent and Captive Financing Activities of Other Companies)*, and**
Audits of Property and Liability Insurance Companies

Issued by the
Accounting Standards Executive Committee
American Institute of Certified Public Accountants

[Effectively superseded by the issuance of FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*.]

Appendix K

Statement of Position 92-3

Accounting for Foreclosed Assets

April 28, 1992

Issued by the
Accounting Standards Division
American Institute of
Certified Public Accountants

NOTICE TO READERS

Statements of Position of the Accounting Standards Division present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the AICPA authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles *in the Independent Auditor's Report*, identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

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SUMMARY

This statement of position (SOP) provides guidance on measuring foreclosed assets and in-substance foreclosed assets after foreclosure. It applies to all reporting entities, except those that account for assets at fair value or market value. It applies to all assets obtained through foreclosure or repossession, except for inventories, marketable equity securities, and real estate previously owned by the lender and accounted for under FASB Statement of Financial Accounting Standards No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects.*

Under the SOP, there is a rebuttable presumption that foreclosed assets are held for sale. The SOP recommends that foreclosed assets held for sale be carried at the lower of (*a*) fair value minus estimated costs to sell or (*b*) cost. Foreclosed assets held for the production of income should be treated the same way they would be had the assets been acquired in a manner other than through foreclosure.

The SOP should be applied to foreclosed assets in annual financial statements for periods ending on or after December 15, 1992.

Accounting for Foreclosed Assets

Scope

1. This statement of position (SOP) provides guidance on determining the balance sheet treatment of foreclosed assets[1] after foreclosure. (Paragraphs A-6 and A-7 of the Appendix discuss the exclusion from this SOP of conclusions on the accounting treatment of results of operations related to foreclosed assets held for sale.) It applies to all reporting entities except those that account for assets at market value or fair value, such as broker-dealers, futures commission merchants, and investment companies. It applies to all assets obtained through foreclosure or repossession except for (*a*) inventories that are covered by chapter 4 of Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins*; (*b*) marketable equity securities that are covered by Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards (Statement) No. 12, *Accounting for Certain Marketable Securities*; and (*c*) foreclosed real estate previously owned by the lender and accounted for under FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*. Except for the requirements in paragraphs 12 and 17, the conclusions of this SOP do not apply to in-substance foreclosed assets (see paragraph A-10 of the Appendix).

Background

2. Paragraph 29 of FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, issued in 1977, requires the following: "After a troubled debt restructuring, a creditor shall account for assets received in satisfaction of a receivable the same as if the assets had been acquired for cash." That requirement has been interpreted in diverse ways.

3. The American Institute of Certified Public Accountants' (AICPA's) Industry Audit Guide *Audits of Stock Life Insurance Companies* requires that foreclosed real estate be carried at the lower of cost (less accumulated depreciation) or market value, net of any encumbrances. Paragraphs 17 and 21 of SOP 75-2, *Accounting Practices of Real Estate Investment Trusts* (as amended by SOP 78-2), require that estimated losses on individual loans and properties be based on net realizable value. The guidance in the AICPA Audit and Accounting Guide *Audits of Savings Institutions* (May 1994) and in the Industry Audit Guide *Audits of Finance Companies* are consistent with SOPs 75-2 and 78-2. The AICPA Industry Audit Guide *Audits of Banks* (May 1994) states that subsequent to foreclosure, a loss on foreclosed real estate should be recognized if cost cannot be recovered through sale or use, but it does not indicate how the loss is to be measured. The AICPA Audit and Accounting Guide *Audits of Property and Liability Insurance Companies* does not address accounting for foreclosed assets.*

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[1] As used in this SOP, the term *foreclosed assets* includes all assets received in satisfaction of a receivable in a troubled debt restructuring, as the term is used in FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*. It includes real property and personal property; equity interests in corporations, partnerships, and joint ventures; and beneficial interests in trusts.

* The AICPA Audit and Accounting Guide *Banks and Savings Institutions* superseded the Guides *Audits of Savings Institutions* and *Audits of Banks* and refers readers to FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, and SOP 92-3.

4. In practice, accounting by creditors for foreclosed assets, particularly real estate assets, is diverse. After foreclosure, some enterprises continue to write down the carrying amount of foreclosed assets for subsequent, further declines in fair value; others do not. After foreclosure, some enterprises discount projected cash flows related to foreclosed assets in estimating net realizable value of those assets; others do not.

5. Sections 4(b)(1) and 4(b)(2)(A) of the Home Owners' Loan Act of 1933 as amended by the Financial Institutions Reform, Recovery and Enforcement Act of 1989 generally provide that the director of the Office of Thrift Supervision prescribe uniform accounting and disclosure standards for savings associations, to be used in determining associations' compliance with applicable regulations, and incorporate generally accepted accounting principles into those standards to the same degree that such principles are used to determine compliance with regulations prescribed by federal banking agencies. Section 1215 of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 also provides the following:

> Before the end of the 1-year period beginning on the date of the enactment of this Act [August 9, 1989], each appropriate Federal banking agency (as defined in section 3(q) of the Federal Deposit Insurance Act) shall establish uniform accounting standards to be used for determining the capital ratios of all federally insured depository institutions and for other regulatory purposes. Each such agency shall report annually to the Chairman and ranking minority member of the Committee on Banking, Housing, and Urban Affairs of the Senate and the Chairman and ranking minority member of the Committee on Banking, Finance and Urban Affairs of the House of Representatives any differences between the capital standards used by such agency and capital standards used by any other such agency. Each such report shall contain an explanation of the reasons for any discrepancy in such capital standards, and shall be published in the Federal Register.

6. The chairman of the Federal Home Loan Bank Board (now the Office of Thrift Supervision) asked the AICPA in 1987 to address the inconsistency between banks and savings and loan associations in accounting for loans and real estate assets. The AICPA's Accounting Standards Executive Committee (AcSEC) attempted to eliminate that inconsistency in 1988 and 1989 but decided to refer the matter to the FASB at that time. On April 4, 1989, soon after AcSEC's decision to refer the matter to the FASB, the chairman of the Federal Home Loan Bank Board wrote to the chairman of the Securities and Exchange Commission (SEC) asking that the SEC or its staff remove the inconsistency for public reporting entities. The SEC has not done so.

7. Further, the chairman of the Federal Deposit Insurance Corporation, in a letter to the FASB dated November 8, 1989, asked the FASB to assist in developing "uniform accounting standards among depository institutions." In that letter, the chairman stated that "the accounting treatment in practice for certain transactions among participants in the financial services industry seems to be more a reflection of the type of charter than the substance of the transaction." Furthermore, the chairman "urge[d] the FASB to reconcile the different accounting practices outlined in [AICPA] guides for thrifts, banks, and finance companies." In early 1990, AcSEC decided that it could deal with the inconsistencies and diversity in accounting for foreclosed assets, and this SOP is a result of that decision.

8. AcSEC believes that all enterprises, not just financial institutions, should account for foreclosed assets held for sale the same way, except that en-

terprises that account for assets at market value or fair value should not change their accounting. AcSEC's primary objectives in issuing this statement of position are to reduce the inconsistencies and diversity in accounting for foreclosed assets and to improve the understandability, comparability, and relevance of amounts reported as foreclosed assets in balance sheets. Another objective is to make all of the AICPA Audit and Accounting Guides and SOPs consistent on this matter. Achieving those objectives will also address the needs of Congress and the thrift and banking regulators.

9. This SOP affects the following AICPA statements of position and industry audit and accounting guides:

a. *Audits of Finance Companies*

b. *Audits of Property and Liability Insurance Companies*

c. *Audits of Stock Life Insurance Companies*

d. *Guide for the Use of Real Estate Appraisal Information*

Conclusions

Held-for-Sale Presumption

10. Most enterprises do not intend to hold foreclosed assets for the production of income but intend to sell them; in fact, some laws and regulations applicable to financial institutions require the sale of foreclosed assets. Therefore, under this SOP, it is presumed that foreclosed assets are held for sale and not for the production of income. That presumption may be rebutted, except for in-substance foreclosed assets, by a preponderance of the evidence. If the held-for-sale presumption is not rebutted, the asset should be classified in the balance sheet as held for sale.

11. The presumption of sale can be rebutted if (*a*) management intends to hold a foreclosed asset for the production of income, (*b*) that intent is not inconsistent with the enterprise's ability to do so or with laws or regulations, including the manner in which the laws or regulations are administered by federal or state regulatory agencies, and (*c*) that intent is supported by a preponderance of the evidence.

Foreclosed Assets Held for Sale

12. After foreclosure, foreclosed assets held for sale should be carried at the lower of (*a*) fair value [2] minus estimated costs to sell or (*b*) cost.[3] Such de-

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[2] *Fair value*, as used in this SOP, is defined in paragraph 13 of FASB Statement No. 15 as follows:

> The fair value of the assets transferred is the amount that the . . . [creditor] could reasonably expect to receive for them in a current sale between a willing buyer and a willing seller, that is, other than in a forced or liquidation sale. Fair value of assets shall be measured by their market value if an active market for them exists. If no active market exists for the assets transferred but exists for similar assets, the selling prices in that market may be helpful in estimating the fair value of the assets transferred. If no market price is available, a forecast of expected cash flows may aid in estimating the fair value of assets transferred, provided the expected cash flows are discontinued ar a rate commensurate with the risk involved.[6]
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> ---
>
> [6] Some factors that may be relevant in estimating the fair value of various kinds of assets are described in paragraphs 88 and 89 of *APB* [Accounting Principles Board] *Opinion No. 16* ["Business Combinations"], paragraphs 12-14 of *APB Opinion No. 21*, "Interest on Receivables and Payables,"and paragraph 25 of *APB Opinion No. 29*, "Accounting for Nonmonetary Transactions."

[3] The *cost* of such assets at the time of foreclosure is the fair value of the asset foreclosed or repossessed. Any specific valuation allowance related to the loan should not be carried forward. This SOP provides no guidance for determining cost subsequent to foreclosure (see paragraphs A-6 and A-7 of the appendix).

termination should be made on an individual asset basis. If the fair value of the asset minus the estimated costs to sell the asset is less than the cost of the asset, the deficiency should be recognized as a valuation allowance. If the fair value of the asset minus the estimated costs to sell the asset subsequently increases and the fair value of the asset minus the estimated costs to sell the asset is more than its carrying amount, the valuation allowance should be reduced, but not below zero. Increases or decreases in the valuation allowance should be charged or credited to income.[4]

13. The amount of any senior debt (principal and accrued interest) to which the asset is subject should be reported as a liability at the time of foreclosure and not be deducted from the carrying amount of the asset; payments on such debt should be charged to the liability. Interest that accrues after foreclosure should be recognized as interest expense.

14. FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, was extracted by the FASB from SOP 78-3, *Accounting for Costs to Sell and Rent, and Initial Rental Operations of Real Estate Projects*; SOP 80-3, *Accounting for Real Estate Acquisition, Development, and Construction Costs*, and the AICPA Industry Audit Guide *Accounting for Retail Land Sales*. These documents did not, in the opinion of AcSEC, apply to foreclosed real estate held for sale. AcSEC therefore believes that the fair-value test in this SOP, not the net-realizable-value test in FASB Statement No. 67, should be applied to foreclosed real estate held for sale, except when the foreclosed real estate was previously owned by the lender and accounted for under FASB Statement No. 67, in which case such foreclosed assets should be accounted for under FASB Statement No. 67.

Foreclosed Assets Held for the Production of Income

15. After foreclosure, assets determined to be held for the production of income (and not held for sale) should be reported and accounted for in the same way that they would be had the assets been acquired other than through foreclosure.

Change in Classification

16. If it is subsequently decided that a foreclosed asset classified as held for sale will be held for the production of income, the asset should be reclassified from the held-for-sale category. The reclassification should be made at the amount the asset's carrying amount would have been had the asset been held for the production of income since the time of foreclosure. Selling costs included in the valuation allowance should be reversed. The net effect should be reported in income from continuing operations in the period in which the decision not to sell the asset is made.

Effective Date and Transition

17. This SOP should be applied to foreclosed assets in annual financial statements for periods ending on or after December 15, 1992, with earlier application permitted. On initial application of this SOP, all enterprises should adjust the carrying amount of foreclosed assets held for sale to the lower of (*a*) the fair value of the asset minus the estimated costs to sell the asset or (*b*) the cost of the asset as of the date of the initial adoption of this SOP. For many

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[4] Because the allowance is considered a valuation adjustment, insurance enterprises should report changes in the valuation allowance as realized gains and losses in income, not as unrealized gains and losses in equity.

enterprises, adoption of this SOP will result in a change in accounting principle. The nature of the change should be disclosed in the financial statements of the period in which the change is made. Any adjustment arising from the initial application of this SOP should be included in income from continuing operations in the period in which the change is made. No restatement of previously issued financial statements or cumulative-effect adjustment as of the beginning of the year this SOP is first applied is permitted.

APPENDIX

Discussion of Major Comments on the Exposure Draft

A-1. This Appendix summarizes considerations that were deemed significant by members of AcSEC in reaching the conclusions in this SOP.

A-2. In the exposure draft, AcSEC concluded that there is a rebuttable presumption that foreclosed assets are held for sale and that foreclosed assets held for sale should be carried at the lower of cost or fair value minus the estimated costs to sell. Few respondents objected to those conclusions.

Held-for-Sale Presumption

A-3. Some respondents requested more explanation of the circumstances under which the held-for-sale presumption could be rebutted. After considering the concerns expressed by respondents about the rebuttable presumption, AcSEC decided not to give detailed, specific guidance, thereby allowing for the exercise of judgment in determining whether the presumption is rebutted by the facts in particular circumstances.

A-4. AcSEC recognizes that some enterprises may hold foreclosed assets for several years before sale and may even operate the assets, but concludes that a holding period in excess of one year does not, in and of itself, rebut the held-for-sale presumption. Further, AcSEC notes that if the form of the foreclosed asset is a majority interest in an enterprise, FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries*, requires the subsidiary to be consolidated unless control is likely to be temporary.

Fair Value

A-5. Some respondents requested guidance on the determination of fair value. AcSEC recognizes that estimating fair value requires judgment. AcSEC concluded, however, that it would be inappropriate and is unnecessary to develop a new definition of fair value in this SOP, and that the definition of fair value in FASB Statement No. 15 should be used in this SOP. Moreover, AcSEC believes that the following discussion about fair value from Statement No. 15, particularly paragraph 82, will be helpful in implementing this SOP.

Concept of Fair Value

79. Some respondents to the Exposure Draft continued to argue that all troubled debt restructurings should be accounted for as modifications of the terms of debt and that none should be accounted for as transfers of assets (paragraphs 66 and 67). Others accepted the need to account for some troubled debt restructurings as asset transfers but held that obtaining assets through foreclosure or repossession under terms included in lending agreements should be distinguished from obtaining assets in exchange for cash or in other "asset swaps." They contended that (*a*) only the form of the asset is changed by foreclosure or repossession, (*b*) the substance of a secured loan is that the lender may choose either to postpone receipt of cash or take the asset to optimize cash receipts and recovery of its investment, and (*c*) foreclosure or repossession is not the completion of a lending transaction but merely a step in the transaction that begins with lending cash and ends with collecting cash.

80. The Board rejected those arguments for the reasons given in paragraphs 71-77, emphasizing that an event in which (*a*) an asset is transferred between debtor and creditor, (*b*) the creditor relinquishes all or part of its claim against the debtor, and (*c*) the debtor is absolved of all or part of its obligation to the creditor is the kind of event that is the basis of accounting under the existing transaction-based accounting framework. To fail to recognize an event that fits the usual description of a transaction and to recognize only the lending and collection of cash as transactions would significantly change the existing accounting framework.

81. Use of the fair value of an asset transferred to measure the debtor's gain on restructuring and gain or loss on the asset's disposal or the creditor's cost of acquisition is not adopting some kind of "current value accounting." On the contrary, that use of fair value is common practice within the existing accounting framework. Paragraph 13 of this Statement explains briefly the meaning of *fair value* and refers to *APB Opinions No. 16, No. 21*, and *No. 29*, which use *fair value* in the same way and provide guidance about determining fair values within the existing accounting framework. The term *fair value* is used in essentially the same way as *market value* was used in the Discussion Memorandum to denote a possible attribute to be measured at the time a debt is restructured. *Fair value* is defined in paragraph 181 of *APB Statement No. 4* as "the approximation of exchange price in transfers in which money or money claims are not involved." Although a "money claim" is necessarily involved in transferring assets to settle a payable in a troubled debt restructuring, the troubled circumstances in which the transfer occurs make it obvious that the amount of the "money claim" does not establish an exchange price. Determining fair value of the assets transferred in a troubled debt restructuring is usually necessary to approximate an exchange price for the same reasons that determining fair value is necessary to account for transfers of assets in nonmonetary transactions (*APB Opinion No. 29*).

82. That point is emphasized in this Appendix because some respondents to the Exposure Draft apparently misunderstood the concept of fair value (paragraph 11 of the Exposure Draft and paragraph 13 of this Statement) and the discounting of expected cash flows specified in those paragraphs. *Paragraph 13 permits discounting of expected cash flows from an asset transferred or received in a troubled debt restructuring to be used to estimate fair value only if no market prices are available either for the asset or for similar assets. The sole purpose of discounting cash flows in that paragraph is to estimate a current market price as if the asset were being sold by the debtor to the creditor for cash. That estimated market price provides the equivalent of a sale price on which the debtor can base measurement of a gain on restructuring and a gain or loss on disposal of the asset and the equivalent of a purchase price on which the creditor*

can measure the acquisition cost of the asset. To approximate a market price, the estimate of fair value should use cash flows and discounting in the same way the marketplace does to set prices—in essence, the marketplace discounts expected future cash flows from a particular asset "at a rate commensurate with the risk involved" in holding the asset. An individual assessment of expected cash flows and risk may differ from what the marketplace's assessment would be, but the procedure is the same. [Emphasis added by AcSEC.]

83. In contrast to the purpose of paragraph 13, *AICPA Statement of Position No. 75-2,*[31] is concerned with different measures—net realizable value to a creditor of a receivable secured by real property and net realizable value of repossessed or foreclosed property. Its method of accounting for assets obtained by foreclosure or repossession thus differs from the method specified in this Statement. It proposes discounting expected cash flows at a rate based on the creditor's "cost of money" to measure the "holding cost" of the asset until its realizable value is collected in cash. The concept of fair value in paragraph 13 does not involve questions of whether interest is a "holding cost" or "period cost" because it is concerned with estimating market price, not net realizable value, however defined. Accounting for transfers of assets in troubled debt restructurings and for the assets after transfer is, of course, governed by this Statement.*

[31] See paragraphs 59 and 60 of this Statement.

Results of Operations Related to Foreclosed Assets Held for Sale

A-6. In the exposure draft, AcSEC proposed that there should be no results of operations—revenues and expenses—from foreclosed assets while they are held for sale; net cash receipts related to foreclosed assets during the holding period would have been credited to the carrying amount of the asset, and net cash payments, except for capital additions and improvements, would have been charged to income as a loss on holding the foreclosed assets. Further, in the exposure draft, AcSEC concluded that no depreciation, depletion, or amortization expense should be recorded. Many respondents objected to the exclusion of the results of operating a foreclosed asset from income; many also objected to crediting net cash receipts to the carrying amount of the asset and charging net cash payments to income. They raised questions about the conservatism of such treatment, about whether the treatment was conceptually sound, and about whether it would be practical to implement. Some comment letters also raised questions about whether it is appropriate not to depreciate foreclosed assets held for sale. After considering the comments, AcSEC decided not to adopt the method proposed in the exposure draft.

A-7. AcSEC considered various other ways to account for operations during the period foreclosed assets are held for sale, such as—

- Reporting the net of revenues and expenses in income, including charges or credits related to changes in the valuation allowance and depreciation expense on depreciable assets, for each reporting period as a gain or loss on holding the asset.
- Reporting the net of revenues and expenses in income, including charges or credits related to changes in the valuation allowance and depreciation expense on depreciable assets held or expected to be held for more than a specified length of time (for example, one year).

* *Note:* Paragraph 13 of SOP 75-2, *Accounting Practices of Real Estate Investment Trusts,* has been effectively superseded by FASB Statement No. 114, *Accounting by Creditors for the Impairment of a Loan,* and FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of.*

- Reporting the net of revenues and expenses in income, including charges or credits related to changes in the valuation allowance, and recognizing no depreciation expense.
- Crediting or debiting the net of revenues and expenses to the asset, and recognizing no depreciation expense. Changes in the valuation allowance would be included in income.

AcSEC believes that it should consider those options further and that its ultimate decision on the treatment of operations during the period foreclosed assets are held for sale should be exposed for public comment; AcSEC intends to undertake such a project. However, because AcSEC believes that its conclusion that foreclosed assets held for sale should be carried at the lower of fair value minus estimated costs to sell or cost would not change regardless of its conclusions on operations of foreclosed assets, AcSEC decided that it should issue the guidance in this SOP now, rather than delay issuing the guidance until the results of operations issues are resolved.

Foreclosed Assets Held for the Production of Income

A-8. In the exposure draft, AcSEC proposed to require that foreclosed assets held for the production of income be carried at an amount not greater than the assets' net realizable value. AcSEC decided to eliminate that statement.

Change in Classification

A-9. AcSEC also decided that, on reclassification of a foreclosed asset from the held-for-sale category, the asset should be measured and recorded as if the asset had been held for the production of income since foreclosure. That decision is consistent with the consensus of the Emerging Issues Task Force in Issue 2 of Issue 90-6, where the reversal of a decision to sell an asset acquired in a business combination gives rise to an accounting as if the asset had never been held for sale.

In-Substance Foreclosed Assets

A-10. Many respondents asked for specific guidance on in-substance foreclosed assets, and they asked whether the SOP would apply to such assets. AcSEC concluded that, except for paragraphs 12 and 17, the guidance in this SOP need not be applied to in-substance foreclosures for the following reasons:

a. The accounting for in-substance foreclosed assets was not explicitly addressed in the exposure draft.

b. AcSEC would have found it difficult to resolve issues concerning senior debt related to in-substance foreclosed assets.

However, AcSEC notes that paragraph 34 of FASB Statement No. 15; paragraph 6 of AICPA Practice Bulletin 7, *Criteria for Determining Whether Collateral for a Loan Has Been In-Substance Foreclosed;*[*] and SEC Financial Reporting Release 28, *Accounting for Loan Losses by Registrants Engaged in Lending Activities*, include accounting guidance related to in-substance foreclosed assets indicating that in-substance foreclosed assets should be accounted for in the same way as assets that have actually been foreclosed or repossessed. Further, AcSEC concluded that for purposes of applying this SOP, the held-for-

[*] Practice Bulletin 7 was withdrawn in December 1994 by the Accounting Standards Executive Committee.

sale presumption could not be rebutted for in-substance foreclosed assets. Accordingly, after in-substance foreclosure, an in-substance foreclosed asset, like a foreclosed asset held for sale, would be reported in the balance sheet at the lower of (*a*) fair value minus estimated costs to sell or (*b*) cost.

Carrying Amount of Assets at Foreclosure

A-11. Some respondents expressed concerns and opinions about the carrying amount of the foreclosed assets to be recognized at foreclosure. The exposure draft indicated that the attribute to be recognized at foreclosure should be the fair value of the collateral, implying that, if at the time of foreclosure the fair value of the collateral is greater than the recorded investment in the related loan, a credit to income would result. Some respondents suggested that no such credits should be permitted and that the carrying amount of the asset recognized at foreclosure should be the lower of the fair value of the collateral or the recorded investment in the loan. Notwithstanding those concerns, AcSEC notes that paragraph 28 of FASB Statement No. 15 requires that foreclosed assets be accounted for at their fair value at the time of foreclosure.

A-12. Some respondents also said that the definition of *fair value*, which is the definition in paragraph 13 of FASB Statement No. 15, implicitly contains a reduction for selling costs. For purposes of applying this SOP, AcSEC believes that the definition of fair value in paragraph 13 of FASB Statement No. 15 should be viewed as the cash sales/purchase price in a principal-to-principal transaction wherein no agents, dealers, brokers, or commission merchants are involved. If either principal decides to involve and pay outsiders to assist that principal, or to bring principals together, any amount paid by that principal is independent of the fair value of the asset and does not affect that fair value. Accordingly, immediately after foreclosure, a valuation allowance related to foreclosed assets held for sale should be recognized for estimated costs to sell through a charge to income.

Offsetting of Debt

A-13. Contrary to what was proposed by AcSEC in the exposure draft, some respondents suggested that nonrecourse senior debt not assumed by the holder of the foreclosed asset be offset against the carrying amount of the asset. To protect its interest in the asset, the holder of the asset will have to settle the debt or have a subsequent transferee take the asset subject to the debt. If debt is offset, leverage is not portrayed, and the degree of possible gain is obscured. Moreover, offsetting nonrecourse senior debt against a foreclosed asset would be inconsistent with the manner in which such debt is portrayed when assets are purchased for cash and there is related nonrecourse debt. Therefore, AcSEC reaffirms that senior debt should not be offset against the asset.

Transition

A-14. Comments were specifically requested on the transition proposed in the exposure draft. Most respondents agreed that determining the cumulative effect of the change in accounting principle would either be impossible or possible only at significant cost for enterprises that do not have available the fair value of foreclosed assets at earlier balance sheet dates, and that a restatement of previously issued financial statements or a cumulative effect adjustment should not be required. Further, AcSEC concluded that, because one of the principal objectives of this SOP is to have consistent accounting of foreclosed assets, those two alternatives should not be permitted.

Appendix L

Statement of Position 92-4

Auditing Insurance Entities' Loss Reserves

May 29, 1992

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

Prepared by the Auditing Insurance Entities' Loss Reserves Task Force of the Insurance Companies Committee
Accounting Standards Division
American Institute of Certified Public Accountants

[The text of this Statement of Position has been deleted from this appendix and incorporated into chapter 4 and appendix A of the guide.]

Appendix M

Statement of Position 92-5

Accounting for Foreign Property and Liability Reinsurance

June 1, 1992

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

Prepared by the AICPA Reinsurance Auditing and Accounting Task Force of the Insurance Companies Committee

American Institute of Certified Public Accountants

[The text of this Statement of Position has been deleted from this appendix and incorporated into chapter 6 of the guide.]

Appendix N

Statement of Position 92-8

Auditing Property/Casualty Insurance Entities' Statutory Financial Statements—Applying Certain Requirements of the NAIC Annual Statement Instructions

October 26, 1992

Prepared by the Insurance Companies Committee
Accounting Standards Division
American Institute of Certified Public Accountants

NOTICE TO READERS

This statement of position presents the recommendations of the Insurance Companies Committee regarding the audit of property/casualty insurance entities' statutory financial statements in applying certain requirements of the National Association of Insurance Commissioners' (NAIC's) Annual Statement Instructions. It has been reviewed by the chairman of the Auditing Standards Board for consistency with auditing standards. AICPA members may have to justify departures from the recommendations in this statement of position if their work is challenged.

Auditing Property/Casualty Insurance Entities' Statutory Financial Statements—Applying Certain Requirements of the NAIC Annual Statement Instructions

Applicability

1. This statement of position (SOP) provides guidance on the impact of certain requirements of the National Association of Insurance Commissioners' (NAIC's) Annual Statement Instructions—Property and Casualty on the auditor's procedures in the audit of statutory financial statements of property/casualty insurance entities.

Introduction

2. The NAIC's Annual Statement Instructions direct property/casualty insurers to require their independent certified public accountants to subject the current Schedule P—Part 1 (excluding those amounts related to bulk and incurred-but-not-reported [IBNR] reserves and claim counts) to the auditing procedures applied in the audit of the current statutory financial statements to determine whether Schedule P—Part 1 is fairly stated in all material respects in relation to the basic statutory financial statements taken as a whole. Schedule P—Part 1 includes Part 1—Summary and Part 1A—1R.

3. Although no separate report on Schedule P—Part 1 is required by the NAIC, the auditor should consider the provisions of SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*, and the provisions of this SOP. However, the requirements of this SOP do not preclude an auditor from issuing a report similar to that illustrated in paragraph 12 of SAS No. 29.

Auditing Procedures

4. Certain of the information in Schedule P—Part 1 is typically subjected to auditing procedures applied in the audit of the basic statutory financial statements (for example, premiums earned and losses paid). Other information not directly related to the basic statutory financial statements is also presented (for example, lines of business classifications for immaterial lines). Although such information may not have been subjected to auditing procedures applied in the audit of the basic statutory financial statements in all instances, such information may have been derived from accounting records that have been tested by the auditor.

5. Paragraph 7 of SAS No. 29 states that although an auditor is not required by generally accepted auditing standards to apply auditing procedures to information presented outside of the basic financial statements, he or she may choose to modify or redirect certain of the procedures to be applied in the audit of the basic financial statements.

6. In applying auditing procedures to the information presented in Schedule P—Part 1, the guidance about auditing the claims data base in paragraphs

4.1 and 4.2 of AICPA's SOP 92-4, *Auditing Insurance Entities' Loss Reserves*, applies. The auditor should also refer to chapter 4 and exhibit B-2 in appendix B of the AICPA Audit and Accounting Guide *Audits of Property and Liability Insurance Companies*.

7. As stated in paragraph 4.2 of SOP 92—4, because claim data and characteristics such as dates and types of loss can significantly influence reserve estimation, the auditor should test the completeness, reliability, and classification of the claim loss and loss expense data during the audit of the statutory financial statements. In extending those procedures to Schedule P—Part 1, the auditor should determine that—

a. The data presented on Schedule P—Part 1 is properly reconciled to the statistical records of the company.

b. Changes between the prior-year and current-year Schedule P—Part 1 are properly reconciled to the current-year audited statutory financial statements.

c. The source of the data for the auditing procedures applied to the claim loss and loss adjustment expense data during the current calendar year (for example, tests of payments on claims for all accident years that were paid during the current calendar year) is the same as (or reconciles to) the statistical records that support the data presented on Schedule P—Part 1.

8. If, as a result of the procedures performed during the audit of the statutory financial statements, the auditor becomes aware that Schedule P—Part 1 is not fairly stated in relation to the financial statements taken as a whole, the auditor should communicate to the company's management and the opining actuary that Schedule P—Part 1 is not fairly stated and should describe the misstatement. If the company will not agree to revise Schedule P—Part 1, the auditor should issue a report on Schedule P—Part 1 and should include a description of the misstatement in that report. (The auditor should refer to SAS No. 29 when a report will be issued.) The auditor should consider the impact of a misstatement in Schedule P—Part 1 on the auditor's report on the statutory financial statements.

Effective Date

9. This SOP is effective for audits of statutory-basis financial statements of property/casualty insurance entities for periods ending after December 15, 1992.

Appendix O

Statement of Position 94-1

Inquiries of State Insurance Regulators

April 20, 1994

Amendment to
AICPA Audit and Accounting Guide
Audits of Property and Liability Insurance Companies
and AICPA Industry Audit Guide
Audits of Stock Life Insurance Companies

Prepared by the
Insurance Companies Committee
Accounting Standards Division

[The text of this Statement of Position has been incorporated into chapter 2 of the guide.]

Appendix P

Statement of Position 94-5

Disclosures of Certain Matters in the Financial Statements of Insurance Enterprises

December 15, 1994

Prepared by the Task Force on
Insurance Companies' Disclosures
Accounting Standards Division

[The following represents information contained in appendix B of SOP 94-5. Paragraphs 1 through 12 and appendix A of the SOP have been incorporated into chapter 4 of this Guide.]

APPENDIX B

Discussion of Conclusions

B-1. This section discusses factors that were deemed significant by members of AcSEC in reaching the conclusions in this SOP. It includes reasons for accepting certain views and rejecting others. Individual AcSEC members gave greater weight to some factors than to others.

B-2. The business and regulatory environment of insurance enterprises has become more complex and volatile, and therefore riskier. Accordingly, AcSEC believed the need existed to reconsider the disclosures made in the financial statements of insurance enterprises.

B-3. FASB Statement of Financial Accounting Concepts No. 1, *Objectives of Financial Reporting by Business Enterprises*, states financial reporting should "provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions" (paragraph 34). Further, the Concepts Statement says that to support that decision-making process, financial reports should help such users "assess the amounts, timing, and uncertainty of prospective net cash inflows to the related enterprises" (paragraph 37) by providing "information about the economic resources of an enterprise, the claims to those resources...and the effects of transactions, events, and circumstances that change resources and claims to those resources" (paragraph 40).

B-4. AcSEC considered a wide variety of potential disclosures, and tried to identify the areas of importance to insurance enterprises for which the current disclosures were lacking. AcSEC concluded that additional disclosures in the financial statements of insurance enterprises about regulatory risk-based capital, the liability for unpaid claims, and certain accounting methods permitted by state insurance departments would help insurance enterprises better meet the objectives of financial reporting in their financial statements.

Risk-Based Capital

B-5. Insurance enterprises operate in a highly regulated environment directed primarily toward safeguarding policyholders' interests and maintaining public confidence in the safety and soundness of the insurance system. Historically, regulation of insurance enterprises has monitored solvency by focusing on their capital. One of the primary tools used by state insurance departments for ensuring that their objectives are being met is risk-based capital (RBC).

B-6. The NAIC has developed an RBC program that is used by state insurance departments to enable them to take appropriate and timely regulatory actions relating to insurers that show signs of weak or deteriorating financial conditions. This program is encompassed in the RBC Model Acts for life and property and casualty insurers, which have been or are intended to be adopted by most of the states. RBC is a series of dynamic surplus-related formulas set forth in the NAIC's RBC instructions for life and health and for property and casualty insurance enterprises. The formulas contain a variety of weighing factors that are applied to financial balances or to levels of activity based on the perceived degree of certain risks, such as asset risk, credit risk, interest rate risk (life insurance enterprises only), underwriting risk, and other business risks, such as risks related to management, regulatory action, and contingencies. The amount determined under such formulas, the authorized

control level risk-based capital, is required to be disclosed in life insurance enterprises' statutory filings starting for the year ended December 31, 1993, and in property and casualty insurance enterprises' statutory filings starting for the year ended December 31, 1994.

B-7. The exposure draft of the SOP contained a requirement that insurance enterprises that are required to calculate RBC should disclose in their financial statements the ratio of total adjusted capital to authorized control level RBC and the amount of total adjusted capital for each fiscal year for which a statement of financial position is presented.

B-8. However, the NAIC's RBC Model Acts for both life and property and casualty insurers have a confidentiality provision, which states:

> [E]xcept as otherwise required under the provisions of this Act [that is, in the annual financial reports filed with state insurance departments], the making, publishing, disseminating, circulation, or placing before the public, or causing, directly or indirectly to be made, placed before the public, in a newspaper, magazine or other publication...with regard to the RBC levels of any insurer...would be misleading and is therefore prohibited.

B-9. Prior to issuing the exposure draft, based on discussions with the drafters of the RBC Model Acts and some state insurance regulators, and based on the fact that the information is already in the public domain, AcSEC believed that the confidentiality provisions were not intended to apply to disclosures in financial statements. However, a number of respondents to the exposure draft stated that they believe disclosing RBC levels in financial statements would be illegal in states that have enacted the RBC Model Acts. They point out that words in the RBC Model Acts appear to be intended to restrict *all* other disclosure of RBC levels, including in insurers' financial statements.

B-10. AcSEC continues to believe, because of the importance of RBC in the regulatory oversight of insurance enterprises, that its disclosure would improve the relevance and usefulness of insurance enterprises' financial statements, and, therefore, it should be disclosed in the financial statements. Nevertheless, AcSEC concluded the legal issues require further consideration.

B-11. AcSEC decided that this SOP should not be delayed while the legal issues regarding RBC disclosures are considered. A separate SOP on RBC disclosures will be considered at a later date.

B-12. Nevertheless, AcSEC encourages insurance enterprises to disclose RBC levels if they are domiciled in states that have not adopted the RBC Model Acts, or if they have otherwise determined that it is legal to make such disclosures in their financial statements.

B-13. The exposure draft also required insurance enterprises whose level of RBC has triggered a regulatory event[1] to disclose certain information in their financial statements. Delaying the issuance of the RBC guidance does not change the fact that under SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, auditors must consider the

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[1] Under the NAIC's RBC Model Acts, when the ratio of total adjusted capital to authorized control level RBC is less than or equal to 2 or less than or equal to 2.5 with negative trends for life insurance enterprises, a regulatory event exists—that is, the insurance enterprises would fail to meet the minimum RBC requirements. There are four types of regulatory events, ranging from least to most serious: company action level event, regulatory action level event, authorized control level event, and mandatory control level event.

need for disclosures about the principal conditions and events that triggered the regulatory event and the possible effects of such conditions and events, as well as management's plans.

Permitted Statutory Accounting Practices

B-14. Permitted statutory accounting practices historically have not been disclosed in the notes to the financial statements, except to the extent that they have been disclosed in the accounting practices and procedures note to the statutory financial statements. With increasing frequency, insurance enterprises have transactions that are not explicitly addressed by prescribed accounting practices, or for which no analogous prescribed accounting practices exist. Furthermore, insurance enterprises often request exceptions from certain prescribed accounting practices. Permitted statutory accounting practices may differ from state to state, and from company to company within a state, and may change in the future. Moreover, permitted statutory accounting practices have been used to enhance insurance enterprises' surplus positions. For example, some state insurance departments have permitted certain insurance enterprises to adjust home office facilities to appraised values even though the states' prescribed statutory accounting practices require that such assets be carried at depreciated historical cost.

B-15. AcSEC believes the required disclosure of permitted statutory accounting practices will enhance the relevance of the financial statements and fulfill the financial reporting objective of providing current and potential investors, creditors, policyholders, and other users of an insurance enterprise's financial statements with useful information. Not only will such disclosures identify situations in which permitted statutory accounting practices enhance an insurance enterprise's statutory capital and RBC position, but they also will improve the comparability of insurance enterprises' financial statements.

Liability for Unpaid Claims and Claim Adjustment Expenses

B-16. Insurance enterprises estimate their liability for unpaid claims and claim adjustment expenses for reported and unreported claims incurred as of the end of the accounting period in accordance with FASB Statement No. 60. The liability is estimated based on past loss experience, adjusted for current trends and other factors that will modify past experience. The liability may be calculated using a variety of mathematical approaches ranging from simple arithmetic projections using loss development factors to complex statistical models.

B-17. FASB Concepts Statement No. 1, paragraph 21, states:

> The information provided by financial reporting largely reflects the financial effects of transactions and events that have already happened. Management may communicate information about its plans or projections, but financial statements and most other financial reporting are historical....Estimates resting on expectations of the future are often needed in financial reporting, but their major use, especially of those formally incorporated in financial statements, is to measure financial effects of past transactions or events or the present status of an asset or liability....To provide information about the past as an aid in assessing the future is not to imply that the future can be predicted merely by extrapolating past trends or relationships. Users of the information need to assess the possible or probable impact of factors that may cause change and form their own expectations about the future and its relation to the past.

B-18. AcSEC believes that disclosures about an insurance enterprise's liabilities for unpaid claims and claim adjustment expenses development are

useful in understanding insurance enterprises' liabilities and results of operations. Furthermore, AcSEC notes the disclosures are the same as some of the loss reserve development disclosures that the SEC requires registrants to file with the commission under Securities Act Guide 6.

B-19. Paragraph 60(a) of FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, requires all insurance enterprises to disclose the basis for estimating the liabilities for unpaid claims and claim adjustment expenses. Furthermore, FASB Statement No. 5, *Accounting for Contingencies*, requires disclosure of loss contingencies not accrued, for which it is at least reasonably possible that a loss has been incurred. Because of the relatively high degree of coverage litigation and the lack of historical information regarding the amount and nature of both known and unasserted claims relating to difficult-to-estimate liabilities (such as those related to environmental related illness claims and toxic-waste cleanup claims), traditional loss reserving techniques may not be used in estimating such liabilities. Therefore, a high degree of judgment is needed in estimating the amount of losses, and practice is developing in the area. Accordingly, AcSEC believes financial statement users will benefit from disclosure of the policies and methods management has used for estimating these amounts.

Discussion of Comments Received on Exposure Draft

B-20. An exposure draft of a statement of position, *Disclosure of Certain Matters in the Financial Statements of Insurance Enterprises* was issued on April 20, 1994, and distributed to a variety of interested parties to encourage comment by those that would be affected by the proposal. Forty comment letters were received on the exposure draft.

Risk-Based Capital

B-21. A number of comments were received on the risk-based capital disclosures. As discussed in paragraphs B-5 through B-13, AcSEC decided to consider a separate SOP at a later date on risk-based capital disclosures. The comments will be addressed at that time.

Permitted Statutory Accounting Practices

B-22. A number of respondents to the exposure draft of the SOP requested that the disclosure requirements for permitted statutory accounting practices be postponed until after the codification is complete. AcSEC believes that the disclosures are especially important before codification to improve understanding of the factors that affect comparability among the statutory capital of insurance enterprises.

B-23. Respondents asked for clarification of how disclosure of the monetary effect of statutory surplus would be calculated, particularly when there is no prescribed accounting practice to compare with the permitted practice. AcSEC agreed and revised the exposure draft to state that for permitted statutory accounting practices used when prescribed accounting practice is silent, a description of the transaction is sufficient. Respondents also asked for clarification about whether there should be disclosure of GAAP-permitted practices when there is no prescribed statutory accounting. If an insurance company uses a GAAP practice in its statutory financial statements when there is no prescribed practice, that is still considered a permitted statutory accounting practice. However, AcSEC agreed that no disclosures should be made for GAAP practices that are used when prescribed statutory practices do not specify the accounting for the transaction.

B-24. Respondents suggested that the requirement in the exposure draft to make a statement about the codification be eliminated. AcSEC agreed the disclosure might be confusing to users of financial statements, and eliminated the requirement.

Liability for Unpaid Claims and Claim Adjustment Expenses

B-25. The exposure draft would have required disclosure of information about actuarial adjustments made for nonrecurring or abnormal experience. A number of respondents suggested that that disclosure requirement be eliminated. AcSEC was persuaded that such actuarial adjustments are a normal part of making estimates that should not be disclosed in the financial statements, and eliminated the requirement.

Appendix R

Information Sources

Further information on matters addressed in this Guide is available through various publications and services listed in the table that follows. Many non-government and some government publications and services involve a charge or membership requirement.

Fax services allow users to follow voice cues and request that selected documents be sent by fax machine. Some fax services require the user to call from the handset of the fax machine, others allow the user to call from any phone. Most fax services offer an index document, which lists titles and other information describing available documents.

Electronic bulletin board services allow users to read, copy, and exchange information electronically. Most are available using a modem and standard communications software. Some bulletin board services are also available using one or more Internet protocols.

Recorded announcements allow users to listen to announcements about a variety of recent or scheduled actions or meetings.

All telephone numbers listed are voice lines, unless otherwise designated as fax (f) or data (d) lines. Required modem speeds, expressed in bauds per second (bps), are listed for data lines.

Information Sources

Organization	General Information	Fax Services	Electronic Bulletin Board Services	Recorded Announcements
American Institute of Certified Public Accountants	*Order Department* Harborside Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 (800) TO-AICPA or (800) 862-4272 Information about AICPA continuing professional education programs is available through the AICPA CPE Division (extension 3) and the AICPA Meetings and Travel Division: (201) 938-3232.	*24 Hour Fax Hotline* (201) 938-3787	*Accountants Forum* This information service is available on CompuServe. Some information is available only to AICPA members. To set up a CompuServe account call (800) 524-3388 and ask for the AICPA package or rep. 748.	
Financial Accounting Standards Board	*Order Department* P.O. Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext. 10			*Action Alert Telephone Line* (203) 847-0700 (ext. 444)
National Association of Insurance Commissioners	*Order Department* 120 W. 12th St., Suite 1100, Kansas City, MO 64105-1925 (816) 471-7004	*Order by Fax* (816) 471-7004		
U.S. General Accounting Office	*Superintendent of Documents* U.S. Government Printing Office Washington, DC 20401-0001 (202) 512-1800 (202) 512-2250 (f)		*U.S. Government Printing Office's The Federal Bulletin Board* Includes *Federal Register* notices and the Code of Federal Regulations. Users are usually expected to open a deposit account. User assistance line: (202) 512-1530 (202) 512-1387 (d) Telnet via internet: federal.bbs.gpo.gov 3001	
U.S. Securities and Exchange Commission	*Publications Unit* 450 Fifth Street, NW Washington, DC 20549-0001 (202) 942-4046 *SEC Public Reference Room* (202) 942-8079	*Information Line* (202) 942-8088, ext. 4 (202) 942-7114 (tty)		*Information Line* (202) 942-8088 (202) 942-7114 (tty)

Appendix S

Schedule of Changes Made to Audits of Property and Liability Insurance Companies

Reference	Change	Date
Preface	Modified to reflect the issuance of SOPs 92-4 and 92-5.	September, 1992
Preface	Modified to reflect the issuance of FASB Statement No. 113 and the resulting withdrawal of a proposed AICPA Statement of Position.	April, 1993
Paragraphs 1.01, 1.04, 1.05, 1.06, and 1.08	Modified.	October, 1994
Paragraph 1.09*e*	Added to include discussion of "private pools."	October, 1994
Paragraphs 1.12, 1.20, and 1.23	Modified.	October, 1994
Paragraph 1.26	Added; Subsequent paragraphs renumbered.	October, 1994
Renumbered paragraph 1.37	Modified.	October, 1994
Paragraphs 1.42, 1.43, 1.44, and 1.45	Replaced with paragraphs 1.43 through 1.50 to provide description of statutory accounting practices; Subsequent paragraphs further renumbered.	October, 1994
Renumbered paragraph 1.51	Revised to make reference to FASB Statement Nos. 97, 113, and 115 and FASB EITF Abstract No. 93-6.	
Renumbered paragraph 1.56	Modified to add "risk-based" to capital in (*c*).	October, 1994
Renumbered paragraph 1.63	Revised to provide description to statutory accounting practices.	October, 1994
Renumbered paragraph 1.64	Modified to include additional references to SEC pronouncements.	October, 1994
Paragraph 2.01	Modified to refer to the current Audit Risk Alert.	October, 1994
Paragraph 2.02	Revised to reflect current ratio information.	October, 1994
Paragraph 2.03	Deleted; Subsequent paragraphs renumbered.	October, 1994
Paragraph 2.06	Added to provide description of risk-based capital.	October, 1994
Paragraph 2.10 (footnote *)	Reference to SAS No. 78 added.	September, 1996

Reference	Change	Date
Paragraph 2.16	Reference to SAS No. 9 changed to SAS No. 65.	May, 1992
Paragraphs 2.17, 2.18, 2.19, 2.20, 2.21, 2.22, 2.23, and 2.24	Added to incorporate SOP 94-1.	October, 1994
Paragraphs 2.25, 2.26, 2.27, 2.28, 2.29, 2.30, 2.31, 2.32, 2.33, 2.34, 2.35, 2.36, 2.37, 2.38, 2.39, 2.40, 2.41, 2.42, 2.43, 2.44, 2.45, 2.46, 2.47, and 2.48	Added to incorporate text of SOP 93-8.	September, 1996
Paragraphs 3.01 and 3.09	Modified.	October, 1994
Paragraph 3.16	Modified.	October, 1994
Paragraph 3.17	Revised to reflect the issuance of FASB Interpretation No. 39.	May, 1992
Paragraphs 3.18 and 3.19	Modified.	October, 1994
Paragraph 3.25	Deleted; Subsequent paragraphs renumbered.	October, 1994
Renumbered paragraph 3.29	Modified.	October, 1994
Paragraph 3.31	Deleted; Subsequent paragraphs further renumbered.	October, 1994
Renumbered paragraph 3.33	Former paragraph 3.36 added as penultimate sentence; Subsequent paragraphs further renumbered.	October, 1994
Renumbered paragraph 3.35	Fourth bullet added.	October, 1994
Paragraph 3.36	Added; Subsequent paragraphs further renumbered.	October, 1994
Renumbered paragraph 3.37	Revised.	October, 1994
Chapter 4	SOP 92-4 integrated into text.	October, 1994
Paragraph 4.77	Reference to SAS No. 11 changed to SAS No. 73; Note reference to the supersession of SAS No. 11 deleted.	May, 1995
Paragraph 4.101	Revised to reflect the issuance of SOP 94-6.	September, 1996
Paragraph 4.102	Revised to reflect the issuance of SAS No. 73; Note reference to the supersession of SAS No. 11 deleted.	May, 1995

Reference	Change	Date
Paragraph 4.103	Reference to SAS No. 11 changed to SAS No. 73; Note reference to the supersession of SAS No. 11 deleted.	May, 1995
Paragraphs 4.111, 4.112, 4.113, 4.114, 4.115, 4.116, 4.117, 4.118, 4.119, 4.120, 4.121, 4.122, 4.123, 4.124, 4.125, and 4.126	Added to incorporate paragraphs 1 through 12 and appendix A of SOP 94-5.	September, 1996
Paragraph 5.20	Revised to reflect the issuance of FASB Statement Nos. 97 and 115.	October, 1994
Paragraphs 5.21 through 5.36	Replaced with paragraphs 5.21 through 5.48 to reflect the issuance of FASB Statement No. 115 and describe statutory accounting practices for investments; Subsequent paragraphs renumbered.	October, 1994
Chapter 6	SOPs *Auditing Property and Liability Reinsurance* and 92-5 incorporated into text and revised to reflect the issuance of FASB Statement No. 113.	October, 1994
Paragraph 6.37 (footnote *)	Reference to SAS No. 78 added.	September, 1996
Renumbered paragraph 6.50	Updated to reflect the issuance of SAS No. 70.	May, 1993
Renumbered paragraph 6.43	Updated to reflect the issuance of SAS No. 70.	May, 1993
Paragraphs 7.01 and 7.02	Revised to reflect the Omnibus Budget Reform Act of 1990.	October, 1994
Paragraphs 7.03 and 7.04	Added to reflect the Omnibus Budget Reform Act of 1990; Subsequent paragraphs renumbered.	October, 1994
Renumbered paragraph 7.19	Modified.	October, 1994
Paragraphs 7.17, 7.18, 7.19, and 7.20	Deleted; Subsequent paragraphs further renumbered.	October, 1994
Renumbered paragraphs 7.20 and 7.23	Modified.	October, 1994
Paragraph 7.25	Deleted; Subsequent paragraphs further renumbered.	October, 1994
Paragraphs 7.29, 7.30, and 7.31	Replaced with paragraphs 7.27 through 7.29 to reflect the issuance of FASB Statement No. 109; Subsequent paragraphs further renumbered.	October, 1994

Reference	Change	Date
Renumbered paragraphs 7.30, 7.31, and 7.32	Revised to reflect the issuance of FASB Statement No. 109.	October, 1994
Paragraphs 7.33 and 7.34	Added to reflect the issuance of FASB Statement No. 109.	October, 1994
Paragraph 7.35	Modified and transferred to paragraph 7.36.	
Paragraphs 7.36 and 7.37	Deleted.	October, 1994
Renumbered paragraph 7.35	Reference changed from FASB Statement No. 96 to FASB Statement No. 109.	October, 1994
Paragraphs 7.39, 7.40, 7.41, 7.42, 7.43, and 7.44	Replaced with paragraphs 7.37 through 7.50 to reflect the issuance of FASB Statement No. 109; Subsequent paragraphs further renumbered.	October, 1994
Paragraph 7.49 (footnote *)	Reference to SAS No. 78 added.	September, 1996
Renumbered paragraph 7.51	Revised to reflect the issuance of FASB Statement No. 109 and to incorporate former paragraph 7.46; Subsequent paragraphs further renumbered.	October, 1994
Renumbered paragraphs 7.52 and 7.53	Reference changed from FASB Statement No. 96 to FASB Statement No. 109.	October, 1994
Renumbered paragraph 7.54	Revised to reflect the issuance of FASB Statement No. 109.	October, 1994
Renumbered paragraph 7.55	Modified and last sentence deleted.	October, 1994
Renumbered paragraph 7.57	Reference changed from FASB Statement No. 96 to FASB Statement No. 109 and last sentence deleted.	October, 1994
Renumbered paragraphs 7.61 and 7.62	Revised to reflect the issuance of FASB Statement No. 109.	October, 1994
Renumbered paragraph 7.63	Reference changed from FASB Statement No. 96 to FASB Statement No. 109.	October, 1994
Paragraph 8.04	Reference to Auditing Interpretation added.	May, 1992
Paragraph 8.07	Modified.	October, 1994
Paragraph 8.09	Reference to FASB Statement No. 115 added.	October, 1994
Paragraph 8.10	Revised to reflect the issuance of FASB Statement No. 115.	October, 1994

Reference	Change	Date
Paragraph 8.18	Clarification of language by changing the term "reinsured" to "ceding company" and "reinsurer" to "assuming company."	August, 1991
Paragraph 8.19	Deleted; Subsequent paragraphs renumbered.	October, 1994
Renumbered paragraphs 8.19 and 8.21	Modified.	October, 1994
Chapter 9	Added by transferring revised text of Appendix D.	October, 1994
Paragraphs 9.03, 9.04, 9.05, and 9.06	Replaced by new paragraphs 9.03 through 9.21 to incorporate SOP 95-5; Subsequent paragraphs renumbered.	September, 1996
Renumbered paragraph 9.26	Revised to reflect the issuance of SAS No. 78.	September, 1996
Renumbered paragraph 9.27	Exhibits replaced to reflect Auditing Interpretation of SAS No. 62.	September, 1996
Renumbered paragraph 9.28	Revised to reflect the issuance of SSAE No. 2.	September, 1996
Renumbered paragraph 9.31	Revised to reflect the issuance of SAS No. 75.	September, 1996
Paragraphs 9.18, 9.19, and 9.20	Replaced by renumbered paragraphs 9.33 through 9.43 to incorporate SOP 95-4.	September, 1996
Appendix A	SOP 92-4 integrated into text.	October, 1994
Appendix A	Reference to SAS No. 78 added.	September, 1996
Appendix C	Revised to reflect the issuance of recent authoritative literature.	September, 1996
Appendix D	Transferred to chapter 9 and revised.	October, 1994
Appendix E	Modified.	October, 1994
Appendix H	Deleted and incorporated into chapter 6.	October, 1994
Appendix I	Deleted and incorporated into chapter 9.	October, 1994
Appendix I	SOP 90-10 superseded by issuance of SOP 95-5.	September, 1996
Appendix J	Deleted and incorporated into Appendix A.	October, 1994
Appendix J	Reference to Industry Audit Guide *Audits of Stock Life Insurance Companies* deleted.	December, 1995
Appendix J	Effectively superseded by FASB Statement No. 115.	September, 1996
Appendix K	SOP 92-3 added.	May, 1992

Reference	Change	Date
Appendix K	References to Audit and Accounting Guide *Audits of Credit Unions* deleted.	February, 1993
Appendix K	Modified to reflect the issuance of Audit and Accounting Guide *Banks and Savings Institutions*; Note reference to supersession of Practice Bulletin 7 added.	September, 1996
Appendix L	Deleted and incorporated into chapter 4 and Appendix A.	October, 1994
Appendix M	SOP 92-5 added.	July, 1992
Appendix M	Deleted and incorporated into chapter 6.	October, 1994
Appendix N	SOP 92-8 added.	February, 1993
Appendix O	Text incorporated into chapter 2.	October, 1994
Appendix P	SOP 94-5 added.	May, 1995
Appendix P	Modified to incorporate paragraphs 1 through 12 and appendix A of SOP 94-5 into chapter 4.	September, 1996
Appendix Q	SOP 95-4 added.	December, 1995
Appendix Q	Deleted and incorporated into chapter 9.	September, 1996

Glossary

Abstract. A form containing basic data shown on a policy. Copies of an abstract may be used by the accounting, statistical, payroll audit, and inspection departments.

Accident year. The year in which an accident occurred.

Account current or agents' account. See *Agency billing.*

Accretion of discount on bonds. Adjustment of the purchase price of bonds purchased at less than par value to increase the value to par at maturity date. The adjustment is calculated to yield the effective rate of interest at which the purchase was made, which is called the *interest method.*

Acquisition costs. Costs that vary with and are primarily related to the acquisition of new and renewal insurance contracts. Commissions and other costs (for example, salaries of certain employees involved in the underwriting and policy issue functions, and medical and inspection fees) that are primarily related to insurance contracts issued or renewed during the period in which the costs are incurred are considered to be acquisition costs.

Additional premium. A premium due from an insured arising from an endorsement.

Adjustment bureau. An organization formed by a group of insurance companies to investigate, adjust, and negotiate claims on behalf of the companies.

Admitted asset. An asset recognized and accepted by state insurance regulatory authorities in determining the financial condition of an insurance company.

Agency billing. Any of various methods of premium billing and collection in which the insured is billed by the agent and the premium is collected by either the agent or the insurance company.

Agency company. An insurance company whose business is produced through a network of agents, as distinguished from a direct writing company whose business is produced by company employees.

Agency reinsurance. Reinsurance arranged to be assumed or ceded for an insurer by one of its agents who usually handles the details of writing the policies and collecting or paying the premiums. For example, on very large risks the agent frequently issues only one policy to the insured and then obtains reinsurance from other companies to reduce the exposure of the insurer to a desired level.

Agency system. A system of producing business through a network of agents. Such agents have a contract to represent the company and are of three classes: local, regional, and general. These classes are compensated at differing rates of commission, and general agents have much greater responsibilities and duties than local and regional agents.

Agent. An independent contractor who represents one insurance company, called an *exclusive agent,* or more than one company, called an *independent agent,* with express authority to act for the company or companies in dealing with insureds.

Agents' balance. Premium balances, less commissions payable thereon, due from agents and brokers.

Aggregate excess of loss. A stop-loss agreement designed to prevent a ceding company's loss from exceeding a predetermined limit. For example, if under an agreement indemnifying a company against losses in excess of a 70-percent loss ratio, the ceding company's loss ratio exceeds 70 percent, then recovery will be made from the reinsurer of the amount necessary to reduce the loss ratio to 70 percent.

Alien company. Insurance company domiciled in a foreign country.

Amortization of premiums on bonds. Adjustment of the purchase price of bonds purchased at more than par value to decrease the value to par at maturity. The adjustment is calculated to yield the effective rate of interest at which the purchase was made, known as the *interest method.*

Annual pro rata. A basis used to calculate unearned premiums involving the assumption that the average date of issue of all policies written during the year is the middle of the year.

Annual statement (convention statement or convention form). A statement furnishing the complete information regarding the company's condition and affairs at December 31 of each year required by insurance departments of the various states in which a company is authorized to transact business. This annual statement must be filed on the form prescribed by the NAIC with the various insurance departments by March 1 of the following year.

Annuity contract. Contract that provides fixed or variable periodic payments made from a stated or contingent date and continuing for a specified period, such as for a number of years or for life.

Application. A request for insurance submitted to the insurer by or on behalf of the insured. An application usually includes sufficient information for the insurer to determine whether it wishes to accept the risk. In some lines of insurance the terms *daily* and *application* are used synonymously.

Assessment enterprise. An insurance company that sells insurance to groups with similar interests, such as church denominations or professional groups. Some assessment enterprises also sell insurance directly to the general public. If the enterprise cannot pay all claims, the members may be assessed.

Assets, ledger. Assets that are recorded in a company's general ledger. They usually include investments, cash, agents' balances, or uncollected premiums and reinsurance recoverable.

Assets, nonadmitted. Assets, or portions thereof, that are not permitted to be reported as admitted assets in the annual statement filed with various insurance departments. Nonadmitted assets are defined by the insurance laws of various states. Major nonadmitted assets include: an excess of book value over statement value of investments, agents' balances or uncollected premiums over three months due, and furniture, fixtures, supplies, equipment, and automobiles.

Assets, nonledger. Assets not recorded on a company's general ledger. They usually include an excess of statement value of stocks and bonds over their book values and accrued interest or other accrued income on investments.

Associations, pools, and syndicates. Organizations formed by several insurance companies or groups of companies as joint ventures to underwrite specialized types of insurance or to write insurance in specialized areas.

Assuming company. A company that accepts all or part of an insurance risk from another company through reinsurance.

Audit premiums. Earned premiums determined from data developed by periodic audits of insureds' records or from periodic reports submitted by insureds. Such audits are made and such reports are submitted either monthly, quarterly, semiannually, or annually.

Automatic treaty. Reinsurance treaty usually pro rata, under which the reinsurer is committed to accept from the ceding company a fixed share of each risk or of specified risks. The ceding company is obligated to cede, and the reinsurer is obligated to accept.

Average reserves. A method of estimating loss liabilities by multiplying the number of outstanding claims by an average amount per claim based on past experience.

Binder. An agreement, which may be written or oral, whereby one party agrees to insure another pending receipt of and final action on the application.

Bordereau. A detailed listing of premiums or loss transactions, or both, usually prepared monthly and given to interested parties. Frequently rendered by ceding companies to reinsurers and by large general agents to companies.

Brokers. Licensed representatives who place the insurance of their clients with insurance companies. Compensation for their services consists of commissions paid to them by the insurance companies. They are not agents of the companies, and the commissions they receive are usually lower than that of agents who legally represent the companies.

Bulk reinsurance. See *Portfolio reinsurance*.

Cancellation. Complete termination of an existing policy before expiration.

Case basis. Liabilities for losses (claims) or loss expenses determined based on individual estimates of the value of each unpaid loss (claim).

Case reserve. A liability for loss estimated to be paid in the future on an outstanding claim.

Catastrophe. A conflagration, earthquake, windstorm, explosion, or similar event resulting in substantial losses. Catastrophe losses—the whole loss insured by an insurance company from a single catastrophic event—are usually reinsured under excess-of-loss treaties in order to limit any one such loss to a specific dollar amount.

Ceding company. A company that transfers all or part of an insurance risk to another company through reinsurance. Also called a *primary company*.

Cession. A unit of insurance passed on to a reinsurer by a ceding or primary company. Under certain kinds of reinsurance treaties, many reinsurers give each transaction a number, called a *cession number*.

Claim. A demand for payment of a policy benefit because of the occurrence of an insured event, such as the death or disability of the insured, the maturity of an endowment, the incurrence of hospital or medical bills, the destruction or damage of property, and related deaths or injuries; defects in, liens on, or challenges to the title to real estate, or the occurrence of a surety loss.

Claim adjusting. The process of investigating, appraising, negotiating and, sometimes, settling claims.

Claim frequency. The relative incidence of claims in relation to an exposure base.

Claim severity. The relative magnitude of the dollar amount of claims.

Claim or loss files. All data relating to each loss or claim together in a folder or stapled together, or the like, and referred to as the loss or claim file.

Class or manual rating. A method of determining premiums based on standard rates for large groups of similar risks.

Combined ratios. The sum of both the loss ratio and expense ratio used to measure underwriting performance.

Commissions. Compensation paid by an insurance company to agents or brokers for placing insurance coverage with the company, usually determined as percentages of the premiums.

Contribution to premium in force. Net change in premiums in force for a period or net original premiums written during a period (total original premiums less original return premiums).

Convention statement or convention form. See *Annual statement.*

Cost recovery method. A method of accounting for insurance coverage provided by the reporting entity in which premiums are recognized as revenue in amounts equal to estimated claim costs when insured events occur until the ultimate premium is reasonably estimable and recognition of income is postponed until that time.

Daily report or daily. A copy of a policy retained by an insurance company or forwarded to the company by an agent. The daily includes all special provisions and endorsements, and it is one of the basic documents in an insurance office.

Declaration sets. Documents generated by an insurance company in processing policy applications and endorsements that include billing statements and insurance ID card, as well as information such as terms of the policies, lines of coverage, premiums, and agent information.

Deposit method. A method of recognizing premium revenue and claim costs when the ultimate premium is reasonably estimable.

Deposit premiums. Provisional premium payments by policyholders that are adjusted at the end of the policy terms based on actual coverage provided.

Development (runoff) of loss reserves. Comparison of the loss reserves outstanding at a particular date with the total of the payments on such losses from the reserve date to the development date, plus the estimated losses still unpaid at the date of the development.

Differences. Term applied to the differences between accounts current rendered by agents and transactions shown on the company's records, caused, for example, by the agents and the company using different cutoff dates or by errors and omissions by the company or the agents.

Direct billing. Billing by an insurance company directly to insureds for premiums due. On collection, the company pays the commission to the agent.

Direct premiums. Total premiums, net of return premiums, on policies issued to provide the primary insurance on a given risk.

Direct writing company. An insurance company whose business is produced by company employees, as distinguished from an agency company whose business is produced by agents.

Discounting. Recording future claim payments and expenses at their present value.

Domestic insurers. Insurance companies domiciled in a particular state.

Earned premiums. Pro rata portions of premiums applicable to the expired period of a policy.

Effective date. The date when insurance coverage under a policy begins.

Endorsement. Documentary evidence of a change in an existing policy that may result in a change in premium, return premium, or no premium adjustment.

Excess insurance. A policy covering the insured against loss in excess of a stated amount. The underlying amount is usually insured by another policy but can be retained by the insured.

Excess-of-loss treaty. A kind of reinsurance contract in which the reinsurer pays all or a specified percentage of a loss caused by a particular occurrence or event (frequently of a more or less catastrophic nature) in excess of a fixed amount and up to a stipulated limit. Most such contracts do not apply to specific policies but to aggregate losses incurred under all policies subject to the particular hazards reinsured. The premium is usually a percentage of the net premiums written by the carrier for the hazards subject to such reinsurance.

Excess schedule preserves. The excess of minimum reserves required by state regulatory authorities over the estimated liability for losses established for certain lines, primarily bodily injury liability and workers' compensation. Also called *Statutory loss reserves*.

Expense ratio. Underwriting expenses divided by written premiums.

Experience rating. Prospective adjustment of premiums based on the insured's past experience under the coverage.

Exposure. Measurement of the extent of a hazard assumed by the carrier. From the statistical standpoint of rate making, exposure is the product of the amount of insurance at risk and the policy period expressed in years.

Face sheet. A sheet affixed to the front of a claim file containing abstracts of coverage and loss notices along with other information for later use in developing statistics for reserve analysis and product pricing.

Facultative reinsurance. Arrangements under which each risk to be reinsured is offered to and accepted or rejected by the reinsurer. Such arrangements do not obligate the ceding company to cede or the reinsurer to accept.

Fair access to insurance requirements (FAIR) plan. A federally approved and state supervised program to make property insurance available in high-risk areas.

Fidelity bond. Insurance that covers employers against dishonest acts by employees.

Fire and allied lines insurance. Property insurance coverage for risks such as fire, windstorm, hail, and water damage.

Foreign insurers. Insurance companies domiciled outside a particular state.

Fronting. An arrangement in which an issuer issues a policy on a risk for and at the request of another insurer with the intent of reinsuring the entire risk with the other insurer.

Funds held by a company under reinsurance treaty. An account used to record a liability from a deposit from a reinsurer or the withholding of a portion of the premiums due as a guarantee that a reinsurer will meet its loss and other obligations.

Funds held by or deposited with ceding reinsurers. An asset account used by a reinsurer to record deposits made with ceding companies, pools, or associations of portions of premiums due from them to guarantee that the reinsurer will meet its loss and other obligations.

General agents. Agents assigned exclusive territories in which to produce business on behalf of an insurance company.

General liability insurance. Liability coverage for most physical and property damages not covered by workers' compensation or automobile liability insurance.

Gross in force. Aggregate premiums from all policies on direct and assumed business recorded before a specified date that have not yet expired or been canceled.

Gross net premium income. As used in reinsurance contracts, gross written premiums, less return premiums and reinsurance premiums. This term has the same meaning as *net written premiums* or *net premiums* in the United States. In Europe, the term *net premiums* refers to gross premiums received less return premiums, reinsurance premiums, and commissions paid on premiums.

Gross premium. The premium charged to a policyholder for an insurance contract. See also *Net premiums.*

Group insurance. Insurance protecting a group of persons, usually employees of an entity and their dependents. A single insurance contract is issued to their employer or other representative of the group. Individual certificates often are given to each insured individual or family unit. The insurance usually has an annual renewable contract period, although the insurer may guarantee premium rates for two or three years. Adjustments to premiums relating to the actual experience of the group of insured persons are common.

Hazard. The risk or peril or source of risk insured against. This term is frequently used interchangeably with the terms *risk* and *peril.*

Incurred-but-not-reported (IBNR) claims. Claims relating to insured events that have occurred but have not yet been reported to the insurer or reinsurer as of the date of the financial statements.

Incurred loss ratio. Ratio calculated by dividing incurred losses by earned premiums.

Incurred losses (claims). Losses paid or unpaid for which the company has become liable during a period. Incurred losses for a period are calculated by adding unpaid losses at the end of the period to losses paid during the period and subtracting unpaid losses at the beginning of the period.

Individual or judgment rating. A method of determining premiums for large or unusual risks based on an evaluation of the individual risk.

In-force premiums. Aggregate premiums from all policies recorded before the specified date that have not expired or been canceled.

Inland marine insurance. Insurance coverage of property capable of being transported (other than transocean).

Installment premiums. Premiums payable periodically rather than in a lump sum at the inception or effective date of the policy.

Insurable value. The stated value in an insurance contract. It may be the cash or market value, the declared value, or the replacement value.

Insurance expense exhibit. A supplement to the annual statement to be filed with each Insurance Department usually by May 1, rather than on March 1, the day on which the annual statement is due to be filed. The net gain or loss from underwriting for each line of business written by the company during the year reported on is shown on this exhibit.

Insurance Regulatory Information System (IRIS). A system of eleven tests based on studies of financially troubled companies compared to financially sound companies. Usual ranges are established under each of the tests. The system is intended to assist in identifying companies requiring close surveillance (formerly called *Early Warning System*).

Insured. The person whose life, property, or exposure to liability is insured.

Interinsurance exchange or reciprocal. An unincorporated aggregation of individuals or firms called *subscribers* who exchange insurance through an attorney-in-fact. Each subscriber is therefore both an insurer and an insured.

Intermediary. A reinsurance broker who negotiates reinsurance contracts on behalf of the reinsured (ceding company) with the reinsurer.

Investment expenses. According to the uniform expense regulation, all expenses incurred wholly or partially in connection with the investing of funds and the obtaining of investment income.

Judgment rating. See *Individual or judgment rating*.

Liabilities, ledger. Liabilities recorded in a company's general ledger.

Liabilities, nonledger. Liabilities not recorded in a company's general ledger but available from other basic records or sources.

Liability for (claim) adjustment expenses. The amount needed to provide for the estimated ultimate cost required to investigate and settle losses relating to insured events that have occurred on or before a particular date (ordinarily, the balance sheet date), whether or not reported to the insurer at that date.

Liability for unpaid claims. The amount needed to provide for the estimated ultimate cost of settling claims relating to insured events that have occurred on or before a particular date (ordinarily, the balance sheet date). The estimated liability includes the amount of money that will be required for future payments on both (1) claims that have been reported to the insurer and (2) claims relating to insured events that have occurred but have not been reported to the insurer as of the date the liability is estimated.

Line. Kind of insurance. In relation to the amount an insurance company accepts on a risk: (1) the limit a company has fixed for itself as maximum exposure on a class of risk and (2) the actual amount the company has in fact accepted on a single risk.

Long-duration contract. An insurance contract that generally is not subject to unilateral changes in its provisions, such as a noncancelable or guaranteed renewable contract, and requires the performance of various functions and services (including insurance protection) for an extended period.

Loss (claim)-adjustment expenses. Expenses incurred in the course of investigating and settling claims. Loss-adjustment expenses include any legal and adjusters' fees and the costs of paying claims and all related expenses.

Loss ratios. Expression in terms of ratios of the relationship of losses to premiums. Two ratios in common usage are (1) paid loss ratio—paid losses divided by written premiums or earned premiums, and (2) incurred loss ratio—incurred losses divided by earned premiums.

Loss reserves. A term used in statutory accounting for the liability for unpaid losses.

Losses. Claims.

Losses, reported. Losses resulting from accidents or occurrences that have taken place and on which the company has received notices or reports of loss.

Maintenance costs. Costs associated with maintaining records relating to insurance contracts and with the processing of premium collections and commissions.

Manual rating. See *Class or manual rating.*

Market conduct examination. A review of an insurance company's sales, advertising, underwriting, risk-rating, and claims practices that may affect policyholders or claimants. It may be performed by or on behalf of regulatory authorities.

Merit rating. Any of various methods of determining premiums by which standard rates are adjusted for evaluation of individual risks or for the insureds' past or current experience.

Monthly pro rata. A basis used for calculation of unearned premiums involving the assumption that the average date of issue of all policies written during any month is the middle of that month.

Morbidity. The relative incidence of disability because of disease or physical impairment.

Mortgage guaranty insurance enterprise. An insurance enterprise that issues insurance contracts that guarantee lenders, such as savings and loan associations, against nonpayment by mortgagors.

Mutual company. Cooperative nonprofit association of persons whose purpose is to insure themselves against various risks.

NAIC (National Association of Insurance Commissioners). An association of the Insurance Commissioners of various states in the United States.

Net premiums for long-duration insurance contracts. The portion of the gross premium required to provide for all benefits and expenses.

Net premiums for short-duration contracts. Premiums written or received on direct and assumed business, less return premiums and less reinsurance ceded premiums.

Ocean marine insurance. Coverage for (1) a ship and its equipment, (2) the cargo, (3) the freight paid for use of the ship, and (4) liability to third parties for damages.

Original premium. The premium for the full term of a policy. In case the policy has been changed, the original premium can be determined by multiplying the amount currently insured by the latest premium rate shown on the policy or an endorsement of the policy.

Paid losses. Disbursements for losses during the period.

Participating company. An insurance company that participates in an insurance pool, association, or syndicate.

Participating insurance. Insurance in which the policyholder is entitled to participate in the earnings or surplus of the insurance enterprise. The participation occurs through the distribution of dividends to policyholders.

Peril. Classification of loss occurrences insured against, such as fire, windstorm, collision, hail, bodily injury, property damage, or loss of profits.

Personal lines. Kinds of insurance policies issued to individuals.

Policyholder dividends. Payments made or credits extended to the insured by the company, usually at the end of a policy year, that result in reducing the net insurance cost to the policyholder. Such dividends may be paid in cash to the insureds or applied by the insureds as reductions of the premiums due for the next policy year.

Policy year. The year during which a policy is effective.

Pooling. Practice of sharing all business of an affiliated group of insurance companies among the members of the group.

Portfolio reinsurance. Reinsurance on a bulk basis. Occurs frequently at the inception or termination of a reinsurance treaty. Also used as a means by which a company may retire from a particular agency or territory or from the insurance business entirely.

Premium. The consideration paid for an insurance contract.

Premium deficiency. For short-duration contracts, the amount by which anticipated losses, loss-adjustment expenses, policyholder dividends, unamortized acquisition costs, and maintenance expenses exceed related revenues.

Premium register. Listing of policies issued, generally in policy-number order. Normally computer generated.

Premium taxes. Taxes levied at varying rates on insurance companies by the various states on premiums written.

Premiums written. The premiums on all policies a company has issued in a period of time, as opposed to *Earned premiums*.

Proof of loss. A sworn statement furnished by an insured to the carrier setting forth the amount of loss claimed. This form, which is usually used in the settlement of first-party losses, includes the date and description of the occurrence, amount of loss claimed, interested insurers, and so on.

Property and liability insurance enterprise. An enterprise that issues insurance contracts providing protection against (1) damage to, or loss of, property caused by various perils, such as fire and theft, or (2) legal liability resulting from injuries to other persons or damage to their property. Property and liability insurance enterprises also can issue accident and health insurance contracts. The term *property and liability insurance enterprise* is the current terminology used to describe a fire and casualty insurance enterprise. Property and liability insurance enterprises may be either stock or mutual organizations.

Pro rata reinsurance. The reinsured and the reinsurer participate in the premiums and losses on every risk that comes within the scope of the agreement in fixed proportion.

Quota-share reinsurance. A form of pro rata reinsurance. A reinsurance of a certain percentage of all the business or certain classes of or parts of the business of the reinsured. For example, a company may reinsure under a quota-share treaty 50 percent of all of its business or 50 percent of its automobile business.

Rating bureau. An organization supervised by state regulatory authorities that assists member companies in obtaining approval for premium rates.

Reciprocal or interinsurance exchanges. A group of persons, firms, or corporations (commonly referred to as *subscribers*) that exchange insurance contracts through an attorney-in-fact (an attorney authorized by a person to act in that person's behalf).

Reinsurance. A transaction in which a reinsurer (*assuming enterprise*), for a consideration (*premium*), assumes all or part of a risk undertaken originally by another insurer (*ceding enterprise*). However, the legal rights of the insured are not affected by the reinsurance transaction, and the insurance enterprise issuing the insurance contract remains liable to the insured for payment of policy benefits.

Reinsurance assumed premiums. All premiums (less return premiums) arising from policies issued to assume a liability, in whole or in part, of another insurance company that is already covering the risk with a policy.

Reinsurance, authorized. Reinsurance placed with companies authorized to transact business in the state of filing.

Reinsurance, unauthorized. Reinsurance placed with companies not authorized to transact business in the state of filing.

Reinsurance ceded premiums. All premiums (less return premiums) arising from policies or coverage purchased from another insurance company for the purpose of transferring a liability, in whole or in part, assumed from direct or reinsurance assumed policies.

Reinsurance in force. Aggregate premiums on all reinsurance ceded business recorded before a specified date that have not yet expired or been canceled.

Reinsurance intermediaries. Brokers, agents, managing general agents, and similar entities that bring together reinsurance purchasers and sellers.

Reported claims. Claims relating to insured events that have occurred and have been reported to the insurer and reinsurer as of the date of the financial statements, as opposed to incurred-but-not-reported (IBNR) claims.

Reporting form contract. Insurance contract for which the premium is adjusted after the contract term based on the value of the insured property.

Retention. The net amount of any risk a company does not reinsure but keeps for its own account.

Retroactive commissions. Commissions paid to agents or brokers for which the final amount is determined based on the insured's loss experience.

Retrocession. A reinsurance of reinsurance assumed. For example, B accepts reinsurance from A, and B in turn reinsures with C the whole or a part of the reinsurance B assumed from A. The reinsurance ceded to C by B is called a *retrocession*.

Retrospective experience rating. A method of determining final premium in which the initial premium is adjusted during the period of coverage based on actual experience during that same period.

Retrospective premium. Premium determined after expiration of the policy based on the loss experience under the policy. The initial premium charged on such policies is referred to as the standard premium.

Return premiums. A premium refund due the insured from an endorsement or cancellation.

Risk. See *Hazard.*

Risk of adverse deviation. A concept used by life insurance enterprises in estimating the liability for future policy benefits relating to long-duration contracts. The risk of adverse deviation allows for possible unfavorable deviations from assumptions, such as estimates of expected investment yields, mortality, morbidity, terminations, and expenses. The concept is referred to as *risk load* when used by property and liability insurance enterprises.

Runoff data. See *Development (runoff) of loss reserves.*

Salvage. The amount received by an insurer from the sale of property (usually damaged) on which the insurer has paid a total claim to the insured and has obtained title to the property.

Schedule rating. A method of determining the premium by which a standard rate is adjusted based on an evaluation of the relative exposure to risk.

Short-duration contract. A contract that provides insurance protection for a fixed period of short duration and enables the insurer to cancel the contract or to adjust the provisions of the contract at the end of any contract period, such as adjusting the amount of premiums charged or coverage provided.

Spread-loss treaty. A contract on an excess-of-loss basis designed to pay certain losses over a given or stipulated amount and to average such losses over a period of years. Five years is the usual period, with the premium adjustable within fixed minimum and maximum limits according to the company's experience. Such a contract protects the ceding company against shock losses and spreads those costs over the given period, subject to the maximum and minimum premium each year.

Statutory accounting practices. Accounting principles required by statute, regulation, or rule, or permitted by specific approval that an insurance enterprise is required to follow in preparing its annual statement for submission to state insurance departments.

Statutory loss reserves. The amount by which reserves required by law on bodily injury and workers' compensation losses exceeds the case-basis loss and loss-expense reserves carried by a company for such losses.

Stock companies. Corporations organized for profit to offer insurance against various risks.

Stop-loss reinsurance. Kind of excess reinsurance also called excess-of-loss ratio. Provides that the insurer will suffer the loss in its entirety until the total amount of the loss is such that the loss ratio (losses divided by, premiums) exceeds an agreed loss ratio,, after which the reinsurer reimburses the insurer the amount needed to bring the loss ratio down to the agreed percentage.

Subrogation. The right of an insurer to pursue any course of recovery of damages, in its name or in the name of the policyholder, against a third party who is liable for costs relating to an insured event that have been paid by the insurer.

Surety bond. Insurance coverage that provides compensation to a third party for the insured's not performing specified acts within a stated period.

Surplus lines. Risks not fitting normal underwriting patterns, involving a degree of risk that is not commensurate with standard rates or that will not be written by standard carriers because of general market conditions.

Policies are bound or accepted by carriers not licensed in the jurisdiction where the risk is located, and generally are not subject to regulations governing premium rates or policy language.

Surplus share reinsurance. Reinsurance on a pro rata basis of only those risks on which coverage exceeds a stated amount.

Surplus treaty reinsurance. A treaty on a pro rata basis reinsuring surplus liability on various risks. The reinsurer shares the gross lines of the ceding company. The amount reinsured varies according to different classes of risks and the net retention that the ceding company wishes to retain for its own account. Ceding companies frequently have several layers of surplus treaties so that they may accommodate very large risks; usually, the reinsurer's participation in any one surplus treaty is limited to a certain multiple of the ceding company's retention. Premiums and losses are shared by the reinsurer and the ceding company on a pro rata basis in proportion to the amount of risk insured or reinsured by each. This is one of the oldest forms of treaty reinsurance and is still in common use in fire reinsurance.

Syndicates. See *Associations, pools, and syndicates.*

Title insurance enterprise. An enterprise that issues title insurance contracts to real estate owners, purchasers, and mortgage lenders, indemnifying them against loss or damage caused by defects in, liens on, or challenges to their titles on real estate.

Treaty. A contract of reinsurance.

Treaty-basis reinsurance. The automatic reinsurance of any agreed-on portion of business written as specified in the reinsurance contract.

Ultimate-developed-cost method. A method of estimating loss reserves based on a statistical average of the ultimate cost of all claims in a particular line.

Underwriting. The process by which an insurance company determines whether and for what premium it will accept an application for insurance.

Unearned premiums. The pro rata portion of the premiums in force applicable to the unexpired period of the policy term.

Workers' compensation insurance. Coverage that provides compensation for injuries sustained by employees in their employment.

Zone examination. An examination of an insurance company undertaken by on or behalf of regulatory authorities in a group of states.

Bibliography

The following publications will assist the auditor in gaining additional knowledge about the insurance industry.

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